ECONOMICS MANUAL

BY

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2ND EDITION

This publication provides a detailed syllabus guide and provides all the necessary information that a student offering economics at "A" Level should know. It also includes comprehensive approaches to the past UNEB questions (1997 – 2015)

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DEDICATION

This book is dedicated to my beloved aunt Mrs Margret Katende and my Uncle; Mr. Dick Lukwago….I am soo grateful for your total commitment towards educating me.

The book covers various components of economics namely: micro economics, production theory, national income, structure of Uganda's economy, population and labour, Money and Banking, international trade, inflation, unemployment, economic planning, public finance and fiscal policy, economic growth and development.

This edition has been written with extensive and detailed consultations from various sources of information on economics such as credible economics textbooks, UNEB questions and marking guides from 1997 to 2015, experienced personnel in economics, comprehensive study of national budgets for different fiscal years, critical analysis of various policy statements released by various ministries and agencies on unemployment, monetary policy, inflation, agricultural and industrial development, long term plans and other various sources of dependable information.

All UNEB questions since 1997 to 2015 have been indicated on top of each sub heading/topic and their answers are given and explained basing on UNEB marking guides and necessary changes have been incorporated in with the aid of highly resourceful personnel in the subject to suit the contemporary UNEB standards.

I am sure that you will find this book very helpful in overcoming the contemporary challenges when answering economics questions.

ACKNOWLEDGEMENT

The production of this resourceful book has not been an easy task. The author has taken several years gathering information from numerous sources implying that the contribution of those sources must be highly recognized and appreciated for the tremendous contribution.

The author is very grateful to all those who contributed effortlessly to the production of this vital book, in particular special recognition and thanks go to my dear parents Mr.Dick Lukwago and Mrs Margret Lukwago for the financial support in the process of producing this book.

I wish to thank my fellow teachers for the legal advice, guidance and encouragement rendered to me in the process of producing this book.

I wish to express my deep appreciation to the lecturers in the DEPARTMENT OF ECONOMICS AND STATISTICS- MAKERERE UNIVERSITY especially Mr. Mr Dumba Sentamu,Mr.Gesa Anthony at Kyambogo University among others for their unconditional professional support whenever approached for guidance on the information contained in this book. Your contribution to the production of this book is enormous.

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There are other numerous direct and indirect stakeholders towards the birth of this work, whether mentioned or not mentioned, your contribution was highly appreciated and felt.

May almighty God bless you abundantly.

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CHAPTER 1: INTRODUCTION TO ECONOMICS

Economics is made up of two papers that is paper one (P220/1) and paper two(P220/2).

Paper one (P220/1) concerns the study of principles, concepts and theories of economics and students to attain paper mastery of subject content taught. It tests whether a student understands economic aspects such as inflation, unemployment, national income, economic planning among others.

Paper two (P220/2) on the other hand is a practical paper that checks to test the candidates ability to apply the knowledge of economic principles and concepts studied to his own country.

It tests the understanding of the applicability of economic principles. It requires a candidate to relate theoretical aspects of the subject taught in paper one to the present situation in his country (Uganda)

Definition of economics

Economics has been defined by various economists but most of them agree on one point.

According to Prof.Robbins, **economics** is a science which studies human behavior as a relationship between ends (needs) and scarce means (limited resources) which have alternative uses. This definition is generally acceptable and appropriate because it treats economics as a subject which looks into fundamental problems of scarcity, choice and opportunity cost. It shows that human wants are unlimited and yet have to be satisfied with limited means.

Economics is a science because it involves laws like any other science for instance the law of demand, the law of supply, the law of diminishing marginal utility and the law of variable factor proportions.

An economic problem is that one of allocating scarce resources in order to satisfy unlimited wants of customers.

An economic problem does exist whenever scarce means are used to satisfy alternative ends/unlimited wants. If the means are not scarce, then there is no economic problem.

Adam smith, an English economist defines economics as an inquiry into the nature and causes of wealth of nations. This definition is concerned with the means by which total volume of production can be increased. It is a science which studies the wealth of nations and accumulation of more wealth.

Alfred marshal tried to link the wealth centered definition, he defines economics as a study of mankind in the ordinary business life. Wealth is regarded as a source of human welfare, not an end in itself but a means to an end.

Today, economics is defined as the study of the allocation of scarce resources among competing ends.

It is a practical science concerning production and distribution of goods and sservices to satisfy unlimited human wants.

NB. Ends are unlimited needs of man which cannot be satisfied at once given the scarce resources while means are limited resources which are used to satisfy unlimited needs of man.

BRANCHES OF ECONOMICS.

Economics is divided into *two major* branches.

1. **Micro economics.**

Micro economics is a branch of economics which analyses the market behavior of individuals/small economic units. It is concerned with economic decisions that affect a small part of the economy such as individual customer"s demand, supply of an individual firm, individual resource owners.

Micro economics is therefore concerned with

- The way on how individual producers decide on what to produce, how to produce and for whom to produce.
- The consumer decisions of what to buy, from where to buy and how much to buy.
- The behavior of resource owners i.e those who have access to factors of production.
- How price is determined in a specific market for a commodity.

2. **Macro economics.**

Macro economics is a branch of economics that is concerned with the larg aggregate behaviour of all individuals in the entire economy as one functioning unit.

It deals with the entire economy as one functioning unit.

It deals with the study of collective economic behaviors and variables concerning the entire economy. ***Such aggregates that affect the entire economy include;***

Level of unemployment, national income, rate of economic growth, general price level, aggregate supply, total investment in an economy, aggregate demand/total spending and saving in an economy, demand and supply of money, balance of payment position.

Commodities

Commodities are items produced by factors of production and are consumed by man to satisfy his wants. These are both tangible and intangible items produced by factors of production to satisfy human wants.

Commodities can be goods or services.

Goods

Goods are tangible items that are used to satisfy human wants and usually have monetary value attached to them. In most cases, for one to acquire them, a cost is normally incurred in terms of money.

Services

Services are intangible items that satisfy human wants and are helpful in making life comfortable and meaningful. They cannot be touched and have no defined form. For instance banking, insurance, transport, legal services, teaching. These services may be personal or commercial.

Types of goods

1. **Economic goods.** These are goods which possess utility and scarce in relation to their demand and their consumption involves a cost in terms of price. **Or**

   These are scarce goods which are priced and provide utility to the consumer. They arise out of scarcity and choice.

Characteristics of economic goods

- Economic goods are relatively scarce.
- They have a money value or command a price hence they are marketable.
- They provide satisfaction or utility to the consumer.
- They have opportunity cost.

2. **Free goods.** These are goods that exist in natural abundance and enough to satisfy consumer"s needs at zero price/cost in terms of money. For instance rainfall, sunshine, fresh air in LDCs where the cost of acquiring them is zero.

Characteristics of free goods.

- They have no market price/consumed at a zero cost. Their supply is greater than their demand at zero cost.
- They are non excludable in consumption.
- They exist in natural abundance.
- They have no money value attached to them.

3. **Public goods.** These are goods which when provided usually by the government for a particular group of individuals become available for others to use at no extra costs and consumption by one person does not reduce the amount available for other users.

Or

These are goods owned and consumed collectively by all members of the public and consumption by one person does not exclude others, usually provided by the government. For instance roads, security/defense and street lights.

Characteristics of public goods.

- They are non excludable. Non paying users cannot be excluded from enjoying such goods such as roads.
- They are non rivalry/ exhaustibility. One can increase satisfaction he enjoys from the commodity without reducing that of others. Consumption of an extra unit by one person does not diminish the amount available for consumption by others.
- They are usually owned and provided by the government on behalf of citizens.

4. Inferior goods. These are goods which are consumed by the poor and their consumption decreases as income of the consumer increases. For instance second hand clothes, cheap food stuffs.

5. Merit goods. These are goods whose consumption is of a high social value meant to improve the quality of life of people and their consumption is of a high social value meant to improve the quality of life of people and their consumption is usually encouraged by the government.
Or

These are goods controlled by the state because of their high social value/benefits but can also be under private individuals. They are meant to improve the quality of life of people. For instance education, use of safe water, health care, use of mosquito nets, defence. They are soo essential and necessary for use by all people**.**

6. Demerit goods. These are goods whose consumption is deemed socially undesirable and are harmful to human life. These are goods whose consumption is discouraged by the government because of their associated disadvantages to human life. For instance toxic drugs, alcohol.

7. Giffen goods. These are goods which are consumed by low income groups such that as their price increases, more is demanded and as their price reduces, less is demanded. When their price increases, the proportion of poor people"s income spent on them also increases and when their price reduces, poor people become better off in real terms.

8. **Producer/capital goods.** These are goods which are used in production of other goods. For example machinery, agricultural and industrial raw materials, plants.
9. **Intermediate goods.** These are semi finished goods which are capable of being used for further production in order to produce other goods. For instance sugar, cotton seeds, wheat floor, timber, baking flour.
10. **Normal goods.** These are goods whose demand increases with an increase in consumer"s income. They are consumed in large quantities as one"s income increases.
11. **Necessity goods.** These are goods which are essential to human life and consumers cannot do without them such that their consumption remains constant regardless of changes in price. For instance water and food.
12. **Luxury goods/goods of ostentation.** These are goods demanded by the rich to show off their economic status and their demand increases with increase in price. For example first hand clothes, conditioned vehicles, golden ear rings, expensive phones and vehicles.
13. **Consumer goods.** These are finished goods ready for final use by consumers. They appear in a form that consumers would wish to have them.
14. **Finished/final goods.** These are goods that are ready for consumption by final users and cannot be processed further.
15. **Private goods.** These are goods that are exclusively owned and enjoyed by an individual who owns and pays for them. Consumption by one individual reduces consumption by others and are excludable. An individual can exclude others from consuming such goods. For instance personal vehicles, personal computer.

UNEB 2015

(i) Differentiate between inferior goods and complementary goods. *(02 marks)*

(ii) Give any two examples of complementary googs. *(02 marks)*

UNEB 2008

Distinguish between the following.

(i) Free good and economic good *(02 marks)*

(ii) Public good and private good *(02 marks)*

UNEB 2005

(i) Differentiate between public goods and merit goods *(02 marks)*

(ii) State any two examples of merit goods in your country *(02 marks)*

HUMAN WANTS

Human wants are human desires/needs that can be satisfied with goods and services backed by the ability to pay. The satisfaction of these wants using scarce means/resources is the basis of all economic activities. The idea of unlimited human desires with limited resources leads to the concepts of scarcity, choice and opportunity cost.

CHARACTERISTICS OF HUMAN WANTS

- They are insatiable. They cannot be fully satisfied due to limited resources.
- They are dynamic in nature. They keep on changing from time to time depending on the prevailing social, political and economic conditions.
- They are recurrent. They need continuous replacement. For instance desire for food.
- They are competitive therefore an individual has to make choice amongest different wants.
- They are complementary. The satisfaction of human wants requires joint use of the available mean/resources.
- They are unlimited/endless in number.

RESOURCES/AGENTS OF PRODUCTION

Resources are factor inputs that are used to produce goods and services to satisfy human wants. They are referred to as factors of production. Resources are both tangible and intangible. For instance land, capital and labour and entrepreneur.

CETERIS PARIBUS

Cateris paribus is an economic term which means holding other factors constant when investigating an economic problem. For instance in trying to explain the law of demand and supply, we assume other factors constant apart from price.

WEALTH

Wealth refers to a stock of assets owned by an individual, a firm or a state at a particular period of time which satisfy human needs.

CHARACTERISTICS OF WEALTH

- It should possess and provide utility.
- It should be relatively scarce or limited in supply.
- It should have money value.
- It should be transferable from one person to another. It is capable of being exchanged.
- It should be able to produce other wealth.

Wealth exists in three forms.

1. ***Personal wealth***. This refers to assets which are owned and exclusively enjoyed by an individual. This includes personal items such as clothes, money, vehicle, household equipment.
2. ***Business wealth***. This refers to assets that are used to produce other goods. These include assets like factory buildings, machinery, raw materials, *Social* company vehicles that are owned by production firms.
3. ***Collective wealth.*** This refers to physical assets that are collectively owned by all members of the society. This consists of wealth owned by the state on behalf of it‟s citizens such as public schools, public hospitals, roads, railways, bridges.

ECONOMIC LAWS

Economic laws are statements of probable results of a given set of conditions. For instance law of supply, law of demand, law of diminishing marginal utility, law of absolute advantage, law of variable factor proportions, law of comparative cost advantage.

FUNDAMENTAL ECONOMIC QUESTIONS

Economic questions arise because of scarcity of resources and answering them leads to a right decision. There are five fundamental economic questions faced by all economies and which all economists try to answer in relation to scarce resources.

1. **What to produce.** There is a need to decide on whether to produce capital goods or consumer goods. Usually in a free enterprise economy, goods produced are those whose demand is high and which command a high price in the market.
2. **How to produce.** This concerns with the choice whether to use capital intensive technology or labour intensive technology.

   The choice of technology in this case would depend on the cost of acquiring it and a low cost technology would be opted for.
3. **When to produce.** This invites a decision whether to produce now or in future. Usually production and supply of goods are determined by the demand for them and production of any commodity should be done when there is demand for it to avoid incurring losses.
4. **For whom to produce.** This concerns with the distribution of goods that have been produced, whom should the goods be produced for usually goods tend to be produced for those who have means of paying for them.
5. **Where to produce.** This deals with the decisions concerning the location of production unit. Whether to locate the firm and produce near the source of raw materials or near market, it depends on the option that is cheaper.

POSITIVE AND NORMATIVE STATEMENTS.

In economics, any organized idea that expresses a reality is a statement. There are basically two types of statements on which economic analysis operates.

a) **Normative statements.** These are imaginary ideas that look at the world as it is ought to be rather than what it is. They depend on judgments about what is good or what is bad but not testable. Such statements deal with how things should be depending on an individual"s opinion. For instance there will be no more high population growth in Uganda in 10years to come, all people will be rich in the next three years. These are normative statements and not testable.
b) **Positive statements**. These are testable statements that express what the world is rather than what it is ought to be. They seek to explain what actually happens and not what ought to happen. They are concerned with reality and are about actual facts by making objective observation. For instance the standard of living in Uganda is still low, there is income inequality in Uganda, the GDP of Uganda is lower than that of USA.

FUNDAMENTAL ECONOMIC PROBLEMS

There are basically three fundamental economic problems. These are;

a) Scarcity.

Scarcity means limited supply of resources as compared/in relation to demand for them. There is limited supply of resources to produce goods and services that are required to satisfy man"s unlimited, competing and insatiable wants.

b) Choice.

Choice refers to the act of making a right decision from the available alternatives in order to use limited resources and satisfy human wants. Choice arises due to scarcity of resources in relation to unlimited human wants.

Therefore, a decision has to be made as regards to which wants should be satisfied first and which ones later.

A relational human being ranks his wants in order of priority/urgency/importance. The order is from the most pressing needs to the least pressing ones. This leads to scale of preference.

NB. Scale of preference

This is a list of an individual"s unsatisfied wants arranged according to priority starting with the most pressing wants and ending with the least pressing wants/ones.

c) Opportunity cost

Opportunity cost is the alternative foregone when choice is made. Opportunity cost is the measure of real cost as opposed to the monetary cost of an economic choice.

When choice is made from many alternatives, the immediate alternative foregone is the opportunity cost.

UNEB 2002

i) Distinguish between opportunity cost and marginal cost. (02 marks)

ii) State the significance of opportunity cost in economics. (02 marks)

UNEB 2000

(i) What is the relationship between choice and opportunity cost (02 marks)

(ii) Give any two uses of opportunity cost concept to the producer. (02 marks)

IMPORTANCE/USES OF OPPORTUNITY COST.

- Guides the producer in making production decisions of what to produce, how to produce, when to produce, for whom to produce and how much to produce.
- Helps the consumer in making consumption decisions.
- It is used in pricing of commodities and factors of production.
- It is useful in international trade to explain the law of comparative advantage as a basis of specialization.

UNEB 2003

i) Define the term opportunity cost. (01 marks)

ii) State any three circumstances under which opportunity cost principle can be applied in economics. (03 marks)

Circumstances under which opportunity cost principle may be applied in economics

- When producers are pricing commodities and factors of production.
- In case consumers are making consumption decisions.
- When producers are making production decisions of what to produce, how much to produce among others.
- When a country is making choice on which commodity to specialize in on the basis of comparative advantage.

RELATIONSHIP BETWEEN THE THREE FUNDAMENTAL ECONOMIC PROBLEMS

It states that due to limited resources/means, choice has to be made between alternatives, the choice of one alternative implies foregoing another which means opportunity cost.

UNEB 2005, 2001

i) What is meant by a transformation curve. (01 marks)
ii) Mention any two factors that may cause the transformation curve to shift outwards. (02 marks)

THE PRODUCTION POSSIBILITY CURVE/FRONTIER OR THE TRANSFORMATION CURVE OR OPPORTUNITY COST CURVE.

Production possibility frontier is a curve showing all possible combinations of two commodities that can be maximumly produced in an economy if all the available resources are fully and efficiently utilized/employed.

Or

It is a curve showing maximum production possibilities for two commodities given the resources available to produce these commodities are fully and efficiently utilized.

Assumptions underlying the production possibility frontier

1. There are only two commodities produced in the country in different proportions.
2. Fixed supply of factors of production which can be reallocated to produce different combinations of commodities/perfect substitution of factors of production.
3. The state of technology used in production of two commodities is given as constant.
4. All resources used in production of both commodities are fully and efficiently utilized.
5. Assumes short run time period when all the available resources are fixed.

THE PRODUCTION POSSIBILITY FRONTIER.

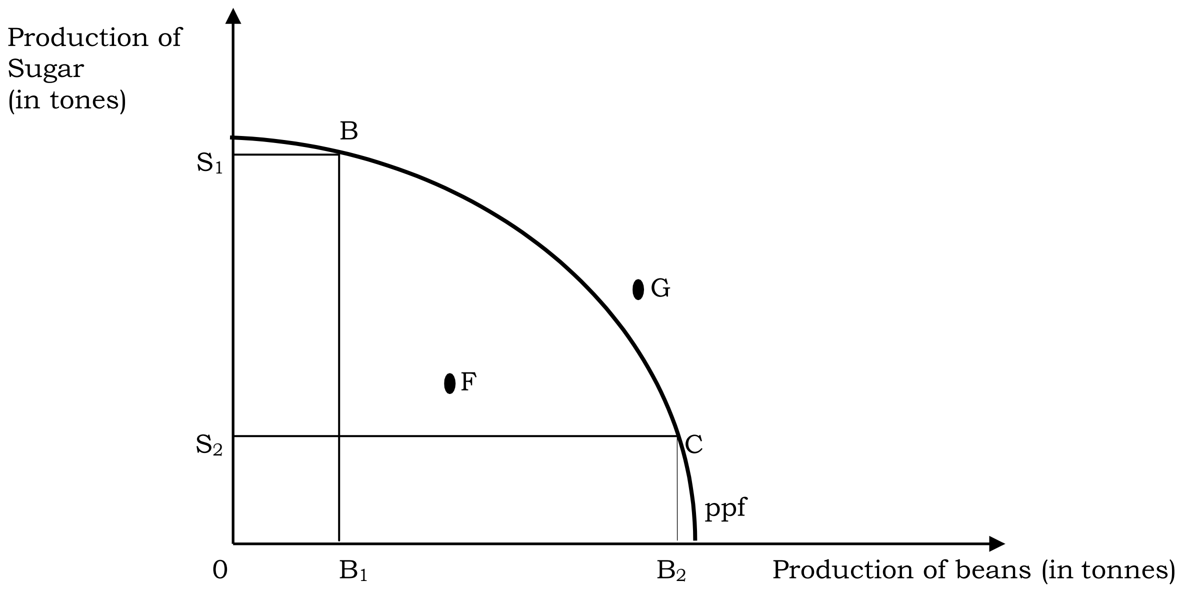


Figure 1.1: the production possibility frontier.

The economy can produce a combination of the two commodities sugar and beans which lie along the ppf. At point B, most of the economy‟s resources are directed to the production of sugar and little to the production of beans.

At point B, most of the economy‟s resources are directed to the production of sugar and little to the production of beans.

At point C, most of the economy‟s resources are diverted to the production of beans and less of sugar is produced.

Points B and C along the ppf show that resources are fully utilized and such points are attainable (best combinations). There is no underutilization of resources.

Points above the ppf such as G are not attainable but desirable. They are beyond the country‟s capacity to produce the two commodities/it is beyond the country‟s resources.

Points inside the ppf such as F are attainable but not desirable. This is an inefficient point and some resources are unemployed/underutilized (excess capacity production.)

NB.

The enclosed area represents the economy‟s capacity to produce and this capacity may be small or large.

The boundary separates attainable quantities from unattainable quantities.

The negative slope of the ppf is called marginal rate of product transformation. It means that for an economy to produce more units of a given commodity, it has to forego more resources that were used to produce another commodity.

The fundamental economic problems of scarcity, choice and opportunity cost can be illustrated using the ppf. The ppf shows the following economic concepts.

1) Scarcity

Because the available resources are limited in supply, the economy cannot produce beyond its available resources/ppf. Therefore, a country cannot produce beyond combinations B and C along the ppf in line with the available resources.

2) Choice

At point B, the economy chooses to produce more sugar than beans implying that sugar ranks higher than beans on the country‟s scale of preference.

At point C, the economy chooses to produce more beans than sugar implying that beans rank higher than sugar on the country"s scale of preference.

A country can choose to produce OS_1, of sugar and OB1 of beans or produce OB_2 of beans and OS_2 of sugar but not both combinations at the same time.

3) Opportunity cost

Opportunity cost is shown along the ppf from point B to C. therefore, to produce B_1B_2 more units of beans, you forego S1S2 more units of sugar.

Thus, opportunity cost of producing B1B2 extra units of beans is S1S2 units of sugar that you forego. An increase in output of one commodity leads to a reduction in output of the other commodity.

4) Efficiency in production

Points along the ppf such as B and C indicate efficiency in production/efficient utilization of the available resources. Resources are maximumly and fully utilized and therefore no excess capacity production.

5) Inefficiency in production

When an economy operates along points inside the ppf, it indicates inefficient use of the available resources implying that such resources are not fully and efficiently utilized as required. Some resources are lying idle or under employed implying excess capacity production. Such a point such as F is attainable but undesirable because it indicates a decline in economic growth.

6) Economic growth

Economic growth is the persistent quantitative increase in the volume of goods and services produced in an economy overtime.

It is illustrated by an outward shift of the ppf to the right. Points which were formerly unattainable are now attainable.

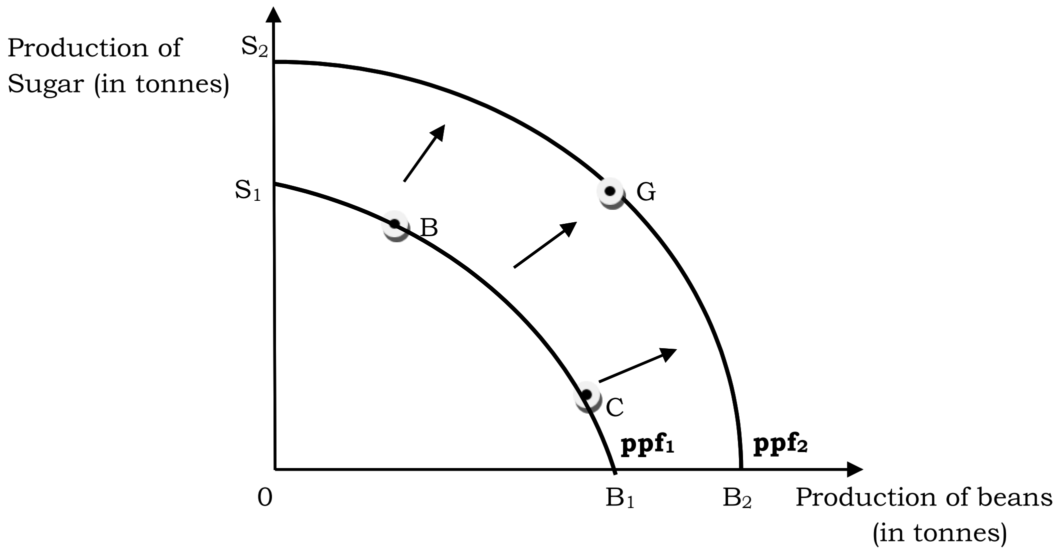


Figure 1,2: illustrating the concept of economic growth.

When there is economic growth, the ppf shifts entirely from its original position ppf_1 to a new position ppf_2.

This shows that economic resources in the country to produce both commodities have increased and a point which was initially unattainable due to scarcity of resources is now attainable.

CAUSES OF AN OUTWARD SHIFT OF THE PPF/REASONS WHY PPF MAY SHIFT TO THE RIGHT

1. An increase in the country"s size of labourforce.
2. An increase in acquisition of better skills in production/increase in workers" efficiency.
3. Discovery of new natural resources.
4. An improvement in the existing state of technology.
5. Increased inflow of foreign resources such as donations and grants.
6. Increase in the entrepreneurship ability/skills.

CAUSES OF A SHIFT IN PRODUCTION POSSIBILITY FRONTIER.

1. A change in level of technology.
2. A change in size of labour fource.
3. A change in the entrepreneurship ability.
4. A change in skills of labour.
5. A change in capital flow.
6. A change in natural resource base.

NB. A shift of the entire ppf inwards or to the left is referred to as economic decline.

IMPORTANCE OF THE PPF

- Helps to solve the problem of resource allocation i.e. enables efficient allocation of resources.
- Helps to determine whether the economy is growing or not i.e. It explains economic growth.
- Helps to determine whether the available resources are being underutilized or not **i.e.** whether there is under employment.
- Helps in pricing of factors of production i.e. determing factor prices.
- Helps to explain the problem of scarcity. Because resources are scarce one cannot produce beyond the ppf using fixed resources.
- Helps a country to make choice on whether to produce more social goods or private goods or whether to produce more consumer goods or producer goods.

ECONOMIC SYSTEMS

An economic system refers to the organization of an economy as regards to ownership, organization, allocation and distribution of resources are concerned.

It focuses on how resources are owned and controlled whether by government, private individuals or by both parties.

There are basically three types of economic systems.

a) **Free enterprise economy**
b) **Planned economy**
c) **Mixed economy**

UNEB 1999, 2011

i) *What is a laissez faire economy.* *(01 mark)*
ii) *Give three demerits of laissez faire economy.* *(03 marks)*

1. **Free enterprise/capitalist/unplanned/market/laissez fair economy**

A free enterprise economy is an economic system without government interference and allocation of resource is guided by market forces of demand and supply.

Productive resources are individually owned and allocated by market forces of demand and supply/price mechanism without government interference.

Features/characteristics of a free enterprise economy.

- Private ownership of resources. All economic activities and means of production are owned by private individuals.
- Limited or no government intervention in resource allocation and decision making.
- Profit maximization is the major aim of producers implying that commodities that command high prices are normally produced.
- Perfect competition among producers and consumers in factor and product markets respectively.
- There is respect of consumer freedom/sovereignty.
- Resources are allocated by forces of demand and supply/price mechanism.
- Prevalence of self interest among firms. Firms are driven by self interest in all activities thereby competing with each other to acquire high profit margin.

MERITS OF A FREE ENTERPRISE ECONOMY.

1. **Encourages production of high quality goods.** Better quality products are produced due to high level of competition among producers.
2. **Encourages consumer sovereignty/leads to proper allocation of resources.** Consumers have a big hand in determining what should be produced which enables them to acquire the best commodity to consume.

3. **Encourages production of a variety of commodities.** Production of a variety of commodities is encouraged which increases consumers' choice.
4. **Encourages inventions and innovations.** There is increased research so as to come up with good quality output and due to competition and private ownership of resources hence economic growth.
5. **Increases employment opportunities.** This is due to increased utilization of resources.
6. **Limits the possibility of surplus production and resource wastage.** Production is carried out in accordance with prevailing market demand hence limited resource wastage.
7. **It is cheap to administer/No administrative costs by the government.** Government doesnot incur costs to monitor the performance of the economy since resource allocation is by market forces of demand and supply.
8. **Encourages flexibility in production.** This is because of quick response to price and profit signals by producers.
9. **Encourages efficiency in production.** This is due to increased hard work among competing producers.

DEMERITS OF A FREE ENTERPRISE ECONOMY

1. **Leads to duplication of products and resource wastage**. Firms engage in unnecessary competition through persuasive advertising.
2. **Leads to unemployment.** Due to stiff competition among firms, it forces inefficient firms to quit production leading to layoff of workers.
3. **Leads to emergence of private monopoly powers.** Stiff competition among firms pushes inefficient firms out of production leaving a few firms in production to establish as monopolies thus consumer exploitation.
4. **Promotes income and wealth inequalities.** Resources are allocated towards some given sections of the population and some firms are pushed out of production and therefore income concentrates in hands of few individuals.
5. **Leads to misallocation of resources.** It neglects the production of cheap commodities affordable by the poor due to profit motive which forces producers to engage in production of luxurious expensive commodities that command high price demanded by the rich in the market.
6. **Results into over exploitation of resources.** Due to desire to maximize profits by the private sector, natural resources are over utilized leading to depletion of non renewable resources.
7. **Ignores production of public goods**. It cannot allocate resources for public use such as roads, security and water supply.

8. **Causes economic instabilities.** Economic instabilities come in such as inflation i.e periods of shortage of commodities since this depends on changes in demand and supply.
9. **Leads to high social costs.** Private interests override social benefits which makes the public to suffer. Private sector struggles to reap as much profits (private benefits) as possible but ignores social costs such as pollution which reduces social welfare.
10. **Consumer choices are distorted by persuasive advertising.** This denies consumers the best option to consume.
11. It cannot cope with unforeseen circumstances. It cannot cater for rapid structural changes such as famine, drought.

2. Socialist/Planned/Centralized/Command Economy

A planned economy is an economic system in which the ownership, allocation and distribution of resources is undertaken by the state/central authority on behalf of citizens. The state determines what to produce and prices to charge.

Characteristics or features of planned/command economy

- State ownership of resources on behalf of the citizens.
- Limited competition due to lack of profit motive since economic activities are carried out to improve welfare of the citizens.
- Social welfare maximizations goal. Production is done to benefit the entire population.
- There is centralized planning. Decision making is carried out by agents appointed by the government.
- Productive resources are publically owned.
- All investments are publically owned and undertaken.
- Price controls i.e minimum and maximum price are set.

MERITS OF A PLANNED/COMMAND ECONOMY.

1. **Limits exploitation of consumers.** The state undertakes the decisions in determining what commodities to be produced and the prices to be charged to favour consumers.
2. **Provides more employment opportunities to people.** In order to improve public welfare and ensure equitable distribution of income more job opportunities are created by the government.
3. **Leads to proper utilization of resources.**Due to proper planning for the economy"s resources, it ensures no resources are wasted.
4. **Provision of public goods and services** which would otherwise have not been considered as a priority under free enterprise economy. For instance road construction, provision of safe water and medical care.
5. **Helps to break private monopoly powers.** There are limited chances of private monopoly and this enables the society to enjoy products at affordable prices.

6. **Prevents social costs that impact negatively on society.** For instance environmental pollution due to state control on resource utilization.
7. **Promotes fair distribution of income and wealth.** Government does not permit private accumulation of more wealth at the expense of the society.
8. **Reduces economic instabilities** such as inflation due to centralized planning where price controls can be used.
9. **Prevents production and consumption of undesirable commodities** such as cigarettes, some brands of alcohol which increase social welfare.
10. **It is easy to attain systematic development and rapid structural changes.** This is due to quick intervention from government.

DEMERITS OF PLANNED/COMMAND ECONOMY.

1. **Limits variety of goods and services.** This is due to presence of few production firms authorized by the government which leads to limited choice by consumers.
2. **Limits competition in production hence inefficiency.** This leads to inefficiency in production thus causing underutilization of resources.
3. **Reduces consumer sovereignty.** Consumers do not have the freedom to decide what should be produced for them.
4. **Leads to a lot of bureaucracy and red tape.** Decision making and implementation of plans are very slow.
5. **Discourages private initiatives towards investment.** This limits private entrepreneurial development since private individuals are not allowed to own resources.
6. **Leads to misallocation of resources.** Resource allocation in most cases follows political motives than economic motives, there may be overproduction due to poor judgment of wants.
7. **Leads to poor quality goods.** This is because of no competition in production process thus reduced welfare.
8. **Encourages political dictatorship in case there is lack of democratic institutions.** This has negative effects on the performance of an economy.

***3.* Mixed economy.**

A mixed economy is an economy that has both private sector and public sectors operating side by side in resource allocation.

Or

This is an economy where resources are owned, controlled and allocated by both the state and the private sector (market forces of demand and supply).

Or

It is an economy with both socialist and capitalist elements existing side by side in resource allocation.

This is an economy where there is a balance between the role of market forces of demand and supply.
There is co-existence of both private and public sectors.
There is regulated competition and consumption.

UNEB 2012

i) What is meant by a mixed economy. (01 mark)
ii) Mention any three merits of a mixed economy (03 marks)

ADVANTAGES/MERITS OF A MIXED ECONOMY

1. **Leads to limited resource wastage.** This is due to regulated competition among producers.
2. **Increases employment opportunities.** Economic activities under government initiative and private individuals increase job opportunities.
3. **Encourages production of a wide variety of goods and services.** Several economic activities are created by both the private sector and public sector.
4. **Individual self interests are regulated i.e.** over utilization of resources is reduced.
5. **Reduces income inequality.** This is due to state control.
6. **Better quality products are produced.** This is because of competition between the private and public sectors.
7. **The public sector provides essential goods which the private sector would not provide.** This is due to the existence of public enterprises that cater for public goods.
8. **Encourages economic stability due to government intervention.** The government controls inflation through relevant monetary and fiscal policies.

CHAPTER 2: PRICE THEORY

Price theory is the study of the role of price in allocation of resources in an economy.

Or

It is the study of the economic behavior of consumers, producers and resource owners through the influence of price as a medium of exchange.

UNEB 2002

i) What is meant by the term price. (01 marks)

ii) State any three methods of price determination in your country. (03 marks)

What is price?

Price refers to the exchange value of a commodity expressed in terms of money. **Or**

It is the amount of money that has to be given up in order to obtain a good or a service or a factor input.

UNEB 2005

i) Distinguish between a normal price and a market price (02 marks)

ii) State any two ways of price determination in your country (02 marks)

CLASSIFICATION OF PRICES

1. **Market price.** This is the prevailing/ruling price for a commodity in the market for a given period of time.

Or

It is the price determined by buyers and sellers in the market in the short run period.

2. **Equilibrium price.** This is price determine by interaction of forces of demand and supply in the market. **Or**

   It is the price at which quantity demanded equals quantity supplied in the market. Price

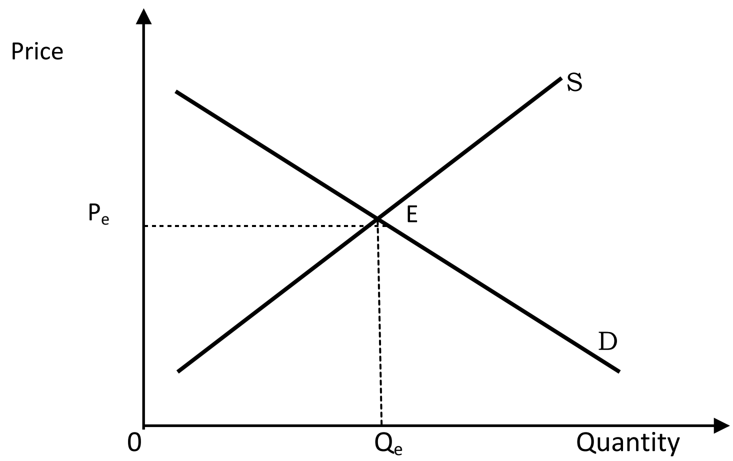


Figure 2.1 equilibrium price (interaction of market forces of demand and supply)

-Pe is the equilibrium price.

-OQe is the equilibrium quantity demanded and supplied.

3. **Normal price.** This is the price which is obtained where supply and demand are equal in the long run period.

It is long run equilibrium price that exists in the market.

4. **Reserve price. This is the least possible acceptable price at which a seller can** allow his commodity to be bought. **Or**

This is the price below which the seller is not willing to sell his commodity.

DETERMINANTS OF RESERVE PRICE/FACTORS CONSIDERED WHEN DETERMINING A RESERVE PRICE

1. **Expected future price for a commodity.** Where a producer expects the price to increase in the near future, he sets a higher reserve price and sets a low reserve price when price of the commodity is expects to reduce in future.
2. **Nature of a commodity/degree of durability.** A durable commodity commands a higher reserve price while a perishable commodity commands a low reserve price.
3. **Storage costs.** Where storage costs are high, the producer sets a low reserve price but where costs of storage are low, a higher reserve price is set.
4. **Expected future demand for a commodity.** When the producer expects demand to increase in the near future, he sets a higher reserve price but when he expects demand to reduce in the near future he sets a lower reserve price.
5. **Cash requirements of the seller/the need for liquid capital.** Where a seller has urgent need for cash, a low reserve price is set while if the seller does not need urgent cash, a higher reserve price is set.
6. **Level of supply of a commodity.** High supply of a commodity leads to a low reserve price while low supply of a commodity leads to a high reserve price.

UNEB 2006

a) *How are prices determined in your country? (06 marks)*
b) *Account for price instability of agricultural products in your country. (14 marks)*

UNEB 1999

i) *Distinguish between a market price and reserve price. (02 marks)*
ii) *State any two determinants of price in your country. (02 marks)*

FORMS/METHODS OF PRICE DETERMINATION IN THE MARKET. (DETERMINANTS OF PRICE IN AN ECONOMY)

1. **Haggling/bargaining.** This is the negotiation between the buyer and the seller of the commodity over the price until both parties agree upon the price such that neither the seller is at a loss nor the buyer is cheated. Normally the seller begins with a high price and keeps on reducing and the buyer begins with a low price and keeps on adding until the two parties agree upon a given price that is reasonable.
2. **Sales auctioning/bidding.** This is where the commodity for sale is presented to many potential buyers through a system of open bidding where potential buyers debate about the price and the highest bidder takes the commodity.
3. **Offers at fixed prices.** In this case producers, individuals and institutions fix prices at which they are to sell their commodities. This is normally done by monopolists who have authority to fix price in the market.
4. **Fixing price by treaty/private treaties.** This is where producers and consumers of a given commodity come together and fix the price through signing an agreement for a specified period of time. For instance international coffee agreement on the world market.
5. **Interaction of market forces of demand and supply/price mechanism.** Forces of demand and supply interact to determine the equilibrium price. When demand is greater than supply, a high price is charged and when supply is greater than demand, a low price is charged.
6. **Resale price maintenance.** This is the setting of commodity prices by manufactures for retailers to sell at to consumers. It is normally done by indicating the price of the commodity on the product itself. For instance newspapers, airtime cards, postage stamps.

MERITS OF RESALE PRICE MAINTENANCE.

- Reduces exploitation of consumers by middle men.
- Ensures price stability in the market/controls inflationary tendencies.
- High quality goods are maintained on the market.
- Increases sales and profits. This is because it is less inflationary.
- Saves time that would be wasted in bargaining.
- Reduces wasteful competition between small scale retailers and large scale retailers.

DISADVANTAGES OF RESALE PRICE MAINTENANCE

- The consumer is exploited if the price is high implying that consumers have no chance of buying at a lower price.
- Makes it hard for retailers to make more profits.
- Eliminates consumer‟s sovereignty in price determination.
- Undermines price mechanism in determining market prices.

7. **Price leadership by oligopolistic firms.** This is where a dominant/low cost/large scale firm in the industry sets the price at which other firms should sell their commodities. This occurs where firms produce similar commodities.
8. **Price legislation/price control.** This is the fixing/setting of commodity prices by the government either a minimum price to protect producers from being under paid or a maximum price to protect consumers from exploitation by producers.

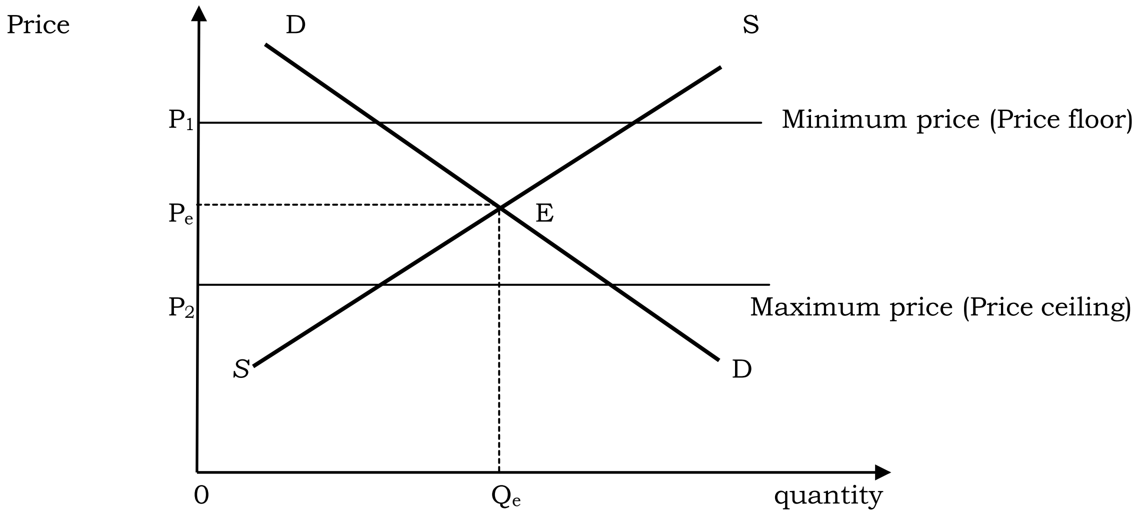


Figure 2.3: minimum price and maximum price.
-OP_e is equilibrium price.
-OP_1 is the minimum price.
-OP_2 is the maximum price.

9. **Collusive pricing among firms.** Firms in an industry come into an arrangement and fix price of the commodity to avoid undercutting or underselling each other.

UNEB 2007

State any four methods of determining prices of commodities in an economy

(04 marks)

UNEB 2000

(i) Differentiate between resale price maintenance and reserve price
(02 marks)
(ii) State any two uses of price in an economy (02 marks)

USE/IMPORTANCE/ROLE OF PRICE IN A FREE ENTERPRISE ECONOMY

1. **Determines the value of goods and services.** High quality goods in most cases command a high price and low quality goods command a low price.
2. **Guides the producer on what to produce.** Production is normally done on commodities whose price is high in the market.
3. **Price guides expenditure/consumption plans of consumers.** Whether to prepare for a high or a low expenditure by consumers depends on the price charged on a commodity.
4. **Determines distribution of income.** Producers who sell their commodities at a high price get high income than those who sell their commodities at a low price.
5. **Guides the producer on what technique of production to use.** This is selected basing on relative factor prices. Where goods are priced highly one uses advanced techniques of production and cheap goods in most cases are produced using simple production techniques.
6. **Guides the producer on where to produce.** Producers usually locate their firms in production areas where factor prices are low and commodity prices are high in order to make high profits.
7. **Guides the producer on how much to produce.** High output is done when there is a high price offered in the market and low output is produced during periods of low prices.
8. **Provides an automatic adjustment between demand and supply conditions in the market/determines for whom to produce.** This helps to establish equilibrium where quantity demanded is equal to quantity supplied.

THE THEORY OF DEMAND

Demand refers to consumer‟s desire to purchase a commodity backed by his financial ability and willingness to pay for that commodity at a given time.

Quantity demanded

This refers to amount of a commodity which a consumer is willing and able to purchase at a given price per period of time.

UNEB 2013

i) Define the term "effective demand" (01 mark)
ii) Give any three factors that limit effective demand (03 marks)

Effective demand is actual purchasing of a commodity by the consumer at a given price in a given period of time. **Or**

It refers to the desire by the consumer to acquire a commodity backed by the ability to pay for it. **Or**

It is the amount of a commodity purchased by a consumer at a given price in a given time.

Factors that limit effective demand.

- Low level of consumers income.
- High prices of goods and services.
- Unfavourable tastes and preferences of the consumer.
- High prices of complementary goods.
- Low prices of substitute goods.
- Expectation of fall in future prices.
- Unfavourable season/end of the season for a commodity.
- Limited credit facilities.
- Government policy against consumption of a product such as high taxation, low subsidization.
- Low levels of advertising.
- Uneven distribution of income.
- Low population size.

Latent demand refers to demand for a commodity that is not backed by financial ability to pay for it at a given price.

A demand curve is a graph showing different quantities of a commodity demanded at various price level in a given period of time.

Or

It refers to a graphical representation of the demand schedule.

It is drawn on the assumption that quantity demanded depends on the price of the commodity ceteris paribus.

A typical demand curve is downward sloping from left to right.

Demand schedule is a table which shows a relationship between different quantities of a commodity demanded at various price levels in a given period of time.

Price (in shillings)	**Quantity demanded (in kilograms)**
500	4
1,000	3
1,500	2
2,000	1

From the demand schedule above, we can derive a normal demand curve by plotting quantity demanded on the horizontal axis against price on the vertical axis.

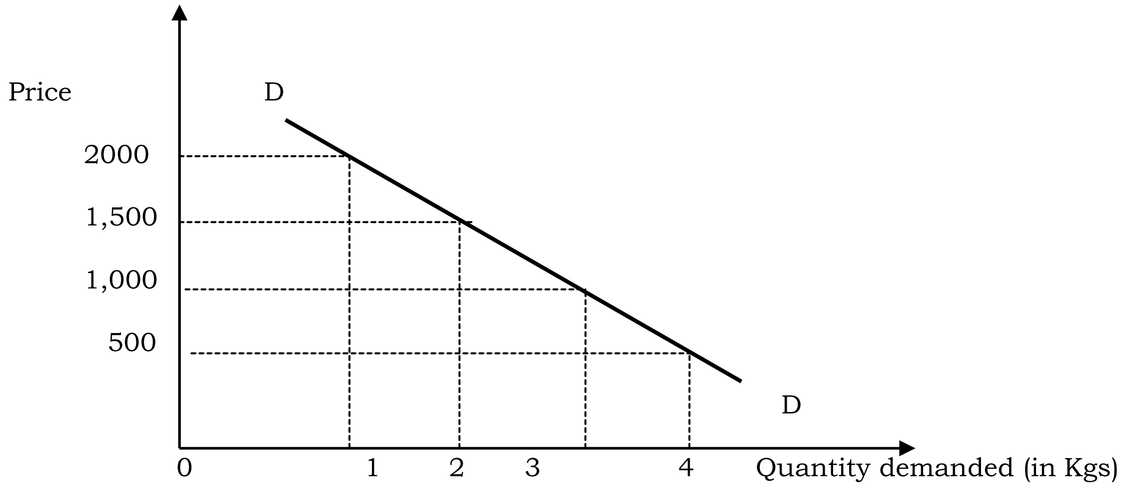


Figure 2.3: a normal demand curve.

A normal demand curve should not touch either axis because if it does so, it becomes abnormal. If it touches X axis, it implies that a consumer can even buy at zero price and if it touches Y axis, it implies that at a certain price, quantity demanded is zero.

Individual demand schedule

Individual demand schedule is a table showing different quantities of a commodity that a single individual is willing to buy at various price levels in a given time.

Market demand

Market demand refers to the total demand for a commodity by a group of consumers at various price levels in a given period of time.

Market demand schedule

Price (in shillings).	Quantity demanded. (consumer A)	Quantity demanded (Consumer B)	Quantity demanded (consumer C)	Market demand (A+B+C)
100	5	5	5	15
200	4	3	2	9
300	3	1	1	5

Table 2.2: A market demand schedule.

Market demand curve is a graphical representation of various units of a commodity demanded by a group of consumers in the market at different price levels.

MARKET DEMAND CURVE

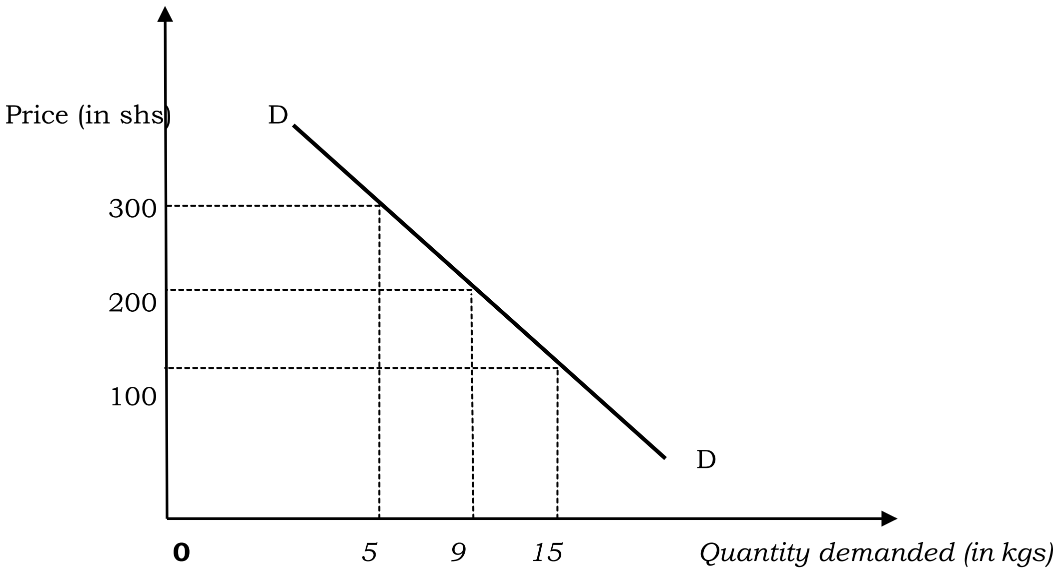


Figure 2.4: A market demand curve.

When the individual demand for three consumers is summed up, you come up with market demand which helps to derive a market demand curve.

THE CONCEPT OF UTILITY

Utility is the amount of satisfaction derived from consumption of commodity at a given period of time. People demand and consume commodities to get satisfaction from them.

Total utility. This is the total satisfaction derived from the consumption of units of a commodity at a given time. It is the sum of the marginal utility derived from different units of a commodity consumed at a given time.

TU= (MU_1+MU_2 +MU_3 +……..MUn)

Marginal utility. This refers to additional satisfaction derived from the consumption of an extra unit of a commodity. As one consumes more units of a commodity, additional satisfaction derived from each extra unit of the commodity reduces and one would continue buying only when the price is reduced.Each additional unit of the commodity consumed gives less utility than the previous unit.

MU= Change in total utility/change in number of units consumed.

Number of units of a commodity	Total utility (TU)	Marginal utility (MU).
0	0	0
1	11	11
2	18	7
3	22	4
4	25	3
5	26	1
6	26	0
7	25	-1
8	23	-2

Table 2.3: relationship between total utility and marginal utility.

From the table, when total utility is increasing, marginal utility is falling and when total utility is at maximum marginal utility is zero and when total utility is reducing, marginal utility is negative.

RELATION BETWEEN TOTAL UTILITY AND MARGINAL UTILITY.

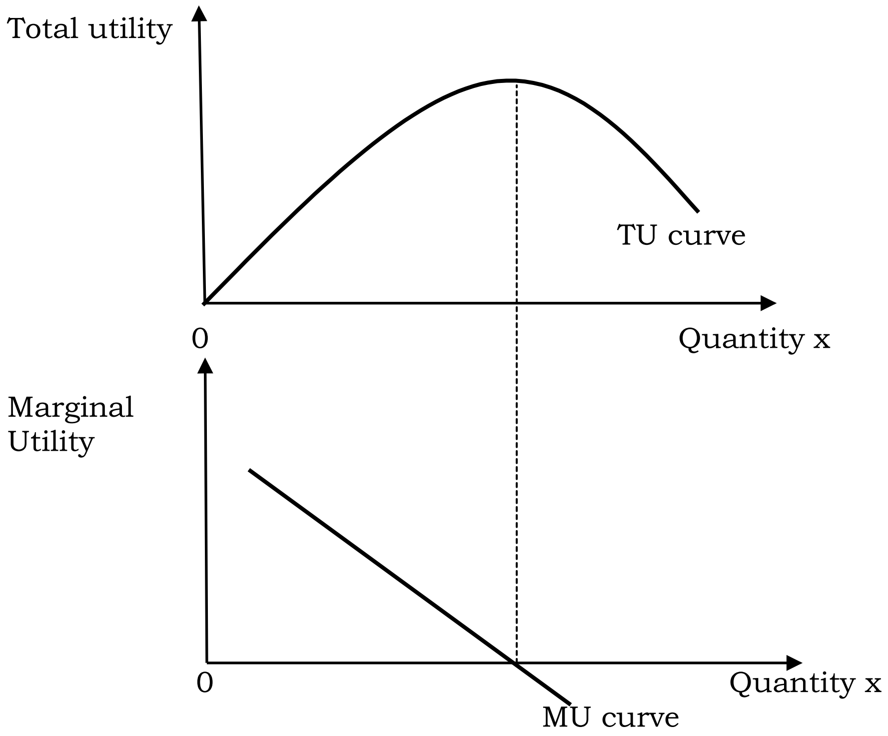


Figure 2.5: Relationship between total utility and marginal utility.

Graphically the marginal utility curve is the slope of the total utility curve.

When total utility is increasing, marginal utility is declining/reducing but positively.

When total utility is maximum, marginal utility is zero. This is the point of satiety/maximum satisfaction/bliss point.

Beyond the point of maximum satisfaction, for more units of a commodity consumed total utility will be declining because marginal utility gained before and therefore marginal utility is negative.

This implies that extra units of a commodity consumed are now giving less satisfaction to the consumer and therefore no need to consume them. Then consumer would only buy more of the commodity if its price is continuously reduced.

UNEB 2006

Explain the meaning of the following terms.

i) *Marginal utility of income.* *(02 marks)*

ii) *Marginal rate of substitute* *(02 marks)*

NB. Marginal utility income. This refers to additional satisfaction obtained from the expenditure of an extra unit of income.

Disutility/dissatisfaction/negative utility. This is satisfaction lost as a result of consuming more units of a commodity beyond the point of satiety. This is experienced at the negative part of marginal utility curve and at the falling part of total utility curve.

Bliss point/point of satiety. This refers to maximum point of total satisfaction derived from consuming given units of a commodity and marginal utility is zero. At this point marginal utility is zero and below this point marginal utility is negative.

Utils. These are units in which utility or satisfaction is measured.

THE LAW OF DIMINISHING MARGINAL UTILITY

The law of diminishing marginal utility states that as more and more successive units of a commodity are consumed, additional satisfaction derived from each additional units consumed goes on reducing/diminishing.

As marginal utility declines, the consumer is willing to pay a less price for a commodity. The consumer can buy more of the commodity if its price is continuously reduced.

This implies that the higher the marginal utility, the higher the price and the lower the marginal utility, the lower the price. Therefore, the price of the commodity is determined by marginal utility (Px = MUx).

Assumptions of the law of diminishing marginal utility.

- Assumes that consumer‟s tastes and preferences are held constant.
- Assumes a single commodity consumed with homogeneous units Consumed units should be exactly the same and possess equal quantity and quality.
- Assumes continuity in consumption. The units consumed should be in succession at a particular time.
- The commodity should be perfectly divisible into smaller units.
- Consumer is assumed to act rationally i.e. should not buy under the influence of others.
- The commodity consumed should be of ordinary type such as soda Therefore commodities such as gold and diamond cannot apply to this case.
- Price of different units of a commodity consumed is the same and remains constant.
- Assumes no change in consumer‟s income.
-

THE LAW OF DEMAND

The law of demand states that, "the higher the price, the lower the quantity demanded of a commodity and the lower the price the higher the quantity demanded of a commodity, other factors remaining constant (ceteris paribus)". Such as inverse relationship between quantity demanded and price produces a downward sloping demand curve.

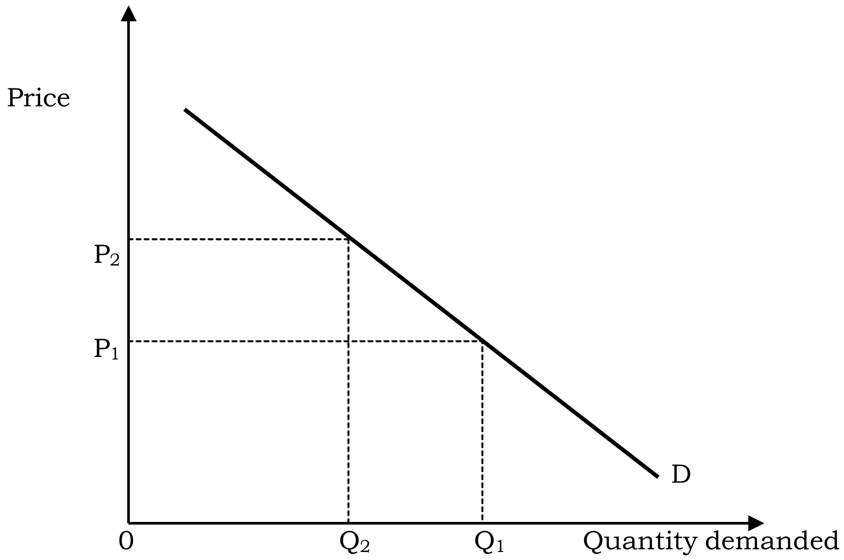


Figure 2.6: A normal demand curve.

At a lower price OP_1, quantity demanded is high at OQ_1 and at a higher price OP_2, quantity demanded is low at OQ_2.

This inverse relationship between price and quantity demanded is attributed to various reasons which help to explain the downward sloping nature of the demand curve.

Reasons why the demand curve is downward sloping/reasons which explain the law of demand

1. **Substitution effect.** When the price of one substitute good falls and that of the other remains constant, the consumer tends to buy more of the substitute good whose price has fallen compared to the one whose price remains constant. This means that at a lower price, quantity demanded is high and at a higher price, quantity demanded is low.
2. **Price effect. Ceteris paribus,** the higher the price of a commodity, the lower the quantity demanded since majority of consumers tend to demand less at a higher price and the lower the price of a commodity the higher the quantity demanded. This follows the law of demand.
3. **Real income effect.** When the price of the commodity falls, the real income of the consumer increases which means that the consumer is able to buy more than before even if his income does not change. However an increase in price leads to a fall in real income of the consumer and demand for that commodity also falls. This makes the demand curve to slope downwards.

4. **Presence of low income earners.** Low income earners can only afford to buy a certain commodity when price of such commodity falls and cannot afford the commodity when price increases implying that at a low price, quantity demanded is high and at a high price, quantity demanded is low.
5. **Different/many uses of a commodity.** For a commodity with several uses such as electricity, when the price for such a commodity increases, it would be used for only a few vital/essential purposes hence a reduction in demand , this follows the law of demand.
6. **The law of diminishing marginal utility.** As marginal utility declines the consumer is willing to pay a lower price for more units of a commodity demanded. He can only buy more of the commodity if the price is decreased which implies that demand is high at a lower price and it is low at a higher price hence downward sloping of the demand curve.

When a consumer continues to buy more units of a commodity, the marginal utility derived from the commodity continues to decline, he will be willing to buy more units only when the price is reduced. (px = MUx).

A MARKET

A market is an arrangement in which buyers and sellers come together to negotiate the exchange of a well defined commodity through the medium of money or barter trade.

TYPES OF MARKETS

1. **Commodity/product market.** This is a market where goods and services are exchanged or traded.
2. **Factor/resource market.** This is a market where factors of production are sold and bought.
3. **Free market.** This is a market where there is exchange of goods and services guided by the forces of demand and supply without government intervention.
4. **Black market.** This is a market where commodities are illegally sold and bought at prices which violate the legal price set by the government. A black market normally occurs out of relative scarcity of goods after fixing a maximum price, therefore goods are sold illegally.
5. **Competitive market.** This is a market where there are many sellers and buyers of a homogenous product.
6. **Imperfect market.** This is a market where there are many sellers and buyers of a differentiated product/commodity.
7. **Controlled market.** This is a market where the government exerts a certain degree of control on the sell of given goods and services.
8. **Spot market.** This is a market where a commodity is traded for immediate delivery.

FEATURES OF A MARKET

1. Existence of a commodity
2. Presence of sellers.
3. Presence of buyers.
4. Existence of a medium of exchange.

ABNORMAL/ REGRESSIVE/EXCEPTIONAL DEMAND CURVES.

Abnormal demand curves are demand curves which violate/disobey the general law of demand such that consumers buy more of a commodity at a higher price or less of a commodity at a lower price. There are certain instances where the law of demand is disobeyed/violated and therefore some demand curves are upward sloping while others are backward sloping.

Abnormal demand refers to demand that does not obey the general law of demand such that consumers buy more of a commodity at a higher price or less of a commodity at a lower price.

This is attributed to the following conditions.

***1.* Demand for goods of ostentation/luxury goods**

Luxury goods are goods consumed by rich people at a higher price so as to show off their economic status/wealth. More is demanded at a higher price than at a lower price. These people believe that only goods at a higher price are worth buying.

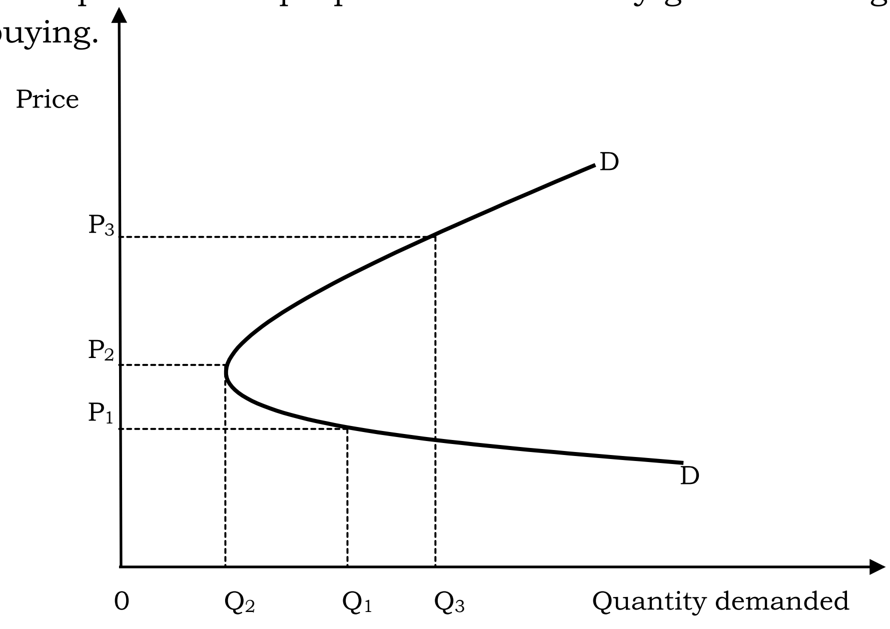


Figure 2.7: Regressive demand curve for luxury goods.

The demand curve for luxury goods is regressive at higher price level. i.e. from point N since an increase in price leads to an increase in quantity demanded.

***2.* Demand for giffen goods**

Giffen goods are goods which take the largest percentage of the budget of low income earners such that as their price increases, demand also increases and as price decreases, demand also decreases. This is because low income earners cannot afford other goods since they are expensive. These are mainly cheap basic food stuffs such as maize flour, potatoes and beans. When the price of such commodities increases, the proportion of total income spent on these goods increases because such consumers stop the consumption of other alternative commodities and spend the money on buying a giffen good, the consumer becomes worse off in real terms. When the price of giffen goods falls, the consumer becomes better off in real terms and spends the remaining income on other commodities previously given up.

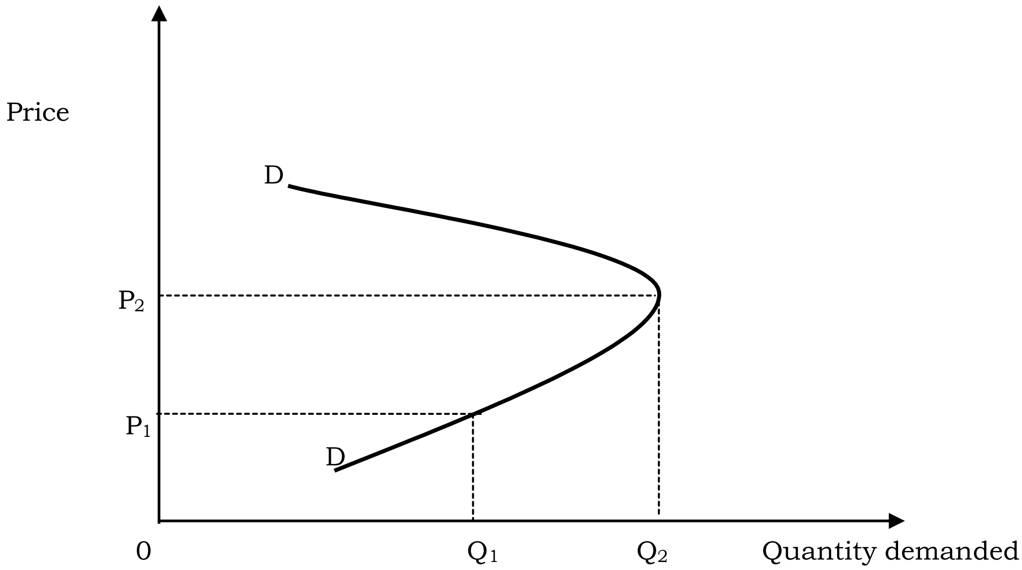


Figure 2.8: regressive demand curve for giffen goods.

The demand curve for a giffen good is regressive at lower price levels. When price increases from OP_1 to OP_2, quantity demanded also increases from OQ_1 to OQ_2.

3. Demand for necessity goods.
Necessity goods are basic items that an individual cannot do without such that as price increases, demand doesnot educe. This means that even if price is high or low, quantity demanded remains unchanged. For instance demand for salt, food.

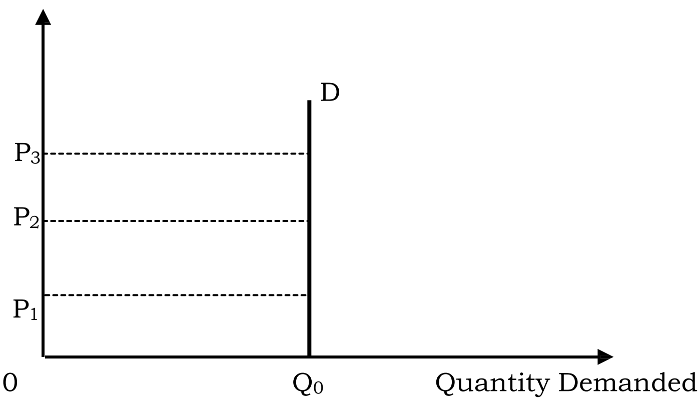


Figure 2.9: Demand curve for necessity goods.

As price increases from OP_1 to OP_2 up to OP_3, quantity demanded remains constant at OQ_o.

4. Future price expectations/expectation of future increase or decrease in price

More of the commodity is demanded at a high price in the present when it is expected that in the near future its price will rise further/rapidly in fear of buying at a more higher price. If the price is expected to reduce further in the near future, consumers buy less of the commodity even at a low price in the present hoping that the price will reduce further.

5. Ignorance effect of consumers

Where consumers are ignorant about the right price, package and labels of a commodity, they are forced to buy more of a commodity at a higher price since they are not sure that a similar commodity may be obtained elsewhere at a low price and here the higher price is mistaken for a higher value of the commodity.

6. Effect of an economic depression

An economic depression is a period characterized by low rate of economic activities, low incomes, low commodity prices and low purchasing power of consumers. During such a period, even if prices decrease, demand will not increase since people have very limited incomes to spend.

7. Bandwagon effect

This is where a consumer demands for more of a commodity at a higher price because he has seen others using the same commodity. If a commodity is bought due to bandwagon effect, more of the commodity is demanded as price goes high since the consumer feels that it is of a superior quality which violates the law of demand.

8. Demand for habit forming goods

For goods consumed out of habit, whether price increases or reduces, quantity demanded remains high such as demand for cigarettes among hard core smokers. This disobeys the law of demand.

UNEB 2004

State any four reasons why a consumer buys less of a commodity when it price falls (04 marks)

Under what circumstances may a consumer buy less of a commodity when it's price falls?

- When it is a period of economic depression.
- In case a consumer prefers goods of ostentation/snob effect.

- When a commodity is a giffen good.
- In case a consumer expects the price of the commodity to reduce further in the near future.
- When a fall in price is associated with a fall in quality of the commodity.

Under what circumstances may demand for a commodity continue to increase with an increase in its price?

- When a commodity in question is a necessity.
- When price of the commodity in question is expected to increase further in the near future/supply of the commodity is expected to be scarce in the near future.
- When the consumer is addicted to the consumption of the commodity in question.
- When the commodity in question is a giffen good.

INTER-RELATED DEMAND

Inter-related demand is a situation where demand for a commodity affects demanded for another commodity either negatively or positively.

Examples/types of inter-related demand.

1. **Joint/Complementary Demand.**

Complementary demand is demand for two commodities which are used together such that an increase or a decrease in demand for one would lead to a corresponding increase or decrease in demand for the other commodity.
Examples of joint demand include- demand for guns and bullets, demand for car and fuel, demand for tooth paste and tooth brush, demand for ink and paper.

2. **Competitive demand**

Competitive demand is demand for commodities which serve the same purpose (substitutes) such that an increase in demand for one reduces demand for another.
An increase in the price of one leads to a fall in quantity demanded of that particular commodity and a corresponding increase in quantity demanded of the other substitute commodity whose price has remained unchanged.
Examples of competitive demand include- demand for Nomi soap and Omo soap, demand for peas and beans, demand for pork and beef.

UNEB 2011

i) *Define the term composite demand.* *(01 marks)*
ii) *State any three examples of composite demand in your country*

(03 marks)

3. **Composite demand**

This refers to the total demand for a commodity which serves many (several) purposes/uses. The demand for such a commodity is meant for multiple purposes.

Examples of composite demand include-

Demand for electricity used for ironing, lighting, cooking, demand for cotton wool for cloth making, cleaning, demand for iron and steel for construction, making furniture, demand for timber used in making furniture, construction, demand for clay used in building, making cups, bricks, stoves, artworks, demand for hides and skins used for making shoes, belts and bags, demand for sugar used for banking, brewing.

4. **Derived demand**

Derived demand is demand for a commodity that results from demand for another commodity that it is used to produce.

Or

This is demand for a commodity not for its own sake but because of demand for what it is used to produce. Usually demand for a factor of production is as a result of demand for goods and services produced by that factor.

Examples of derived demand include-

Demand for a builder is derived from the demand for a house, demand for a carpenter is derived from the demand for furniture.

5. **Independent/autonomous demand**

Independent demand is demand for a commodity which does not affect and is not affected by demand for another commodity. It is demand for commodities which are not related at all.

Examples of independent demand include-

Demand for bullets and demand for a radio, demand for a phone and demand for a trouser, demand for a computer and demand for shoes.

FACTORS DETERMINING/AFFECTING/INFLUENCING QUANTITY DEMANDED FOR A COMMODITY

NB. Neutral points must be given and each point should be explained in two sides showing high quantity demanded and low quantity demanded for a commodity.

1. **Price of the commodity.** Ceteris paribus, at a higher price, the commodity becomes more expensive hence low quantity demanded while at a low price more of a commodity is demanded since it makes it cheaper.
2. **Level of consumer's income.** This depends on the nature of the commodity. Ceteris paribus, for normal goods, high level of consumer's income implies high purchasing power hence high quantity demaneded while low level of income of the consumer reduces purchasing power hence low quantity demanded.
3. **Population size and its composition.** Ceteris paribus, a bigger population size in an area leads to high quantity demanded for a commodity while a small population size leads to a small market size thus low quantity demanded for a commodity.
4. **Consumer's tastes and preferences.**

Favourable consumer‟s tastes and preferences for a commodity encourage consumption hence high quantity demanded while unfavourable consumer‟s tastes and preferences for a commodity lead to low quantity demanded for a commodity.

5. **Seasonal factor/changes.** Favourable season for a commodity leads to high quantity demanded such as demand for gumboots and umbrellas during rainy season, demand for meat and Christmas cards during Christmas period while unfavourable season for a commodity leads to low quantity demanded for instance demand for Christmas cards after Christmas period, demand for jackets during a dry season.
6. **Government policy of subsidization and taxation.** Favourable government policy on consumption such as subsidizing consumers and low direct taxes increase their disposable income hence high quantity demanded whereas unfavourable government policy through high direct taxes reduce consumer‟s disposable income hence low quantity demanded for a commodity.
7. **Level of advertising.** High level of advertising through persuasive advertising for a commodity attracts more consumers to such a commodity hence high quantity demanded whereas low level of advertising leads to low quantity demanded for a commodity.
8. **Expectation of future changes in price.** When the price of a commodity is expected to increase in the near future, quantity demanded for that commodity increases in the present while if the price of the commodity is expected to reduce in the near future, quantity demanded for such a commodity reduces in the present since consumers hope to buy such a commodity at a much reduced price in future.
9. **Nature of income distribution among consumers.** Equitable distribution of income among households leads to high quantity demanded for a commodity while uneven distribution of income among households leads to low quantity demanded for a commodity.

10. **Price of other commodities.** These may be substitutes or complements of the commodity in question i.e price of a substitute commodity (substitutes). When price of a substitute increases, quantity demanded for the commodity in question increases. For instance when the price of Nomi soap increases, demand for Omo soap will increase but when the price of a substitute reduces, quantity demanded for a commodity in question reduces.

Price of complementary goods (complements). An increase in price of a complementary commodity decreases quantity demanded for the commodity in question while a fall in price of a complementary commodity increases quantity demanded for the commodity in question.

11. **Availability and terms of credit such as hire purchase.** Presence of enough credit facilities increases quantity demanded while limited access to credit facilities leads to low quantity demanded.

DEMAND FUNCTION.

Demand function is a statement showing technical relationship between quantity demanded for a commodity and the major determinants of demand.

Qdx = f(Px,Y,TP,SF,PC,LA……….)

Where

Qdx = Quantity demanded for commodity X,P = price of the commodity X,Y= income of the consumer,

TP= tastes and preferences of the consume, SF=seasonal factor, PC = price of other commodities, LA= level of advertising.

CHANGE IN DEMAND

Change in demand refers to an increase or a decrease in amount of a commodity demanded due to a change in other factors affecting demand when the price of the commodity is held constant/at a constant price.

Or

It refers to an increase or a decrease in the amount of a commodity demanded at a constant price due to a change in other factors that affect demand. It involves a shift in the demand curve either to the right left.

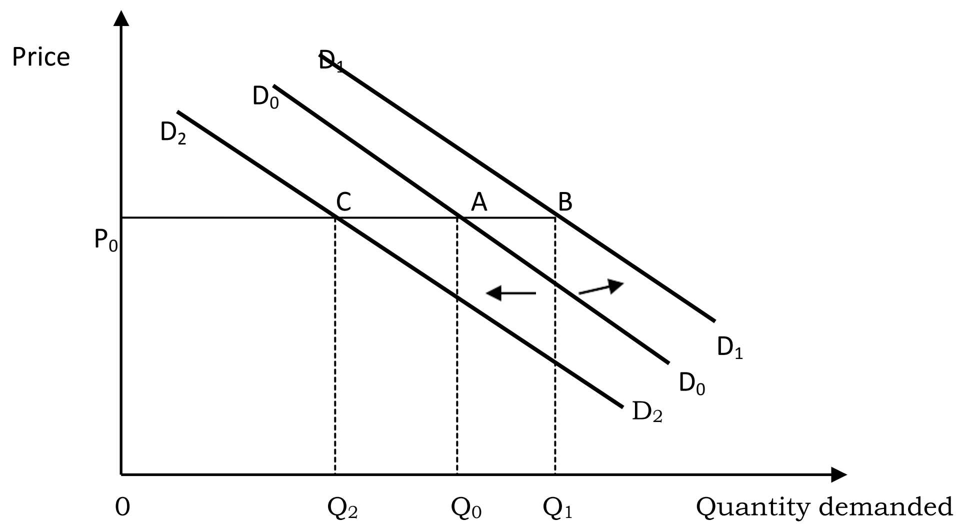


Figure 2.10: change in demand.

A shift in the demand curve from left to right (D_o D_o to D_1D_1) indicates an increase in demand for a commodity. More of a commodity is demanded at a constant price.

A shift in the demanded curve from right to left (D_oD_o to D_2D_2) indicates a decrease in demand for a commodity. Less of a commodity is demanded at constant price.

AN INCREASE IN DEMAND.

An increase in demand refers to a rise in the amount demanded of a commodity due to favourable changes in other factors affecting demand when the price of the commodity is held constant.

Or

An increase in demand refers to a situation in which more quantity of a commodity is demanded due to other factors affecting demand when price is held constant.

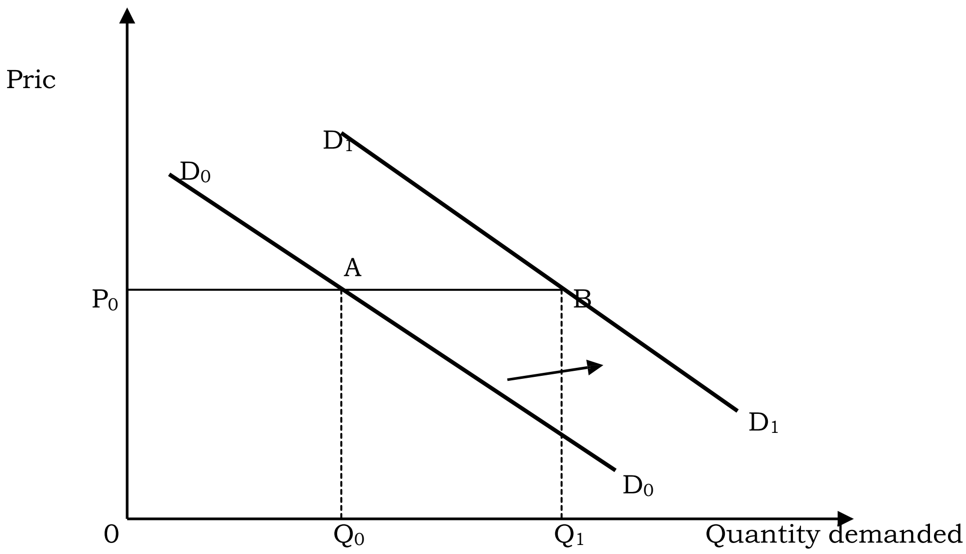


Figure 2.11: An increase in demand.

A shift of the entire demand curve from D_oD_o to D_1D_1 illustrates an increase in demand.

A DECREASE IN DEMAND

A decrease in demand refers to a fall in the amount of a commodity demanded due to unfavorable changes in other factors affecting demand when the price of the commodity is held constant. **Or**

A decrease in demand refers to a situation in which less quantity of a commodity is demanded due to other factors affecting demand when price is held constant.

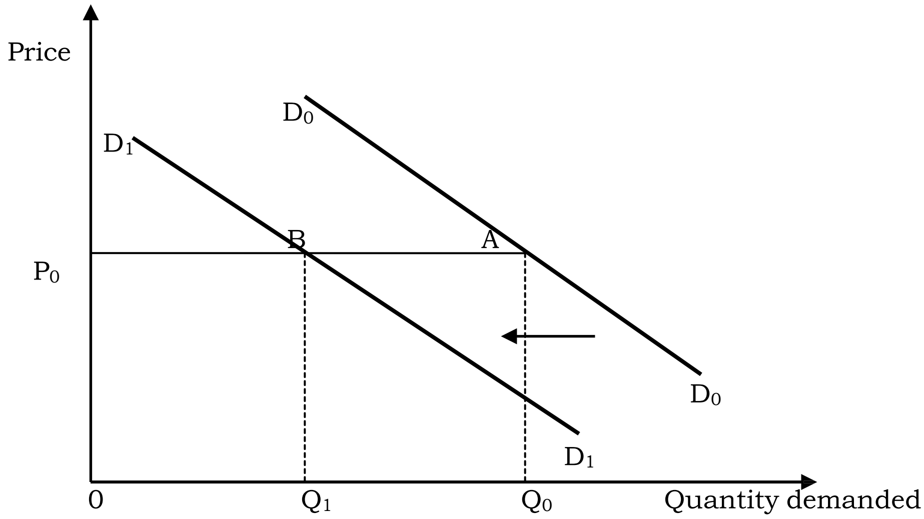


Figure 2.12: a decrease in demand.

A shift of the entire demand curve from right to the left i.e DoDo to D1D1 illustrates a decrease in demand.

CHANGE IN QUANTITY DEMANDED

Change in quantity demanded refers to an increase or adecrease in the amount of a commodity demanded due to a change in price of a commodity other factors that influence demand remaining constant.

It can be described as the extension or contraction along the same demand curve.

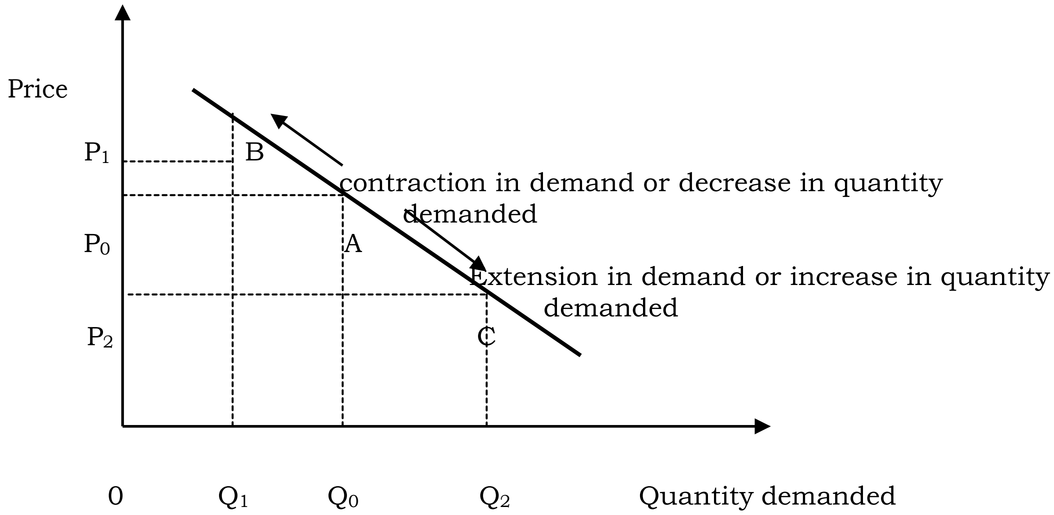


Figure 2.13: change in quantity demanded.

- Movement from point A to B illustrates a contraction in demand which shows a decrease in quantity demanded.
- Movement from point A to C illustrates an extension in demand and this shows an increase in quantity demanded.

A DECREASE IN QUANTITY DEMANDED

Decrease in quantity demanded refers to a fall in the amount of a commodity demanded due an increase in price of that commodity, other factors affecting demand held constant.

Or

It is an upward movement along the same demand curve as a result of an increase in price of a commodity, other factors affecting demand held constant.

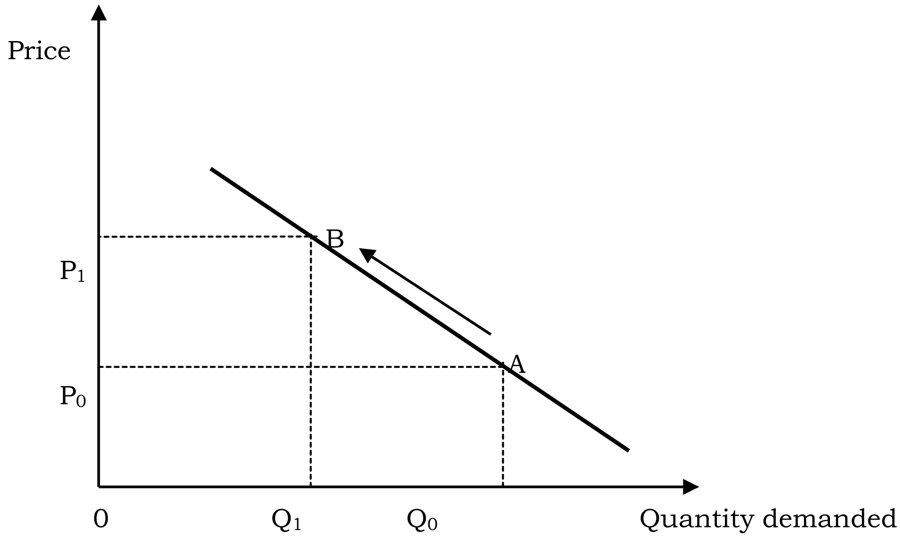


Figure 2.14: a decrease in quantity demanded.

A movement from point A to B shows a decrease in quantity demanded as a result of an increase in price from OP_o to OP_1.

AN INCREASE IN QUANTITY DEMANDED

An increase in quantity demanded refers to a rise in the amount of a commodity demanded as a result of a fall in price of the commodity, other factors affecting demand held constant.

Or

It is a downward movement along the same demand curve as a result of a fall in price of that commodity, other factors affecting demand held constant.

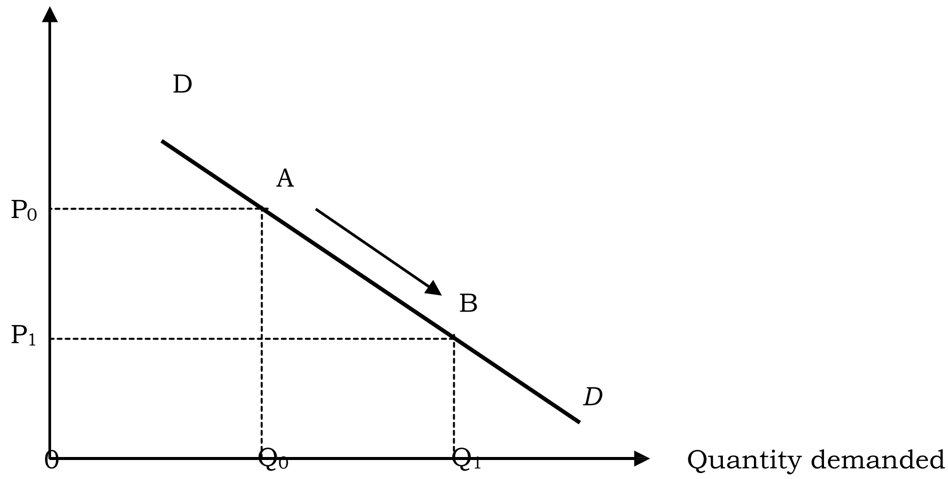


Figure 2.15: an increase in quantity demanded.

A movement from point A to B shows an increase in quantity demanded as a result of a decrease in price from OP_0 to OP_1.

UNEB 2007

a) Distinguish between a change in demand and a change in quantity demanded (04 marks)

b) Explain the factors that lead to a change in demand (16 marks)

FACTORS THAT LEAD TO A CHANGE IN DEMAND FOR A COMMODITY.

NB. Both an increase and a decrease in demand are catered for and it implies an increase, a decrease, a rise, a fall, a positive change, a negative change, favourable change and unfavourable change in other factors that influence demand for commodity apart from price of the commodity.

Neutral points should be presented using the phrase <u>change</u> and each point should be explained in <u>two sides</u> catering for an increase in demand and a decrease in demand.

1. **A change in price of substitute commodities.** An increase in price of a substitute commodity leads to an increase in demand for a commodity in question while a decrease in price of a substitute leads to a decrease in demand for a commodity in question.
2. **A change in level of consumer's income.** A rise in income of the consumer leads to an increase in demand while a fall in income of the consumer leads to a decrease in demand.
3. **Expectation of future changes in price of the commodity.** If price of the commodity in question is expected to decrease in the near future, demand increases in the current period while if price is expected to increase in the near future, demand increases in the current period.
4. **A change in population size and its structure.** An increase in population size increases market for a commodity leading to an increase in demand while a decrease in population size in an area reduces demand for a commodity at a constant price.
5. **A change in government policy of subsidization and taxation.** Unfavourable change in government policy through imposing high direct taxes on consumers reduces their disposable income which leads to a decrease in demand while favourable change in government policy through subsidization of consumers leads to an increase in demand.
6. **A change in consumer's tastes and preferences.** Favourable change in consumer‟s tastes and preferences for a commodity leads to an increase in demand while unfavourable change in government policy through subsidization of consumers leads to an increase in demand.
7. **A change in income distribution among consumers.** Even distribution of income among households leads to an increase in demand while

uneven distribution of income among households leads to a decrease in demand.

8. **A change in the level of advertising.** An increase in the level of advertising through persuasive advertising leads to an increase in demand while a reduction in the level of advertising leads to a decrease in demand.
9. **A change in seasonal factors.** Favourable change in season for a commodity leads to an increase in demand such as demand for meat and Christmas cards during Christmas season while unfavourable change in season for a commodity leads to a decrease in demand for a commodity.
10. **A chance in price of complementary goods.** A rise in the price of a complement leads to a decrease in demand for a commodity in question while a fall in the price of a complement leads to an increase in demand for a commodity in question.
11. **A change in availability of credit facilities such as hire purchase.** Increased availability of credit facilities leads to an increase in demand while reduced availability of credit facilities leads to a decrease in demand.

FACTORS THAT LEAD TO AN INCREASE IN DEMAND FOR A COMMODITY

(Price of the commodity in question remains constant but there is a positive change in other factors that affect demand for a commodity).

1 **An increase in consumer's income.** A rise in consumer"s incomeincreases the purchasing power of the consumer thus enabling him to buy more of a commodity at constant price.
2 **An increase in population size.** Increased number of people in an area increases market for a commodity at a constant price.
3 **A favourable change in consumer's tastes and preferences.** This implies that more of a commodity is demand at a constant price.
4 **Equitable distribution of income setting in.** majority of consumers are able to demand for a commodity since income becomes evenly spread which increases demand even though the price remains unchanged.
5 **A fourable change in government policy of subsidization.** Where the government encourages consumers to buy more of a commodity through increased subsidization, more of the commodity is demanded even if its price remains constant.
6 **An increase in price of a substitute commodity.** More of the commodity in question is demanded at constant price when the price of its substitutes increases since consumers run away from purchasing the substitute.
7 **A decrease in price of a complement(s) of a commodity.** More of a commodity in question is demanded at a constant price as longer as price of its complements reduces. For example fall in price of cars increases

their demand which leads to a corresponding increase in demand for fuel at a constant price.

8 **A favourable change in seasonal factor.** Season for a commodity becoming favourable increases demand at a constant price. For instance demand for Christmas cards and meat increases during Christmas period even if the price is held constant.

9 **Expectation of future increase in price of a commodity.** When the price of a commodity is expected to increase in the near future, demand for such a commodity increases in the present at a constant price.

10 **An increase in the level of advertising.** If a commodity is extensively advertised, many consumers become aware of it and more of it is demanded at a constant price.

FACTORS THAT LEAD TO A DECREASE IN DEMAND FOR A COMMODITY

(Price of the commodity in question remains constant but there is a negative change in other factors that affect demand for a commodity).

1. **A decrease in consumer's income.** Reduction in income of the consumer leads to a fall in consumer‟s purchasing power which implies that he buys less of the commodity at a constant price.
2. **A decrease in population size of an area.** Where the population size in an area reduces, demand for a commodity also reduces if even price is unchanged.
3. **A decrease in price of a substitutes(s).** Less of the commodity in question is demanded at a constant price if the price of its substitute reduces since consumers resort to such a substitute whose price has reduced.
4. **An increase in price of a complement(s).** Demand for a commodity in question reduces at a constant price if the price of its complements increases.
5. **Unfavourable change in government policy of taxation.** Increased direct taxes reduce consumer‟s disposable income and less of a commodity is demanded even if its price remains constant.
6. **Expectation of future reduction in price of a commodity.** Less of a commodity is demanded at constant price in the present since consumers expect to buy more when the price reduces in the near future.
7. **Uneven distribution of income setting in.** where income increases to concentrate in the hands of few consumers, less of the commodity is demanded at a constant price since more consumers have limited income to purchase the commodity.
8. **A fall in the level of advertising/unsuccessful advertising.** In case a commodity is poorly advertised and adverts prove to be misleading to the public, demand for such a commodity reduces even if price is held constant.

9. **Unfavourable change in consumer's tastes and preferences.** Tastes and preferences of the consumer becoming unfavourable towards a commodity reduces demand at a constant price.
10. **Season for a commodity becoming unfavourable.** Demand for a commodity reduces when the season for it becomes unfavourable. For instance demand for Christmas cards reduces after Christmas season even when the price is unchanged.

THE CONCEPT OF SUPPLY

Supply refers to amount/quantity of a commodity that a producer/firm is willing and able to offer to the market for sale at a given price in a specified period time.

Quantity supplied refers to the amount of a commodity produced and available for sale in the market at acertain price in a given period of time.

Effective supply refers to the actual quantity of a commodity that a producer is able to offer to the market at various prices in a given time.

SUPPLY SCHEDULE.

Supply Schedule is a table showing different quantities of a commodity supplied to the market for sale at a given price per period of time.

Or

This is a table showing various quantities of a commodity that a producer or a firm is willing and able to offer to the market for sale at various price levels in a given period of time.

Price of commodity (in shillings).	**Quantity supplied (in kgs).**
500	15
1000	25
1500	35
2000	45
2500	55

When the above information is plotted on a graph, a normal supply curve is derived.

THE SUPPLY CURVE

Supply curve is a graph showing different quantities of a commodity supplied to the market at various prices in a given time.

Or

Supply curve is a graphical representation of various/different quantities of a commodity that a supplier/producer is willing and able to put to the market for sale at various price levels in a given time.

Or

It refers to a graphical representation of the supply schedule.A normal supply curve is upward sloping from left to right implying that at a higher price, quantity supplied of a commodity is high and at a lower price, quantity supplied of a commodity is low.

From the above supply schedule, a normal supply curve is derived.

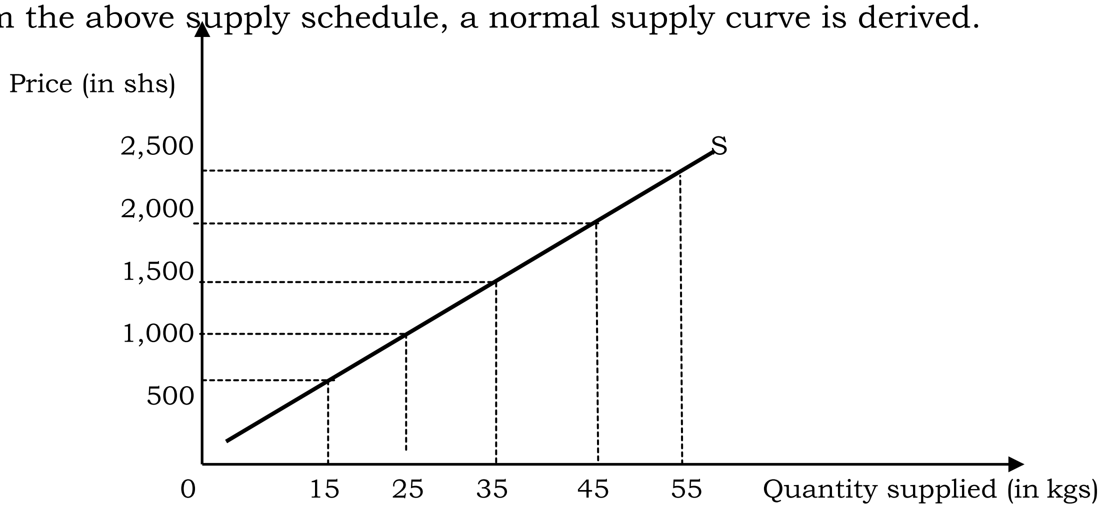


Figure 2.16: The supply curve.

MARKET SUPPLY

Market supply refers to the total supply by various firms in the market of a given commodity at various price levels in a given period of time.

Or

It refers to the total amount of a commodity that various producers are able and willing to offer to the market for sale at various prices in a given time.

It is obtained by summing up the various quantities of a commodity supplied by individual firms in the market at given price levels.

This produces market supply schedule from which a market supply curve is derived.

MARKET SUPPLY SCHEDULE.

Price of a commodity (in shs)	**Quantity supplied by firm A. (kgs)**	**Quantity supplies by firm B. (kgs)**	**Market Supply (A+B)**
200	5	4	9
500	10	5	15

Table 2.5: Market supply schedule.

Market supply curve

Market supply curve is a graph showing all quantities of a commodity that are supplied to the market by various firms at different price levels per period time.
Market supply curve shows the summation of all supply curves by all individual suppliers in the market.
Basing on the above market supply schedule, a market supply curve can be derived.

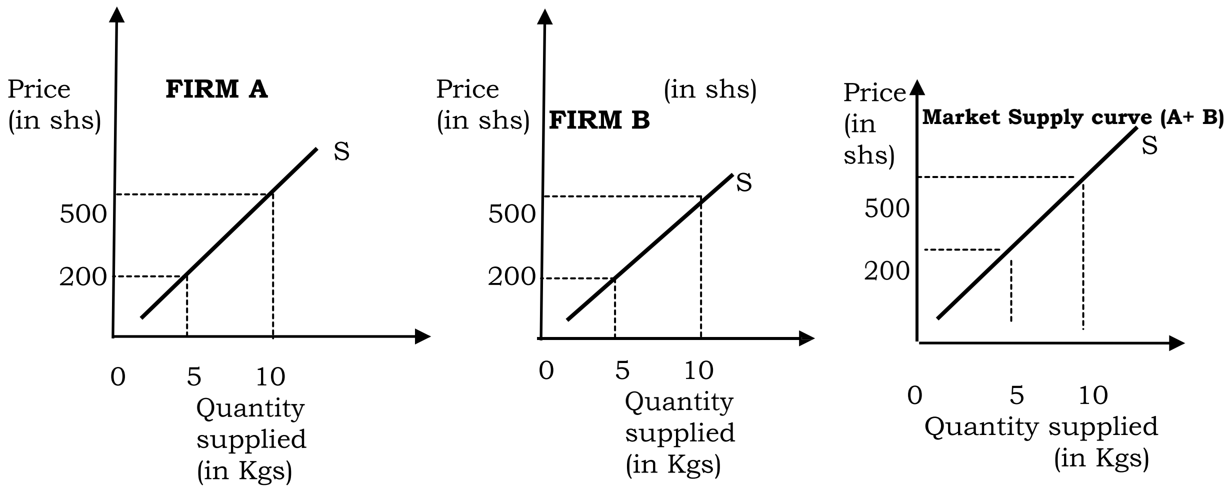


Figure 2.17: individual supply curves and market supply curve.

UNEB 2014

i) *State the law of supply.* *(01 marks)*
ii) *Mention any three factors that causes a decrease in supply of goods in an economy.* *(03 marks)*

UNEB 2008

i) *State the law of demand and supply.* *(02 marks)*
ii) *How is price of a commodity determined in a laissez faire economy.* *(02 marks)*

THE LAW OF SUPPLY

The law of supply states that, "the higher the price of a commodity, the higher the quantity supplied and the lower the price of a commodity, the lower the quantity supplied, other factors remaining constant (ceteris paribus)."

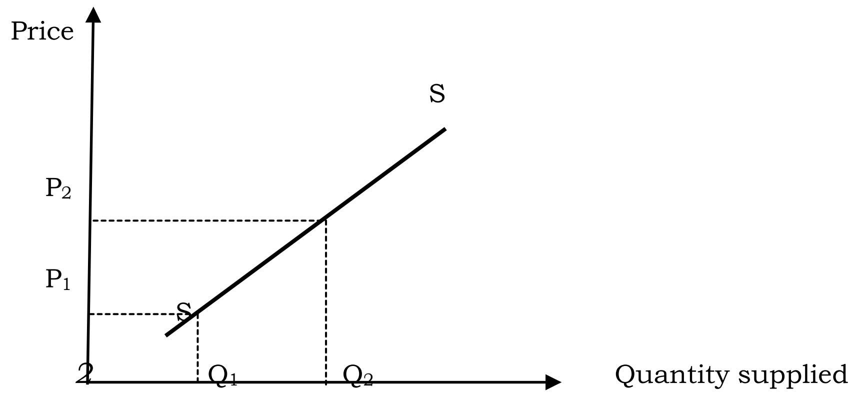


Figure 2.18: relationship between price level and quantity supplied.

At a lower price OP_1, quantity supplied is low at OQ_1 and at a higher price OP_2, quantity supplied is high at OQ_2.

ABNORMAL/REGRESSIVE/EXCEPTIONAL SUPPLY CURVES.

Abnormal supply curves are supply curves that do not conform to the general law of supply such that suppliers supply more of a commodity at a low price or less of a commodity at a higher price.

There are some instances where the general law of supply is violated/disobeyed. Abnormal supply curves are explained basing on the following situations.

1. **Backward bending supply curve of labour.** The supply of labour tends to increase with increase in the wage rate after a certain level beyond any further increase in wage rate results into a decline in labour supply.

Backward bending supply curve for labour.

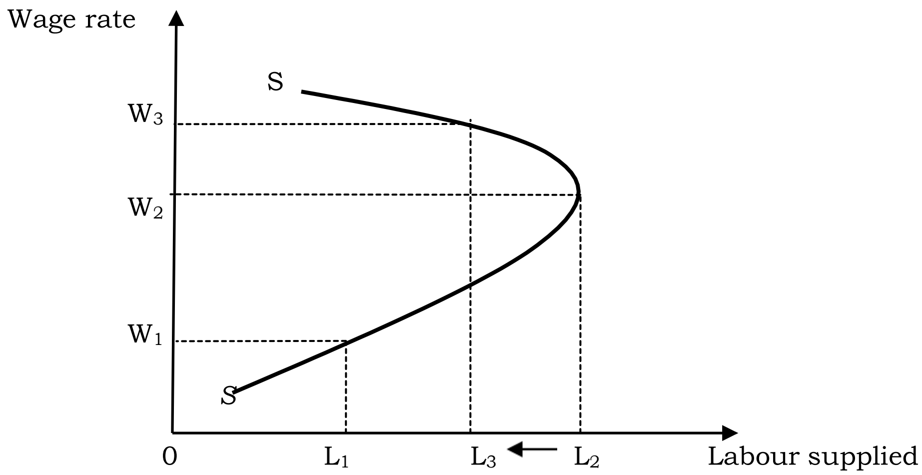


Figure 2.19: backward bending supply curve for labour.

An increase in the wage rate from W_1 to W_2 increases labour supply from L_1 to L_2.

Any increase in the wage rate beyond W_2 i.e to W3 does not increase supply of labour instead leads to a reduction in labour supply from L_2 to L_3. This produces a backward bending supply curve for labour.

UNEB 2001

Give any four reasons why labour supply curve may be regressive (04 marks)

Reasons which explain backward bending supply curve for labour

- **Presence of target workers.** These aim at achieving certain objectives and when the objectives are achieved they abandon the jobs even if the wage is increased.
- **High desire/preference of leisure to work.** After workers realizing an increase in their wage rate they resort to leisure time activities thus spending less hours on the job to consume the excess income.

- **Fear of progressive taxation.** This reduces disposable income thus discourages workers from over working hence reduced labour supply.
- **Reduction in real income due to high rate of inflation.** Increase in wage with persistent increase in prices for commodities reduces real income of the worker thus low labour supply at an increased wage rate.
- **Political and cultural factors** such as discrimination in the labour market, insecurity in the place of work.

2. **Fixed supply of land.** Land has perfectly inelastic supply curve because its supply is fixed and therefore quantity supplied remains constant at various price levels.

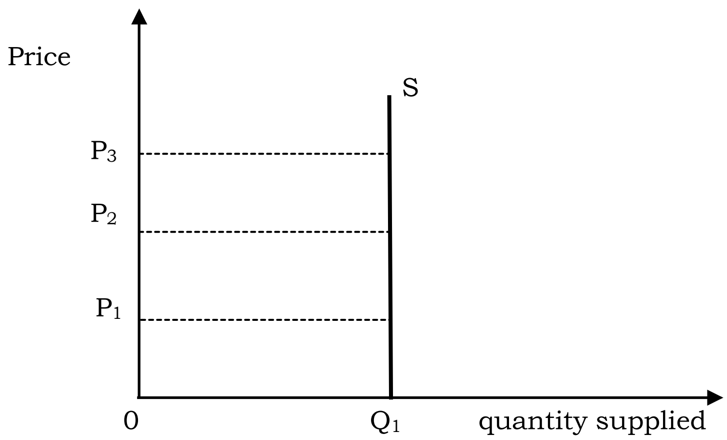


Figure 2.20: perfectly inelastic supply curve for land.

Quantity supplied remains constant at OQ_1 but price changes from OP_1 to OP_2 up to OP_3.

3. **Supply of perishable commodities.** Even if the price for perishable commodities is low, quantity supplied increases since output cannot be reserved for future use implying that at a low price, quantity supplied is high.

4. **Speculative supply.** When the price is expected to increase further in the near future, producers supply less output on the market evenif price is high since they hope to supply more when the price finally increases further and when the price is expected to reduce further in the near future, producers supply more on the market even at a low price in the present period.

INTER-RELATED SUPPLY.

Interrelated supply is a situation where supply of a commodity is affected by supply of another commodity either negatively or positively.

TYPES OF INTER-RELATED SUPPLY.

1. **Joint/complementary supply.**

Joint supply is supply of two or more commodities which are produced together using the same resources such that the supply of one leads to a corresponding supply of the other commodity..

An increase in supply of one commodity leads to an increase in supply of another and a decrease in supply of one commodity also leads to a decrease in supply of another commodity.

Examples of joint supply include- supply of meat and hides from animals, supply of coffee beans and coffee husks, supply of wool and mutton.

2. **Competitive supply**

Competitive supply is a supply of two or more commodities that are produced using the same resources/raw materials such that an increase in supply of one commodity leads to a decrease in production and supply of the other commodity.

Examples of competitive supply include- supply of chicken and eggs, supply of poles and supply of timber, supply of milk and ghee from cows, supply of land for cultivation and supply of land for construction.

3. **Composite supply.**

Composite supply is supply of commodities that fall in the same category. These goods are normally, close substitutes of each other.

Examples of composite supply include – supply of pork, chicken and beef, supply of tea and coffee.

4. **Independent supply.**

Independent supply is supply of a commodity that does not affect the supply of another commodity. Examples of independent supply include- supply of timber and supply of clothes, supply of iron bars and coffee, supply of phones and sugar.

UNEB 2006

Study the table below and answer the questions that follow.

	A	*B*	*C*	*D*
Price of maize (in shs)	*10*	*20*	*30*	*40*
Quantity of maize supplied (in kgs)	*50*	*100*	*150*	*200*

a) Draw the supply curve using the information above. (02marks)

b) Calculate price elasticity of supply from point A to D. (02 marks)

c) Examine factors that influence quantity supplied of a commodity in an economy. (16marks)

FACTORS THAT INFLUENCE/AFFECT QUANTITY SUPPLIED OF A COMMODITY

NB. Neutral points must be presented and each point should be explained in two sides showing high quantity supplied and low quantity supplied.

1. **Price of a commodity.** Ceteris paribus more of a commodity is supplied to the market at a higher price because production is encouraged while less of a commodity is supplied at a lower price since it discourages more production.

2. **Cost of production/prices of factors of production.** Low cost of production makes it cheap to produce more of a commodity leading to high quantity supplied while high cost of production makes expensive to produce more thus low quantity supplied.

3. **Level of technology used in production.** Use of advanced technology in production increases output which leads to high quantity supplied while use or backward technology limits output hence low quantity supplied.

4. **Price of other commodities.** These may be competitively supplied goods or jointly supplied goods. For competitively supplied commodities /substitutes, an increase in price and supply of a substitute reduces quantity produced and supplied of the other commodity in question while a decrease in price and supply of a substitute increase quantity supplied of the other in question.

For jointly supplied commodities/complements, an increase in price and supply of a complement, increases supply of the other commodity in question while a decrease in price and supply of a complement reduces quantity supplied of the other commodity in question. For instance beef and hides, mutton and wool.

5. **Goal/objectives of the firm/producer.** Profit maximization aiming firm usually supplies less output and a higher price while a sales maximization aiming firm tends to supply high level of output at a low price to benefit from sales revenue.
6. **Gestation period of a commodity.** Long gestation period for a commodity to be produced takes time to increase production which leads to low quantity supplied as soon as price increases.
7. **Number of producers or suppliers of a commodity.** Large number of suppliers for a given commodity leads to high output and quantity supplied while few suppliers of a commodity lead to low output and quantity supplied.
8. **Political climate.** Political stability encourages producers to concentrate on production activities leading to high output and quantity supplied while political instability scares away producers which discourages investment leading to low output and quantity supplied.
9. **Government policy regarding supply of a commodity.** Favourable government policy that encourages production such as subsidization of producers, fair taxes makes it cheap to produce leading to highproduction thus high quantity supplied while unfavourable government policy such as low subsidies, high indirect taxes makes it expensive to produce leading to low quantity supplied.

10. **Expectation of future changes in price.** When the price of a commodity is expected to increase in the near future, suppliers keep the stock for selling in future and this reduces quantity supplied in the present while when the price of a commodity is expected to fall in future, sellers bring to the market what they have in stock to avoid a loss in future hence high quantity supplied in the present period.
11. **Degree of freedom of entry of new firms into production.** Free entry of new firms into production of a commodity increases output and quantity supplied while restricted entry of new firms into production leads to emergence of monopolists and reduce production so as to charge high prices which leads to low quantity supplied.
12. **Working conditions.** Favourable working conditions such as high wages, fringe benefits such as medical care, transport allowances motivate workers thus increased productionand quantity supplied while unfavorable working conditions reduce morale of workers hence output and low quantity supplied of a commodity.
13. **Level of demand/market size for a commodity.** A large market size for a commodity attracts more production due to expanded market leading to high quantity supplied while a small market size for a commodity leads to low quantity supplied.
14. **Natural factors especially in agriculture.** For the supply of agricultural products, favourable natural factors such as good climatic comndiotions lead to high quantity supplied of agricultural commodities while unfavourable natural factors reduce output level and quantity supplied of agricultural commodities.

THE SUPPLY FUNCTION

Supply function is a statement that shows a technical relationship between quantity supplied of a commodity and the major factors that influence supply.

QSx=f(Px,Gp,Np,Lt,Nf,Pc…….).

Where,

QSx=quantity supplied of commodity x,Px= price of commodity x,Gp= gestation period, Np= number of producers, Lt=level of technology, Nf=natural factors, Pc=price of other commodities.

CHANGE IN QUANTITY SUPPLIED

Change in quantity supplied refers to an increase or a decrease in the amount of a commodity supplied due to a change in price of a commodity when other factors that affect supply are held constant. It involves an upward and downward movement along the same supply curve.

Price of the commodity in question changes but other factors that affect supply remains constant.

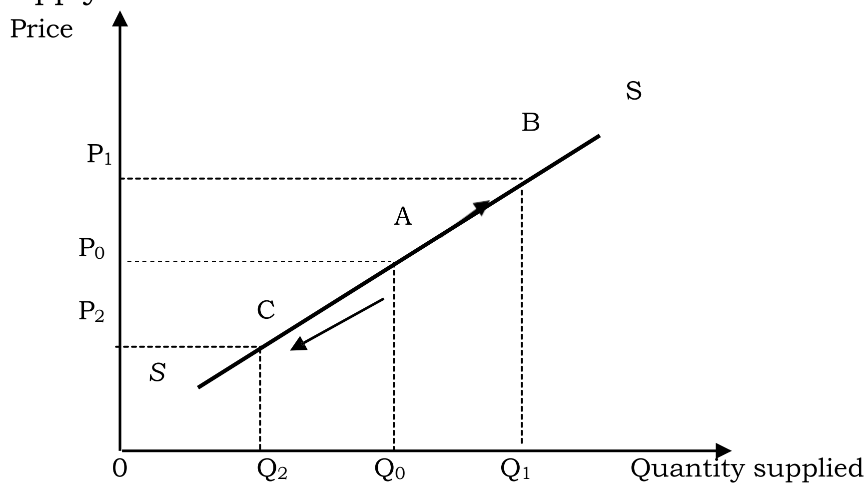


Figure 2.21: change in quantity supplied.

A movement from point A and B shows an increase in quantity supplied due to an increase in price from OP_o to OP_1.

A movement from point A to C shows a decrease in quantity supplied due to a fall in price of a commodity from OPo to OP_2.

AN INCREASE IN QUANTITY SUPPLIED

An increase in quantity supplied refers to an upward movement along the same supply curve due to an increase in price of the commodity when other factors that affect supply are held constant.

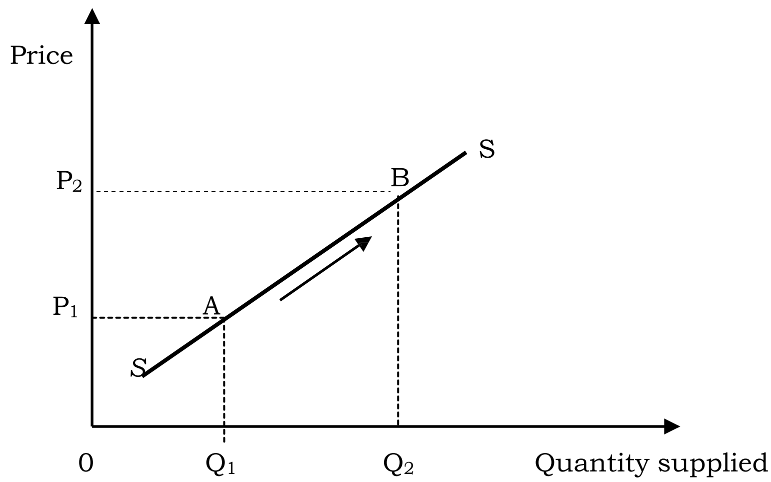


Figure 2.22: an increase in quantity supplied.

A movement from point A to B shows an increase in quantity supplied due to an increase in price from OP_1 to OP_2.

A DECREASE IN QUANTITY SUPPLIED

A decrease in quantity supplied refers to a downward movement along the same supply curve due to a decrease in price of a commodity when other factors that affect supply are held constant.

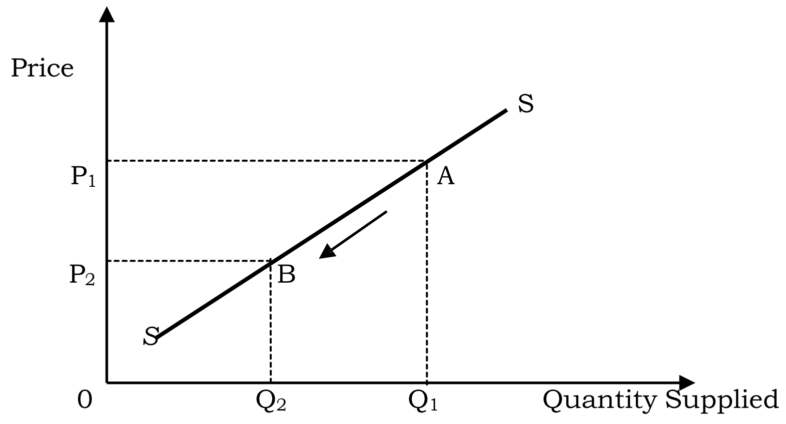


Figure 2.23: a decrease in quantity supplied.

A movement from point A to point B shows a decrease in quantity supplied due to a decrease in price from OP1 to OP2.

CHANGE IN SUPPLY

Change in supply refers to either an increase or a decrease in amount of a commodity supplied due to a change in other factors that affect supply when price of the commodity is held constant.

Or

It refers to an increase or a decrease in quantity supplied of a commodity at a constant price due to a change in other factors that influence supply.

It is illustrated by a shift of the entire supply curve form its original point either to the right or to the left at a constant price.

Price of the commodity in question remains constant but other factors that affect supply change.

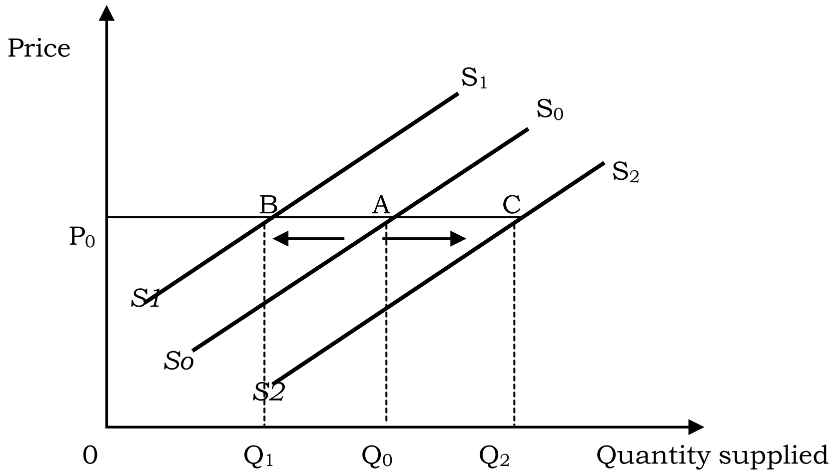


Figure 2.24: change in supply.

A shift in the entire supply curve to the left from SoSo to S1S1 indicates a decrease in supply. A shift of the supply curve to the right from SoSo to S2S2 indicates an increase in supply.

CAUSES OF A CHANGE IN SUPPLY/FACTORS THAT LEAD TO A CHANGE IN SUPPLY

NB. Price of the commodity in question is held constant. Two sided points employing the phrase CHANGE must be presented and explained in two sides showing a positive change in the factor that increase es production leading to an increase in supply and a negative change in the factor that discourages/reduces production leading to a decrease in supply of a commodity.

1. **A change in cost of production.**An increase in cost of production discourages production which leads to a decrease in supply while a decrease in the cost of production encourages production which leads to an increase in supply.
2. **A change in level of technology used in production.** An improvement in the level of technology increases production leading to an increase in supply while a decline in the level of technology reduces production leading to a decrease in supply.
3. **A change in number of producers or suppliers.**A increase in the number of sup[pliers for a commodity increases output leading to an increase in supply while a decrease in the number of suppliers reduces output leading to a decrease in supply.
4. **A change in level of demand/market size for a commodity.** An increase in market size for the commodity encourages production leading to an increase in supply while a decrease in market size for a commodity discourages production leading to a decrease in supply.
5. **A change in gestation period.** An increase in gestation period for commodity leads to low output hence a decrease in supply while a reduction in gestation period leads to high output hence an increase in supply.
6. **A change in objectives of a form/producer.** Sales maximization objective of the firm leads to high output hence an increase in supply while profit maximization objective of the firm leads to low output hence a decrease in supply.
7. **A change in government policy on production or supply of a commodity.** Favourable change in government policy towards supply of a commodity through subsidization and fair indirect taxes leads to an increase in supply while unfavourable change in government policy on supply through high indirect taxes discourages production which leads to a decrease in supply.
8. **A change in availability of factors of production.** An increase in supply of factors of production increases production leading to an

increase in supply while a decrease in supply of factors of production discouraged production leading to a decrease in supply.

9. **A change in natural factors especially in agriculture.** Favourable change in natural factors in agriculture increases production leading to an increase in supply of agricultural products while unfavourable change in natural factors reduces production leading to a decrease in supply.
10. **A change in working conditions.** Favourable change in working conditions increases production leading to an increase in supply while unfavourable change in working conditions reduces production leading to a decrease in supply.
11. **A change in political climate.** An improvement in political climate encourages production leading to an increase in supply while poor political climate discourages production leading to a decrease in supply.
12. **Expectation of future price changes.** Expectation of future price decrease leads to an increase in supply in the present while expectation of future price increase leads to a decrease in supply in the present.
13. **A change in price of jointly supplied good(s)/complementary good(s).** a reduction in price of jointly supplied good leads to an increase in supply of a commodity in question.
14. **A change in price of substitutes/competitively supplied good (s).** an increase in price of substitutes reduces supply of a commodity in question while a decrease in price of substitutes increases supply of a commodity in question at constant price.

UNEB 2012

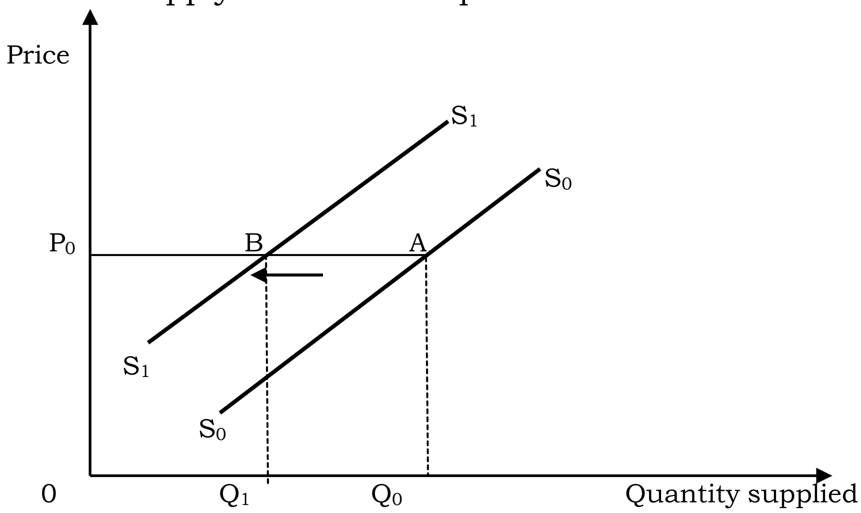
a) *Differentiate between competitive supply and joint supply. (04 marks)*
b) *Explain the conditions that may lead to a decrease in then supply of a commodity in your country. (16 marks)*

A DECREASE IN SUPPLY

A decrease in supply refers to a shift of the supply curve to the left at a constant price due to other factors that affect supply of a commodity.

Or

It refers to a fall in the amount of a commodity supplied due to other factors that affect supply at a constant price.



A shift in the supply curve from S_oS_o to S_1S_1 at a constant price $0P_1$ illustrates an increase in supply.

FACTORS THAT LEAD TO A DCREASE IN SUPPLY OF A COMMODITY.

[price of the commodity in question is held constant but there is appositive or favourable change in other factors that affect supply of a commodity which encourages more production leading to more supply of An increase in demand for a commodity. Arise in demand for a a commodity.]

- An increase in the number of producers/suppliers. Production increases and supply of a commodity as well due to several producers joining the production of a commodity.
- commodity increases production hence an increase in supply at a constant price.
- A decrease in the number of suppliers/producers (exit of some firms from the industry). Where some producers have abandoned production of a commodity. It implies a reduction in production levels and supply reduces at a constant price.
- Government policy on supply of a commodity becoming unfavourable. This is in form of imposing heavy taxation on producers which discourages more production and reduces supply at constant price.
- A decrease in supply of factors of production/a fall in efficiency of factors of production. Where factors of production have become scarce, output and supply reduce at a constant price.
- Increased gestation period of a commodity. Less of a commodity is supplied in the short run at a constant price whenever the commodity requires a long period of time to be produced.
- A decrease in price of complementary good(s)/jointly supplied good(s). a reduction in price of a jointly supplied commodity reduces its supply which also reduces supply of the other commodity in question at a

constant price. For instance a decrease in price of meat reduces its supply which leads to a reduction in supply of hides at a constant price.

- An increase in price substitutes/competitively supplied good(s). where the price of a competing supplied commodity increases, supply of the commodity in question reduces at a constant price since its production is reduced. For example an increase in price of eggs reduces supply of chicken a constant price.
- Goal of the producer changing from sales maximization to profit maximization. Where the objective of a firm changed from sales maximization to profit maximization, it tends to reduce production and supply low quantity at a fixed price.

1 Expectation of future increase in price of a commodity. Where the price of a commodity is expected to increase in future, production in the present is reduced which reduces supply in the present at a constant price.

2 Reduction in the level of technology used in production (a shift from capital intensive technology to poor/labour intensive technology). Less of a commodity is therefore produced at a constant price in case there is a break down in production techniques since it reduces production.

3 Political climate becoming unfavourable/political instability setting in. producers do not concentrate on production activities due to uncertainty for life and property which reduces production leading to a decrease in supply at a constant price.

4 A decrease in demand for a product/fall in market size for a commodity. After the market for a commodity has reduced, production is discouraged and producers supply less of such as commodity at a constant price to avoid incurring losses.

5 Natural factors becoming unfaavourable especially in agriculture. This in form of poor climatic conditions which reduce output hence a decrease in supply of agricultural products at a constant.

6 Breakdown in infrastructure. Where infrastructure breaks down, it discourages production and reduces supply of a commodity at a constant price.

UNEB 2009

a) *Distinguish between increase in supply and an increase in quality supplied. (04 marks)*

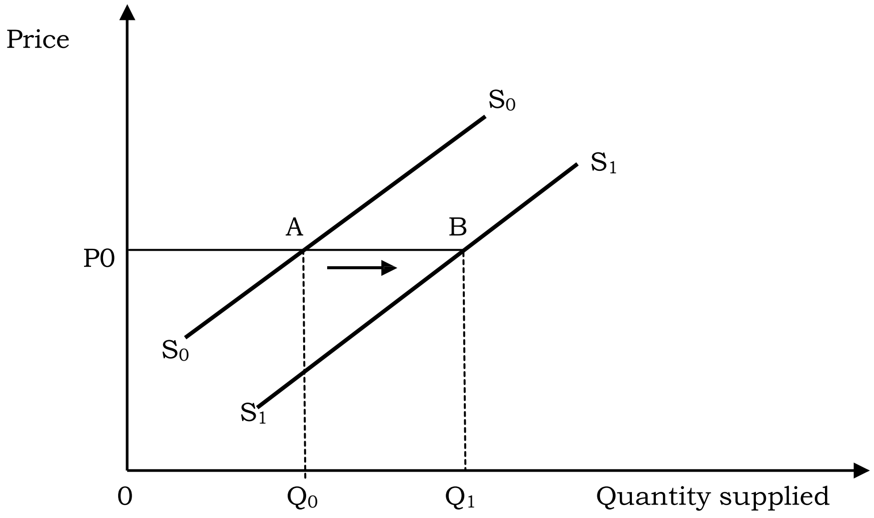
b) *Examine the factors that lead to an increase in supply of a commodity. (16 marks)*

AN INCREASE IN SUPPLY

An increase in supply refers to a shift of the supply curve to the right at a constant price due to other factors that affect supply of a commodity.

Or

It refers to a rise in the amount of a commodity supplied due to other factors that affect supply at a constant price.



Fgure 2.26: An increase in supply.

A Shift in the supply curve from S_oS_o to S_1SS_1 at a constant price OP_1 Illustrates an increase in supply.

FACTORS THAT LEAD TO AN INCREASE IN SUPPLY OF A COMMODITY

(Price of the commodity in question is held constant but there is a positive or favourable change in other factors that affect supply of acommodity which encourages more production leading to more supply of a commodity.

1. **An increase in the number of producers\suppliers.** production increases and supply of acommodity as well due to several producers joining the production of a commodity.
2. **An increase in demand for a commodity.** A rise in demand for a commodity increases production hence an increase insupply at a constant price.
3. **A decrease in cost of production.** Reduction in cost of production makes it cheap to produce more of a commodity and increase supply at aconstant price.
4. **An increase in price of complementary good[s]/jointly supplied good[s].** Where there is an increase in price of jointly supplied commodity,supply of the other commodity in question increase supply of hides at a constant price.
5. **An improvement in the level of technology used in production.** Advancement in production techniques increase production and output leading to high output hence an increase in supply.
6. **Natural factors be coming favorable especially in agriculture.** Climatic conditions and other natural factors be coming favourable especially in agriculture, it becomes easy to increase production and supply at a constant price.
7. **A decrease/fall in price of substitute[s]/competitively supplied good[s].** When the price of competing commodities falls, it becomes less

profitable to supply them hence increasing the supply of a commodity in question whose price has remained constant. forexample a reduction in price of eggs increase supply of chicken at a constant price.

8. **A reduction in gestation period for a commodity.** When gestation period for a commodity becomes short, supply increases in the short run even at a constant price.
9. **A favourable change/improvement in working conditions.** Workers tend to concentrate on production to increase supply when working conditions become favourable in from of good accommodation, medical and transport allowances.
10. **A favourable change in government policy on supply of acommodity.** This is through increased subsidization of producers in production of a commodity which increases production and supply at a constant prices.
11. **Expectation of future decrease in price of the commodity.** When price of a commodity is expected to fall in future, producers release all their output to the market in the present leading to an increase in supply.
12. **Improvement in political climate.** Political climate becoming favourable encourages more production and supply of a commodity as well at a constant price.
13. **Goal of the producer changing from profit maximization to sales maximization.** Where a firm"s objective changes to sales maximization, it increases production and supply at a constant price to benefit from sales revenue.
14. **Improvement in infrastructure development/distribution systems.** Improvement in transport and communication facilities such as roads, railways help to coordinate production and increase supply at a constant price.
15. **Reduced gestation period for a commodity.** This increases supply of a commodity in the short run at a constant price.
16. **Increased availability of factors of production/resources.** This enables increased production at a constant price.

PRICE MECHANISM

Price mechanism is a system in a free enterprise economy where prices in the market are determined by interaction of market forces of demand and supply. Price determines allocation of resources and there is consumer sovereignty.

The government does not influence investors, manufacturers and businessmen on what to produce, when to produce, how much to produce and for whom to produce.

Resource allocation means the way in which scarce factors of production are put to different uses.

Assumptions underlying price mechanism.

- Free entry and exit of firms in production. Higher profits attract new firms and inefficient firms are freen to leave production.
- No government intervention and resource allocation is determined by forces of demand and supply.
- Perfect knowledge of market conditions by both producers and consumers such as knowledge about price of a commodity supplied.
- There is consumer sovereignty i.e the consumer is a king in determining production decisions of producers.
- The aim of producers is to maximize profits and therefore sell goods at a higher price and the aim of the consumers is to maximize utility/satisfaction and therefore buy form the cheapest supplier.
- Existence of many buyers and many sellers implying that there is no monopoly in buying and selling.
- Perfect mobility of factors of production both occupationally and geographically. Factors of production can easily move from where they are less paid to where they are highly paid.

UNEB 2003

a) *What is meant by the term price mechanism?* *(04 marks)*
b) *Explain the role of price mechanism in the allocation of resources in an economy.* *(16 marks)*

UNEB 2011

a) *Explain the role of price mechanism in the allocation of resources in an economy.* *(10 marks)*
b) *Discuss the implications of relying on price mechanism in the allocation of resources in an economy.* *(10 marks)*

UNEB 1997

a) *Examine the role of price mechanism in a free enterprise economy.* *(08 marks)*
b) *What are the merits and demerits of price mechanism?* *(12 marks)*

ROLE OF PRICE MECHANISM IN RESOURCE ALLOCATION

Positive role of price mechanism in a free enterprise economy.

1. **Prices tend to determine when to produce.** Production is only done especially when demand is high reflected by high prices in the market.

2. **Determines what to produce.** This leads to efficient allocation of resources. Production is directed to commodities that fetch high prices in the market and where consumers are able to pay for those commodities.
3. **Enables consumers to buyfrom the cheapest source and maximize utility/promotes consumer sovereignty.** Price mechanism grant consumer utility and they play abig role in what should be produced.
4. **Provides automatic adjustment between demand and supply [how much to produce].** prices help to establish equilibrium between the two forces of demand and supply which helps to prevent over production**.**
5. **Determines income distribution.** Individuals with resources which are highly priced and those who efficiently contribute to production process get income than inefficient producers.
6. **Determines the type of technology to be used in production [how to produce].** This is selected basing on relative factor prices. This implies that commodities which are cheap are produced using very cheap technology.
7. **Prices tend to provide an incentive to economic growth.** Producers whose output is highly priced maximize profits and plough back the abnormal profits made to make inventions and innovations leading to high output.
8. **Determines where to produce/Location of production units.** Whether to produce near the source of raw materials or near the market depend on where it is profitable and where the cost of production is low.
9. **Facilitates competition in production thus better quality products.** Stiff competition is created among producers and this leads to efficiency and production of better quality products to benefit consumers.
10. **Determines distribution of commodities/for whom to produce.** Since producers are profit motivated, they normally produce for consumers who are able to pay high prices for products.

MERITS/POSITIVE IMPLICATIONS OF PRICE MECHANISM IN RESOURCE ALLOCATION

1. **Provides incentives for hard work and efficiency.** This is due to high profit motive due to high competition among producers.
2. **Leads to efficient allocation and utilization of resources,** resources such as land, capital, labour are allocated to produce commodities which fetch high prices and whose demand is high due to high level of competition.
3. **Encourages competition in production thus better quality goods.** Forces of demand and supply are left to interact; firms compete to capture a large market which leads to production of better quality products.
4. **Encourages production of a variety of commodities.** Different types of commodities are produced when their demand and prices are high hence increasing consumer"s choice and standard of living. This means that consumers are able to exercise their choice.

5. **Encourages geographical distribution of commodities/arbitrage.** This benefits producers. Commodities are transferred from areas where prices and demand are low to areas where prices and demand are high.
6. **Encourages research, inventions and innovations which leads to economic growth.** High prices and profits encourage innovations and inventions through research and this leads to technological development so as to maximize more profits through increased output.
7. **Reduces costs of administration because government control is not necessary.** It does not require administrative machinery through price controls since it is automatic.
8. **Commodities are produced according to consumer sovereignty/decentralizes economic powers.** Individual households make their own decisions and what is demanded is what is produced. This leads to maximum satisfaction from a unit of money spent by consumers.
9. **Leads to increased employment opportunities.** This is because of increased economic activities due to free entry of new firms into production.

Hoarding refers to restriction of supply of commodities by producers to create artificial scarcity in order to increase prices.

DEMERITS/NEGATIVE ROLE OF PRICE MECHANISM IN RESOURCE ALLOCATION (DEFECTS/SHORTCOMINGS OF PRICE MECHANISM)

1. **Results into emergence of private monopoly.** Because of no regulatory bodies which are agents of the government to control production,a strong firm may establish itself as a monopolist and over power weak firms leading to monopoly thus high prices.
2. **Leads to consumer exploitation due to ignorance.** Prices determined by forces of demand and supply do not reflect the consumers needs perfectly because consumers are ignorant about some market conditions such as price, quality and quantity of the commodity.
3. **Results into income inequality.** Resources and commodities go to those who paid high prices and stiff competition pushes inefficient firms out of production implying that incomes concentrate in the hands of those with access to factors of production.
4. **Leads to misallocation of resources/leads to disappearance of cheap goods/does not allocate resources to priority areas.** Resources are directed to the production of luxurious commodities demand by the rich who are able to pay high prices and neglects cheap necessary goods demanded by the poor are ignored.
5. **Leads to unemployment problem.** Because of free entry and exit in production, inefficient firms are eliminated from market thus unemployment and some resources whose prices low are likely to remain unemployed.

6. **Leads to wasteful competition and duplication of activities.** This is through expensive advertisements in the process of competing for customers to get high profits. This leads to wastage of resources.
7. **Leads to absence of public goods/does not allocate resources to public utilities.** Public goods such as roads, railways, defence and other nonprofit making enterprises which are vital to the society are ignored since firms aim at profit maximization.
8. **Leads to divergence between social and private benefits.** For instance over exploitation of resources leading to quick depletion.
9. **Leads to economic instabilityies/inflationary tendencies.** Relying heavily on price mechanism results into inflation and its negative effects when there is excessive demand over supply of commodities.
10. **Leads to distortion of consumer's choice.** This is through extensive advertising which confuses consumers on the best options to buy. Consumers are forced to buy what they do not need.
11. **Does not adjust easily to rapid structural changes.** Changes especially during unforeseen circumstances such as wars, floods, famine need quick response/adjustment from the government which is not possible with price mechanism since it cannot easily plan for the future.

REASONS WHY THE GOVERNMENT MAY INTERFERE WITH THE OPERATIONS OF PRICE MNECHANISM OR WHY IS IT NECESSARY FOR GOVERNMENT TO INTERFERE WITH THE OPERATIONS OF PRICE MECHANISM.

Because of defects of price mechanism, government will intervene ion its operations in order:-

- To minimize economic instabilities such as inflation and recession.
- To reduce income inequality.
- To control monopoly tendencies.
- To minimize social costs such as pollution.
- To prevent consumer exploitation due to market imperfections.
- To guide efficient allocation of resources to priority areas.
- To reduce unemployment.
- To effect necessary structural adjustments/changes in an economy.
- To cater for provision of public goods.
- To control wasteful competition and duplication of activities in production.

UNEB 2004

a) *Examine the role of price mechanism in an economy. (10 marks)*
b) *What are the limitations of price mechanism in allocating resources? (10 marks)*

LIMITATIONS OF PRICE MECHANISM IN RESOURCE ALLOCATION

NB. These are given as factors that hinder proper and successful operation of price mechanism but not as negative outcomes of price mechanism**.**

1) **Government intervention/interference.** Usually the government interferes with the functioning of price mechanism through taxation and price control, therefore resources are not fully allocated by forces of demand and supply.
2) **Existence of ignorance in the market.** Consumers and sellers are ignorant about some parts of the market as regards to quality and prices of products, hence price determined under price mechanism may not reflect consumers" or producers" wants perfectly.
3) **Existence of monopolies.** Under price mechanism there is free competition which may push some firms out of production leading to monopoly which interferes with proper operation of price mechanism by restricting output and charging high prices.
4) **Immobility of factors of production.** All factors of production are expected to move freely from one place to another depending on forces of demand and supply, however there are some factors of production which are occupationally and geographically immobile due to limitations of factor mobility.
5) **Inability to forecast future trends.** Price mechanism may not reveal what will happen in future because of lack of proper planning and producers end up supplying less output in situations where prices are high or high output in situations where prices are low.
6) **Limited capital.** Inadequate capital limits all that would be productive enterprises and quantity supplied may not always match with quantity demanded due to inadequate capital which keeps output low.
7) **Limited skilled labour.** Price mechanism requires the level of output to be high and at its best quality to satisfy any existing demand which implies using skilled labour which may be inadequate thus limiting production process.
8) **Existence of poor infrastructure.** Poor infrastructure such as poor roads, poor railway network limit the transfer of resources from one area to another depending on demand and price.
9) **Existence of irrational producers and consumers.** There are some consumers who are not after utility maximization because they do not increase demand when prices are low and there are some producers who are not after profit maximization because they fall to increase supply of commodities in the market when prices are high.
10) **Limited entrepreneurship ability.** Under price mechanism there must be new commodities entering the market now and then which requires entrepreneurs to make innovations and inventions but these

may be in short supply which makes it hard for quantity supplied to be equal to quantity demanded.

NB. Market failure refers to the inability of price mechanism to achieve the best results possible in resource allocation.

HOW TO REDUCE DEFECTS/DEFICIENCIES OF PRICE MECHANISM.

NB. Reducing defects of price mechanism calls for government intervention in the operations of price mechanism in resource allocation implying that market forces of demand and supply in price determination are interfered with.

1. **Formation of consumer associations.** These are meant to educate many consumers on quality and prices of commodities hence reducing consumer ignorance.
2. **Use of progressive taxation.** This involves taxing the rich highly to reduce income inequalities.
3. **Subsidization of weak firms and high cost industries.** Government can subsidize infant and inefficient firms to withstand stiff competition from already existing firms. This is accompanied by encouraging producers to use labour intensive techniques of production to reduce unemployment.
4. **Set up state enterprises to provide cheap services to the public**/ control prices of public goods and establishment of nonprofit making ventures which are vital to the society.
5. **Issuing of costly licenses to producers.** This is meant to minimize social costs and reduce over exploitation of resources.
6. **Proper government planning in order into forecast future needs (structured changes) of the society.** This helps to direct resource allocation and economic growth.
7. **Use of price controls.** This is done through setting minimum and maximize price to protect producers and consumers from exploitation and ensure price stability.
8. **Nationalization of private enterprises.** This helps to control emergence of private monopolies thus, minimizing consumer exploitation.

UNEB 2002

a) Distinguish between price control and price discrimination. *(04 marks)*
b) Examine the merits and demerits of price control in an economy. *(16 marks)*

PRICE CONTROL/LEGISLATION

Price control is fixing or setting of prices of commodities by the government, either maximum price to protect consumers or minimum price to protect producers.

It is an intervention by the government in price mechanism; therefore forces of demand and supply are interfered within price determination.

It can either be maximum price legislation (price ceiling) or minimum price legislation (price floor).

The financial and economic policy package of 1981 in Uganda led to the removal or price controls on trade implying price liberalization which was intended to increase supply of commodities and inputs to ensure sustained stability in general price level. For instance the liberalization of agricultural commodity prices caused the collapse of various marketing boards in Uganda.

MAXIMUM PRICE

Maximum price is price set by the government below equilibrium price above which it becomes illegal for a commodity to be bought or sold. It protects consumers.

The price is usually set below equilibrium price to protect consumers from exploitation by producers through overcharging them.

MAXIMUM PRICE LEGISLATION

Maximum price legislation refers to fixing/setting of prices of commodities by the government below equilibrium price above which it becomes illegal to sell or buy the commodity. It is intended to protect consumers.

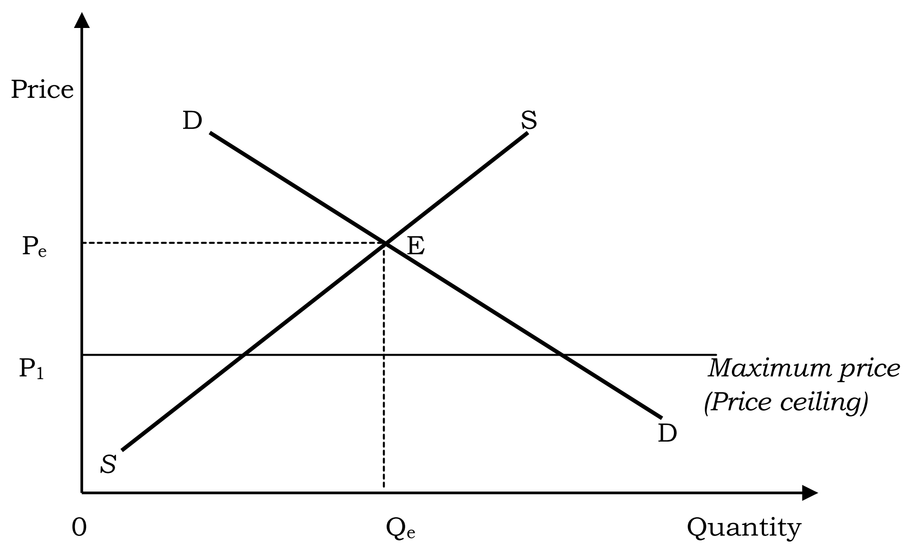


Figure 2.27: Maximum price.

-OPe is the equilibrium price determined by forces of demand and supply.

OP1 is the maximum price fixed by them government below equilibrium price.

MINIMUM PRICE

Minimum price is price set by the government above equilibrium price below which it becomes illegal for a commodity to be bought or sold. It is intended to protect producers.

The price is usually set above equilibrium price to protect producers from exploitation by consumers through underpaying them.

MINIMUM PRICE LEGISLATION

Minimum price legislation refers to fixing/setting of prices of commodities by the government above equilibrium price below which it becomes illegal to buy or sell the commodity. It is intended to protect producers.

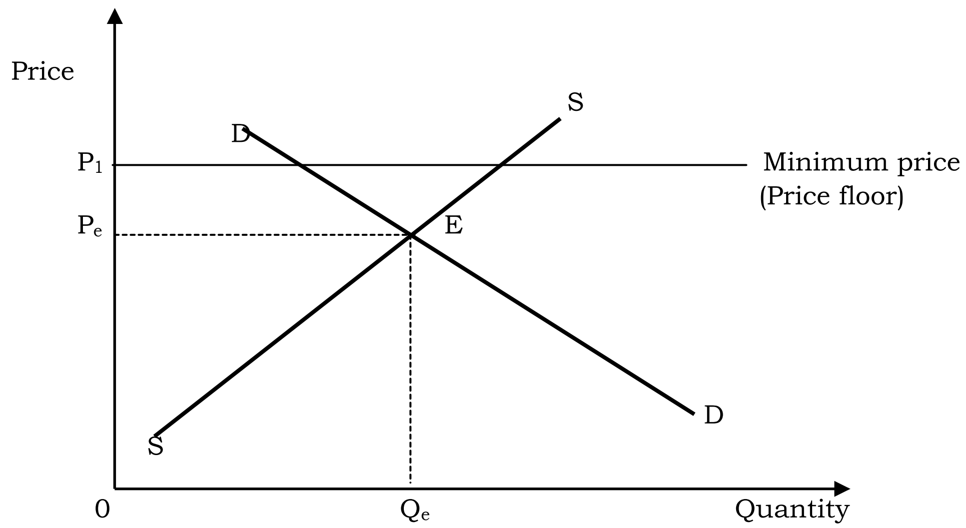


Figure 2.28: Minimum price.

-OP_e is the equilibrium price determined by forces of demand and supply.

-OP_1 is the minimum price set by the government above equilibrium price.

NB. Price support is where government buys surplus output on the market arising from fixing a minimum price. It aims at supporting a minimum price/ producers.

UNEB 2001

a) Distinguish between price ceiling and price floor. (04 marks)
b) Explain the effects of price control in an economy. (16 marks)

UNEB 2000

a) Distinguish between price control and price support. (04 marks)
b) Examine the merits and demerits of price control in an economy (16 marks)

UNEB 1998

a) *Differentiate between maximum price and minimum price legislation (04 marks)*

b) *Examine the merits and demerits of government price control. (14 marks)*

ADVANTAGES/POSITIVE EFFECTS OR IMPACT OF PRICE CONTROL IN AN ECONOMY

NB. Explaining or stating the point is justified by either minimum or maximum price.

1. **Price stability is maintained.** Then government fixes prices considered to be fair for both producers and consumers and therefore prices remain stable which helps to control inflation.
2. **Restricts monopoly powers.** The government fixes a maximum price which is below what a monopolist charges to reduce the level of profits.
3. **Protects consumers from exploitation by producers who may wish to charge high prices to maximize profits.** This is achieved by setting a maximum price especially during scarcity of essential goods.
4. **Protects producers from exploitation by consumers.** This is through fixing a minimum price which is a fair price to producers.
5. **Leads to increase in output.** Supply increases through fixing a minimum price which encourages more production leading to economic growth.
6. **Helps to establish industrial peace.** Minimum price can impact on the level of wage paid to labour and if the price of labour is also fixed through a minimum wage, it reduces the would ne strikes by workers demanding for higher wages.
7. **Helps producers to realize stable incomes.** Fluctuations in incomes of producers are minimized since producers are protected by minimum price.
8. **Helps to offset an economic depression.** Inorder to influence high level of economic activities, the government sets a minimum price to eliminate a depression thus increases employment, prices and incomes.
9. **Reduces income inequality.** This is achieved by setting a maximum price which doesnot highly benefit producers at the expense of consumers.
10. **Discourages production and consumption of harmful/undesirable commodities.** The government fixes a minimum price to reduce demand for commodities such as marijuana since such price is high and scares away buyers.
11. **Helps to make essential goods available to all groups of people such as soap, salt.** This is achieved by setting a maximum price which is affordable by majority of the consumers which leads to higher standard of living.

REASONS FOR SETTING A MINIMUM PRICE IN AN ECONOMY/WHY IS IT NECESSARY FOR GOVERNMENT TO SET/ENFORCE A MINIMUM PRICE IN AN ECONOMY

- To maintain price stability.
- To protect producers from exploitation by consumers through underpaying.
- To increase output.
- To establish industrial peace.
- To ensure stability in incomes of producers.
- To offset an economic depression.
- To discourage consumption of undesirable and harmful commodities.

REASONS FOR SETTING A MAXIMUM PRICE IN AN ECONOMY/WHY IS IT NECESSARY FOR GOVERNMENT TO SET/ENFORCE A MAXIMUM PRICE IN AN ECONOMY

- To maintain price stability. This helps to control inflation.
- To restrict monopoly powers.
- To make essential goods available to all groups of people.
- To protect consumers from exploitation by producers who may wish to charge high prices to maximize profits.
- To reduce income inequality.

DEMERITS (NEGATIVE EFFECTS OR IMPACTS) OF PRICE CONTROL IN AN ECONOMY.

NB. Explaining or stating the point is justified by either minimum or maximum price.

1. **Results into storage problems due to unmanageable surpluses.** There is excess production of goods and services in case of a minimum price which leads to unmanageable surpluses.

2. **Reduces investment due to reduced incentives for private entrepreneurs.** maximum price is a low price in the market which discourages producers and slows down economic growth.

3. **Results into unemployment.** A maximum price forces producers to reduce the level of investment by laying off workers thus reducing employment opportunities.

4. **Leads to shortages in supply on the market.** A maximum price increases demand and reduces supply of commodities in the market.

5. **Leads to inefficient allocation of resources.** i.e. doesn"t allow price mechanism to operate freely in resource allocation. Maximum price forces producers to get engaged in production of commodities which have less or no price controls.

6. **It is expensive for government to enforce.** High administrative costs are likely to be incurred by the government in ensuring proper operation of a maximum price.

7. **Encourages trade malpractices.** Maximum price encourages sellers, hoard commodities, smuggle goods to sell them in foreign markets which creates artificial shortages of goods in the local market.

8. **Leads to increased costs of production.** Where prices of factor inputs are fixed high and setting a maximum price which may not be enough for producers to meet costs of production increases the cost of operating business.

9. **Leads to production at excess capacity.** Producers are not ready to expand production due to low prices resulting from setting a maximum price leading to underutilization of resources.

10. **Leads to reduction in social welfare.** Minimum price reduces the real income of consumer"s high cost of living and a reduction in standard of living.

UNEB 2010

a) Distinguish between maximum and minimum price legislation. (04 marks)
b) Why may the use of price controls be avoided in an economy. (16 marks)

WHY MAY THE USE OF PRICE CONTROLS BE AVOIDED IN AN ECONOMY.

- Fear of causing shortages in supply by discouraging production.
- To avoid unmanageable surpluses and storage problems.
- Fear of causing production at excess capacity/under utilization of resources.
- To avoid causing trade malpractices/black markets.
- Fear of raising costs of production.
- Fear of causing unemployment/to avoid unemployment.
- To avoid discouraging investment.
- To avoid high administrative costs on these price controls.
- Fear of reducing social welfare of people through high cost of living.
- To avoid unnecessary distortion of price mechanism which may lead to misallocation of resources.

PRICE FLUCTUATIONS

Price fluctuations are changes in prices in form of an increase or a decrease over a period of time because of changes in demand and supply in the market which is not controlled. This normally happens due to shortages or excessive supply of commodities especially in a market which is not controlled.

UNEB 2015

a) *Account for the price fluctuation of agricultural products in an economy. (10 marks)*

b) *Suggest measures that should be taken to stablise prices of agricultural products in an economy. (10 marks)*

UNEB 2014

a) *Why is there a need to stabilise prices of agricultural products in an economy? (08 marks)*

b) *Describe the measures that should be adopted to stabilise prices of agricultural products in developing countries. (12 marks)*

UNEB 2001

a) *Explain the causes of agricultural price fluctuations in your country. (12 marks)*

b) *What are the effects of such price fluctuations in your country. (08 marks)r*

UNEB 2012

a) *Why do prices of agricultural products fluctuate. (10 marks)*

b) *What are the effects of agricultural price fluctuations on an economy. (10 marks)*

UNEB 1997

a) *Explain the causes of agricultural price fluctuations in your country. (12 marks)*

b) *What measures can be taken to solve this problem. (08 marks)*

CAUSES/REASONS FOR PRICE FLUCTUATIONS OF AGRICULTURAL PRODUCTS IN AN ECONOMY

NB. One should clearly show an element of prices increasing (high prices) and falling (low prices) in the process of explaining the points given. Balanced explanation must be given showing an upward trend and downward trend in prices.

1. **Divergence between planned and actual oputput levels.** Its difficult to match planned and actual output levels so shortages result into high prices and surpluses result into low prices. When actual output is less than planned output, supply reduces and price increases but when actual output is greater than planned output, supply increases and price falls.

2. **Inelastic demand/low price elasticity of demand for agricultural products.** Demand for agricultural products especially food stuffs is inelastic which means whether price is high or low. Demand is almost the same. Therefore, during surplus output, prices fall while during shortages in output, prices increase.

3. **Long gestation period for agricultural products.** When prices are high producers plan to produce more output but this takes a longtime, so in the short run prices remain high and in the next period there is over production which leads to a fall in prices.

4. **Perishability of agricultural products thus problems of storage.** Agricultural products are perishable and cannot be stored for along period of time thus prices are low during harvest time due to high output and during non harvest periods there are several shortages and prices increase.

5. **Bulkiness of agricultural products and difficult to transport.** This makes them difficult to transport from places where they are in plenty and at low prices to places where they are scarce and at high prices. Therefore in areas of scarcity, prices are high and in areas of abundant supply, prices are low.

6. **Natural factors which affect the level of output/heavy dependence on nature.** Agriculture depends on natural factors, when natural factors are favourable, agricultural output increases hence low prices while when natural factors are unfavourable agricultural output reduces hence high prices.

7. **Unplanned production by many agricultural producers/farmers.** Agriculture is carried out by many farmers who are uneducated and therefore difficult to mobilize to plan production and stabilize prices. It becomes difficult to plan and make actual predictions leading to high output and low prices in some periods while low output in other periods leads to high prices.

8. **High competition from synthetic fibres/artificial substitutes on the world market.** Agricultural products have restricted market on the world market due to competition from artificial substitutes and this becomes difficult to dispose off surplus output hence low prices while during shortages in output, prices increase. For instance cotton and sisal compete against synthetics such as nylon, silk and polythene.

9. **Weak bargaining power on the world market/external determination of prices.** Prices of agricultural exports are dictated by major external buyers/developed countries implying that during periods of excessive output prices fall while during periods of low output prices increase.

10. **Poor surplus disposal machinery/system.** There are transport problems to allow arbitrage, shortage of storage facilities such as warehouses to accommodate surplus output for sale in periods of scarcity and high prices. This leaves prices to increase during excessive output in some areas while prices reduce during scarcity of output.

11. **Changes in costs of production.** A rise in the costs of production reduces agricultural output and prices increase but a decrease in cost of production expands agricultural output and prices fall.

12. **Low income elasticity of demand for agricultural products.** When people"s incomes increase, they continue consuming almost the same quantity of such products such as foodstuff. This means that surplus output cannot be easily absorbed implying that during periods of high out prices fall and during periods of low output, prices increase.

13. **Agricultural products form a small part of inputs in manufactured goods.** This means that excess supply cannot be absorbed in the manufacturing industry which leads to low prices during excessive output for example rubber forms a very small part of car compared to steel.

EFFECTS OF AGRICULTURAL PRICE FLUCTUATION ON AN ECONOMY

1. **Leads to instability/fluctuations in incomes of farmers.** It makes it difficult for producers to determine how much they will earn in the next period because incomes increase when prices are high and reduce when prices are low.
2. **Leads to fluctuations/instability in government tax revenue.** Taxes collected from farmers have to vary as prices of their produce vary. Taxes increase during high prices and reduce during low prices.
3. **Causes unstable foreign exchange earnings.** Foreign exchange earnings keep fluctuating as prices of exports fluctuate. During high prices for exports, earnings form such exports increase and during low prices for exports, earnings from such exports reduce.
4. **Causes balance of payment instabilities.** Total earnings from abroad on agricultural exports keep fluctuating thus disequilibrium in balance of payment position.
5. **Causes instabilities/influctuations in Gross domestic product.** Agriculture contributes greatly to GDP but this keeps changing form year to year depending on changes in prices of agricultural products.
6. **Investment in agriculture becomes uncertain.** Fluctuation in prices breeds inefficient/irrational use of land as farmers change form one crop to another depending on changes in prices for agricultural produce.
7. **Results into seasonal unemployment/instability in employment levels.** Because of price fluctuations, farmers at times plan to reduce

output and lay off some farmers in given seasons when price is expected to be low.

8. **Worsens income inequality between farmers and industrial producers.** Farmers incomes keep lagging behind as compared to those of their counter parts in other sectors such as industrial production.
9. **Leads to difficulty in planning on the side of government.** It becomes difficult for government to plan properly basing on expected earnings form the sector.
10. **Leads to unstable/deteriorating terms of trade.** As prices of agricultural products fluctuate, quantities of exports that are exchanged for imports fluctuate leading to unstable terms of trade.
11. **Encourages rural urban migration and its negative effects.** Due to poor agricultural performance, farmers in rural areas can even give up the production and migrate to urban areas for other businesses especially when prices have reduced sharply.
12. **Leads to instabilities in exchange rates.** As prices of agricultural exports keep on changing, fluctuations in exchange rates result.

MEASURES TO REDUCE PRICE FLUCTUATIONS OF AGRICULTURAL PRODUCTS.

1. **Use of price control.** This is the fixing of a minimum or maximum price for such products by the government to keep prices stable.
2. **Improving storage facilities.** More storage facilities for agricultural output help to stabilize supply and consequently price stability.
3. **Encouraging diversification in agriculture.** Farmers through the government should be helped to reduce dependence on a few crops and promote venturing in production of a variety of crops to enable farmers earn income from a variety of products thus reducing effects of price fluctuations.
4. **Improving transport systems.** This involves extending railways, roads to areas of production to help in transporting agricultural products from areas of plenty and low prices to areas of scarcity and high prices.
5. **Use of price support.** This is where the government buys surplus output on the market arising from mixing a minimum price with the aim of supporting producers.

   Farmers sell their products at the market price and then present their receipts to the government which pays them the difference between the market price and the price which government considers being realistic to farmers.
6. **Strengthening international commodity agreements.** Countries should organize themselves for the case of export crops and formulate policies such as fixing quotas and price for agricultural exports. For example Uganda is a member of international coffee agreement.

7. **Use of stabilization fund.** Amount of money is kept in periods of high prices and this is used to compensate farmers in periods of low prices to stabilize their income. The government through marketing boards make profits and keep part of it as a stabilization fund. This fund is used to stabilize prices or incomes of farmers in periods when prices in the market are low.
8. **Operation of buffer stocks.** This is where surplus produce is bought by marketing boards (government agencies) and stored when supply is in plenty and released to the market in periods of scarcity to avoid fluctuations in supply and prices. This creates an accumulated stock of output which stabilizes supply, prices and income.
9. **Modernization of agriculture by improving technology.** This is through use of fertilizers, irrigation practices, mechanization to reduce over reliance on weather and other natural factors to stabilize supply and price and increase the quality of agricultural products.
10. **Process agricultural products to add value/establishment of agro based industries.** Processing agricultural commodities helps to reduce on their bulkiness and stabilize their prices. Adding value to agricultural products stabilizes prices on the world market.
11. **Expand market through encouraging economic integration.** This helps to absorb surplus agricultural output in expanded foreign markets such as EAC, COMESA. This leads to stable and higher prices.

NB. International commodity agreements are set up by buyers and producers to fix prices and quotas for a particular commodity in order to stabilize prices and incomes of producers.

This helps to ensure a stable market, stable prices, stabilizes supply and improves quality of output. This in this long-run improves terms of trade for the producer country.For instanceinternational coffee organization, international cocoa organization, international tea promotion association, OPEC.

OBJECTIVES OF INTERNATIONAL COMMODITY AGREEMENSTS.

- To stabilize prices of primary products.
- To regulate supply of commodities.
- To improve terms of trade of producing countries.
- To stabilize revenue of farmers/export earnings of producers.
- To promote cooperation between importing exporting countries.
- To increase bargaining power of producing countries for fair prices on the world market.

Advantages of buffer stock

- Stabilizes producer‟s revenue.
- Allows proper planning in agriculture basing on stable incomes.
- Minimizes price fluctuations.
- Stabilizes supply of output.

Advantages of stabilization fund

1) Stabilizes revenue/income of producers/farmers.
2) Leads to greater output produced because the government continues to pay a reasonable price even when it would have been low.
3) Reduces price fluctuations for agricultural products.

THE CONCEPT OF ELASTICITY.

Elasticity is defined as the measure of the degree of responsiveness of dependent variables to independent variables. It is a measure of percentage change in one variable in respect to the percentage change in another variable. In this case dependent variable include:-

1. Quantity demanded.
2. Quantity supplied.

While independent variables include the factors that influence the above dependent variables. These are the factors that influence quantity demanded or quantity supplied of a commodity such as price of a commodity.

1. Elasticity of demand
2. Elasticity of supply

UNEB 2010

(i) What is meant by the term elasticity of demand (01 marks)
(ii) Mention any three factors which determine elasticity of demand for a commodity. (03 marks)

EASTICITY OF DEMAND

Elasticity of demand is defined as the measure of the degree of responsiveness of quantity demanded of commodity due to changes in factors affecting demand for that commodity.

Or

It refers to the ratio of change in demand for a commodity to change in the factors that affect demand such factors may include price of the commodity, income of the consumer, price of related commodities.

Elasticity of demand can be described as.

1. Price elasticity of demand.
2. Income elasticity of demand.
3. Cross elasticity of demand.
4. Point elasticity of demand.
5. Arc elasticity of demand.

PRICE ELASTCITY OF DEMAND

Price elasticity of demand is the measure of degree of responsiveness of quantity demanded of a commodity due to changes in price of that commodity.

Or

It is the ratio of percentage change in quantity demanded of a commodity to the percentage change in the price of the commodity in question.

It can be expressed in the formula.

$$\text{Price elasticity of demand} = (-)\frac{\%\text{change in quantity demanded.}}{\%\text{ changes in price of the commodity}}$$

$$PED = \frac{\%\Delta Q}{\%\Delta P} \quad \text{or} \quad PED = \frac{\Delta Q}{\Delta P} \times \frac{OP}{OQ}$$

Where ΔQ= change in quantity demanded for a commodity, ΔP= change in price of the commodity, OQ= original quantity demanded of the same commodity, OP=Original price of the same commodity. NB. Price elasticity of demand does not have units.

- A negative is multiplied in the formula to make the answer positive otherwise, the formula would always give a negative answer implying a negative slope of the demand curve and this would make interpretation of price elasticity of demand difficult.

UNEB 2012

(i) Given that an increase in the price of commodity x from shillings 1500 to shillings 1800 resulted into a change in quantity demanded for commodity y from 600 units to 570 units, calculate the cross elasticity of demand.

(02 marks)

(ii) State the relationship between commodities x and y. (02 marks)

Examinable examples.

- The price of the commodity reduced from shillings 15 to shillings 5 and quantity demanded of the same commodity increased from 2kgs to 4kgs. Calculate price elasticity of demand.

Price elasticity of demand=(-)ΔQ/ΔPXOP/OQ

(-)4-2/5-15X15/2.

(-)2/-10X15/2

(-)-1.5

<u>PED=1.5</u>

- The price of the commodity increased from shillings 800 per kg to shillings 1,000perkg and this resulted into a reduction in quantity demanded from 500kgs to 400kgs. Calculate price elasticity of demand.price elasticity of demand=(-) ΔQ/ΔPXOP/OQ

(-)400-500/1000-800X800/500

(-) -100/200x800/500

(-)-1/2x8/5

(-)-0.8

PED = 0.8

3. The price of the commodity increased by 25% which resulted into a reduction in quantity demanded of the commodity form 25kgs to 15kgs. Calculate price elasticity of demand.

Price elasticity of demand= $\frac{(-)\ \%\ change\ in\ quantity\ demanded}{\%\ change\ in\ price\ of\ the\ com\mathrm{mod}\,ity}$

(-)15-25/25x100/25%

(-)-10/25x100/25%

(-)-40%/25%

(-)-1.6

PED =1.6

INTERPRETATION OF PRICE ELASTICITY OF DEMAND/CATEGORIZATION OF PRICE ELASTICITY OF DEMAND

Price elasticity of demand is described according to the answer obtained using the formula for price elasticity. It ranges from zero to infinity.

i) Elastic demand

Elastic demand is where price elasticity of demand is greater than one but less than infinity.

Or

This is where a very small percentage change in price results into a very big percentage change in quantity demanded of a commodity. For instance demand for substitutes.

Price elasticity of demand is greater than one but less than infinity i.e. between one and infinity.

1 <PED< Infinity. Price elasticity of demand is very high.

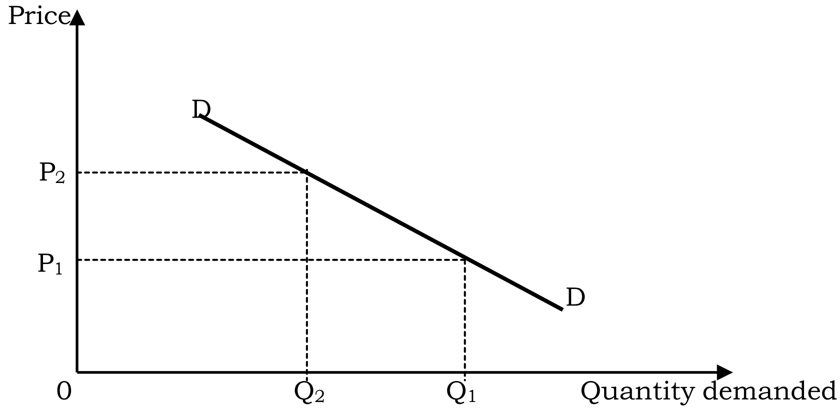


Figure 2.29: elastic demand curve.

A small change in price from OP_1 to OP_2 leads to a proportionately greater change in quantity demanded from OQ_1 to OQ_2.

ii) Inelastic demand

Inelastic demand is where price elasticity of demand is less than one but greater than zero.

Or

This is where a very big percentage change in price results into a very small percentage change in quantity demanded of a commodity.

$O< PED<1$.price elasticity of demand is very low.

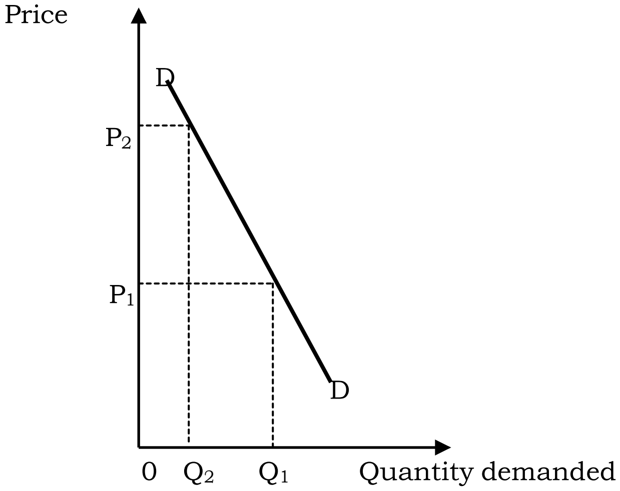


Figure 2.30: Inelastic demand curve.

A big percentage change in price from OP_1 to OP_2 leads to a smaller percentage change in quantity demanded from OQ_1 to OQ_2.

iii) Perfectly elastic demand.

Perfectly elastic demand is where price elasticity of demand is equal to infinity implying that a given constant price, any quantity of a commodity is demanded.

This is where buyers are prepared to purchase all the output that is made available on the market at a given price. Price elastciiy of demand is equal to infinity.

PED = Infinity.

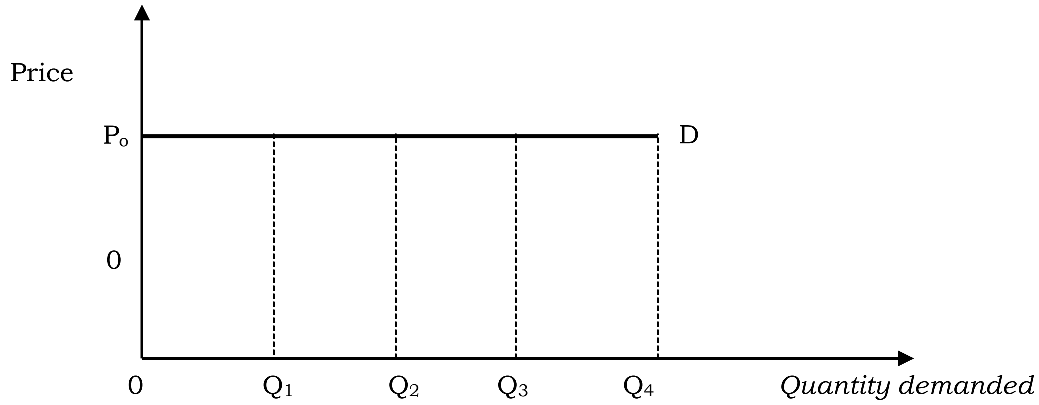


Figure 2.31: perfectly elastic demand curve.

At price OP_0 buyers purchase indefinitely i.e. OQ_1, OQ_2, OQ_3 and OQ_4.

iv) Perfectly inelastic demand.

Perfectly inelastic demand is where price elasticity of demand is equal to zero. **Or**

It means that a given percentage change in price doesnot cause any percentage change in quantity demanded of a commodity.

This is where quantity demanded does not respond to changes in price at all. Price changes do not cause any change in quantity demanded. Price elasticity of demand is equal to zero. PED=O.

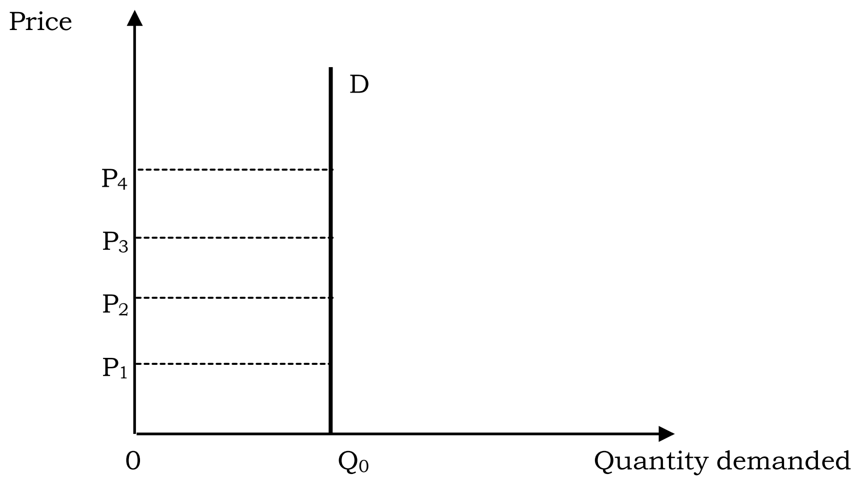


Figure 2.32: perfectly inelastic supply curve.

Changes in price from OP_1 toOP_2, to OP_3 upto OP_4 leave quantity demanded OQo unchanged.

v) Unitary elasticity of demand.

Unitary elasticity of demand is where price elasticity of demand is equal to one. **Or**

This is where a given percentage change in price causes exact equal percentage change in quantity demanded of a commodity. One percentage change in price results into one percentage change in quantity demanded. PED =1.

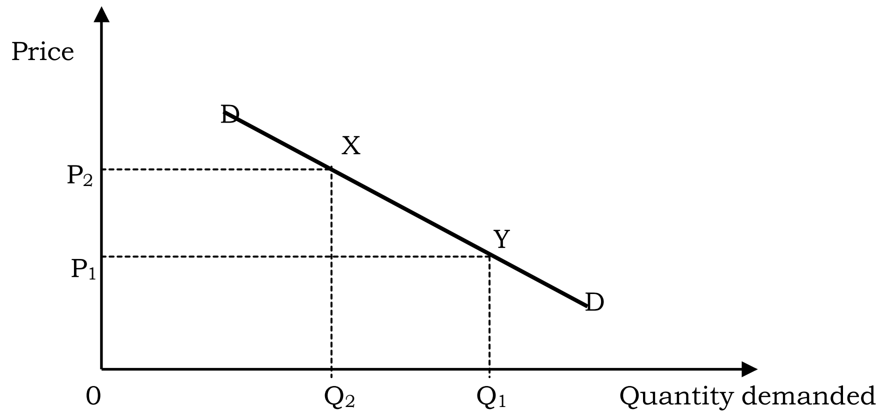


Figure 2.33: Unitary elasticity of demand.

Quantity demanded OQ_1-OQ_2 changes exactly by the same percentage with the price OP_1-OP_2.

$OP_1YQ_1=OP_2XQ_2$.

UNEB 2005

a) *Distinguish between price elasticity of demand and income elasticity of demand. (04 marks)*

b) *Explain the factors that influence price elasticity of demand. (16 marks)*

DETERMINANTS OF PRICE ELASTICITY OF DEMAND/FACTORS THAT INFLUENCE/AFFECT PRICE ELASTICITY OF DEMAND

NB. Neutral points must be presented and explanation for each point should clearly show elastic demand and inelastic demand.

1. **Time period.** In the short run, demand for a commodity tend to de inelastic because time is too short for the consumers to make adjustments from one commodity to another, but in the longrun a commodity has elastic demand because consumers have got enough time to adjust from one commodity to another.
2. **Level of consumer's income.** Ceteris paribus, high income consumers respond less to price changes hence inelastic demand but low income earners are too sensitive to price changes and any slight increase in p[rice makes them not afford the commodity hence elastic demand.
3. **Degree of necessity of a commodity.** Price elasticity of demand for a necessary tends to be inelastic because it is indispensable for instance food, salt. However a luxurious commodity is dispensable and has elastic demand because the consumers can do without it.
4. **Availability/possibility of substitutes.** A commodity with many substitutes has elastic demand because when price increases consumers shift to substitutes immediately while a commodity with few or no substitutes tends to have inelastic demand.
5. **Availability of complements/complementarities between goods.** A commodity that is used with other commodities tends to have inelastic demand provided one has already been bought for example demand for

fuel may not reduce even if price increases provided people still use vehicles. However a commodity that does not go hand in hand with others has elastic demand.

6. **Proportion of consumer's income spent on a commodity.** A commodity which takes a small fraction of the consumer‟s income tends to be price inelastic for instance match box, needles, razorblades because consumers tend not to feel an effect of an increase in price whereas a commodity which takes a large percentage of the consumer‟s income tends to be price elastic when price changes.
7. **Level of convenience in acquiring a commodity.** A commodity that is more convenient and easy to acquire by consumers tends to have inelastic demand for example a commodity sold in the school canteen or next door to your home. However a commodity that cannot easily be acquired by consumers has elastic demand since they have to walk long distances to acquire it.
8. **Degree of habit/addiction in the use of a commodity.** A commodity consumed out of habit/addiction has inelastic demand for instance demand for cigarettes among hard core smokers because consumers feel they cannot do without them but where a consumer who is not addicted to consumption of a commodity, its demand becomes price elastic.
9. **Level of advertising/level of awareness of availability of cheaper goods.** High level of advertising through persuasive/intensive advertising for a commodity leads to inelastic demand while low level of advertising leads to elastic demand.
10. **Level of durability/perishability of a commodity.** A durable commodity such as a radio, a television has inelastic demand because even if price of such a commodity falls by a big margin one may not buy another one when he already has one while a perishable commodity has elastic demand since consumers buy more when price falls.
11. **Expectation/speculation about future price changes.** If price of the commodity is expected to increase in future, demand becomes inelastic in the present because consumers prefer to buy now well knowing that the price would be higher in future. However if price is expected to fall in future, demand would be elastic in the present because consumers buy less today and expect to buy more at a lower price in future.
12. **Number of uses of a commodity.** A commodity with several uses has elastic demand such as electricity because when price increases consumers use it for only few vital purposes and as price reduces a commodity can be put to many uses as possible. However a commodity with very few uses tends to have inelastic demand because as price changes quantity demanded remains almost the same.
13. **Level of consumer's ignorance/consumer's knowledge about the market.** Consumers buy a commodity at a higher price when they are ignorant without perfect knowledge about market conditions and this

leads to inelastic demand while informed consumers with perfect knowledge about market conditions have elastic demand.

14. **Season of the commodity.** During a favourable season for a commodity, its demand is inelastic while during unfavourable season for a commodity. Its demand becomes elastic.
15. **Possibility of postponement of demand for a commodity.** A commodity whose demand can easily be postponed has elastic demand while a commodity whose demand cannot be postponed has inelastic demand.

UNEB 2015

(i) *Define the term income elasticity of demand* *(01 marks)*
(ii) *Given that an increase in the income of a consumer from Shs25,000 to Shs40,000 resulted in a change in demand for a commodity from 780 units to 600 units, calculate the income elasticity of demand.* *(03 marks)*

UNEB 2004

i) *Distinguish between income elasticity of demand and price elasticity of demand.* *(02 marks)*
ii) *State any two uses of the concept of price elasticity of demand in your country.*

(02 marks)

APPLICABILITY IMPORTANCE/USES OF PRICE ELASTICITY OF DEMAND

Price elasticity of demand is important to three categories of people.

1. **The producer.**
2. **The government**
3. **The consumer**

a) IMPORTANCE/USES OF PRICE ELASTICITY OF DEMAND TO THE PRODUCER

NB. Explanation should clearly show elastic and inelastic demand.

1. **Helps the producer in price and revenue determination for his commodity.** The producer charges a high price on his goods whose demand is inelastic and gains more revenue and a lower price is charged on goods with elastic demand in order to sell as much output as possible and earn more revenue.
2. **Helps the producer who is a monopolist to carryout price discrimination.** This is possible when the market is divided into sub markets with different elasticities. In a market where demand for a commodity is inelastic, the monopolist charges a high price but in a market where demand for the same commodity is elastic, the monopolist charges a lower price.

3. **Helps the producer to determine wages for workers.** If demand for the commodity produced by labour is elastic, wages become low but if demand for products produced by labour is inelastic wages paid to such labour tend to be high.
4. **Helps the producer to determine the degree of advertising.** If price elasticity of demand for a commodity is elastic, the producer undertakes massive advertising but if demand for a commodity is inelastic, the producer undertakes informative advertising.
5. **Helps the producer to determine tax incidence.** If the producer is producing a commodity with inelastic demand, a very big percentage of the tax is shifted to the consumer in form of high prices and a producer shifts a small percentage of the tax to consumers where demand is elastic.
6. **Helps the producer to determine how much to supply on the market.** A producer supplies less of a commodity where demand is inelastic to gain more revenue and more is supplied where demand is elastic to increase sales and gain more revenue.

b) IMPORTANCE/USES OF PRICE ELASTICITY OF DEMAND TO THE GOVERNMENT.

NB. Explanation should clearly show elastic and inelastic demand.

1. **Helps the government in formulation of taxation policies.** The government raises more revenue by charging high taxes on commodities with inelastic demand because consumers almost buy the same quantity as price increases and the government charges low taxes on commodities with elastic demand to avoid increment in price which reduces demand.
2. **Helps the government in formulation of devaluation policy.** For devaluation to be successful, price elasticity of demand for both imports and exports should be price elastic. This increases foreign exchange earnings from exports and reduces foreign exchange expenditure on imports.
3. **Helps the government in subsidization policy on industries.** The government subsidizes highly producers of commodities with elastic demand in order to attract customers and producers of commodities within inelastic demand are not highly subsidized since their commodities are demanded even at high prices.
4. **Helps government in determining wages.** The government pays high wages to labour with inelastic demand while low wages are offered to labour with elastic demand.
5. **It is helpful in determining tax incidence.** Where demand is price elastic, the producer bears a big burden of the tax and where demand is inelastic, the customer bears a big burden of the tax.

c) IMPORTANCE/USES OF PRICE ELASTICITY OF DEMAND TO CONSUMERS

1. **Helps the customer in planning for his expenditure decisions.** Where demand is inelastic, the consumer budgets for a greater expenditure since the commodity is either a necessity or has no close substitutes are usually have many substitutes.

2. **Helps the consumer to determine how much of a tax is to be paid.** A consumer pays a high tax on a commodity with inelastic demand while a low tax is paid on a commodity with elastic demand.

UNEB 2009

(i) Define the term income elasticity of demand. (01 marks)
(ii) State any three uses of income elasticity of demand in your country. (03 marks)

INCOME ELASTICITY OF DEMAND

Income elasticity of demand is the degree of responsiveness of quantity demanded of a commodity due to a change in consumer"s income.

It is given by-

$$\frac{\text{\%change in quantity demanded.}}{\text{\%change in income of the consumer.}}$$

Or $YED = \dfrac{\Delta Q/OQ X100}{\Delta Y/OY X100}$

Or $\Delta Q/YXOY/OQ$.

Where ΔQ = change in quantity, OY =original income, OQ=original quantity and ΔY=change in income.

Interpretation of income elasticity of demand.

- If income elasticity of demand is positive, the commodity in question is said to be a normal good. As income increases, quantity demanded also increases.
- If income elasticity of demand is negative, it means that the commodity in question is an inferior good. As income increases, less of the commodity is demanded.
- If income elasticity of demand is equal to zero, it means that the commodity in question is a necessity. As income increases or decreases, quantity demanded remains constant.

Examinable examples

1. The income of Mr. Stephen increased from shillings 25,000 to shillings 30,000 and quantity demanded reduced from 900kg to 600kg.
   a) Calculate income elasticity of demand.
   b) What is the nature of the commodity and give a reason for your answer?

1. Income elasticity of demand =ΔQ/ΔYXOY/OQ

600-900/30000-

25000x25000/900

-300/500x25000/900.

-1/3x5/1

YED=-1.65

2. The commodity is an inferior good.

Because quantity demanded reduces as the consumer‟s income incre3ases.

2. Mr. Stephen originally demanded 5bars of soap when his income was shillings 5,000 and when his income increased to shillings 20,000 quantity demanded remained constant at 5bars.

(i) Calculate income elasticity of demand.

ii) Specify the nature of the commodity.

Income elasticity of demand =ΔQ/ΔYXOY/OQ

5-5/20000-5000X5000/5

YED=0/15000X5000/5

0X1000=0

YED = 0

The commodity is a necessity because change in income of the consumer does not affect quantity demanded.

3. Given that the consumer‟s income increased from shs 5,000 to shs 8,000permonth leading to an increase in quantity demanded for the commodity by 10%.

i) Calculate income elasticity of demand.
ii) Specify what commodity is this by giving a reason.

1. Income elasticity of demand=ΔQ/OQX100/ΔY/OYX100

10%/8000-5000/5000X100

10%/3000/5000X100

10%/60%

YED=0.16.

The commodity in question is a normal good since an increase in consumer"s income leads to an increase in quantity demanded.

IMPORTANCE OF INCOME ELASTICITY OF DEMAND.

- Helps to distinguish different types of commodities/nature of goods such as necessities, inferior goods and normal goods.

Change in consumer"s income.

- Enables producers to forecast the direction of future demand for their commodities in case of a change in consumer"s income.
- Helps the government in taxation and subsidization policies. Necessity goods should be taxed less and highly subsidized.

CROSS ELASTICITY OF DEMAND

Cross elasticity of demand is defined as the degree of responsiveness of quantity demanded of one commodity (X) due to a change in price of another commodity (Y).

$$\text{Cross elasticity of demand} = \frac{\%\text{ change in quantity demanded of commodity x}}{\%\text{ change in price of commodity Y}}$$

Or $$\frac{\Delta Q\surd OQx \text{ X } 100}{\Delta Py/OPyX100}$$

Or Qx/PyxOPy/OQx

Where, ΔQx= change in quantity of commodity X, OQx= original quantity of commodity X,Py= change in price of commodity Y and ΔOPy= original price of commodity Y.

Interpretation of cross elasticity of demand.

(i) If cross elasticity of demand is positive, the commodities x and y are substitutes. An increase in price of one commodity leads to an increase in quantity demanded of the other commodity.
(ii) If cross elasticity of demand is negative, the commodities x and y are complements/joint products. An increase in price of one commodity leads to a decrease in quantity demanded of another commodity.
(iii) If cross elasticity of demand is zero, the two commodities x and y are not related at all. Quantity demanded for commodity x is not affected by changes in price of commodity y.

Importance of cross elasticity of demand.

- Helps to determine whether the commodity has complements or substitutes.
- Helps to determine the degree of monopoly.

- ➢ Helps to show the relationship between commodities consumed.
- ➢ Helps the government in taxation policy. Substitutes generate less tax revenue compared to complements.
- ➢ Provides knowledge to consumers about the extent of their bargaining power. A consumer has a strong bargaining power when a commodity has substitutes than when it has complements.

Examinable questions.

If the price of commodity Y increases from shillings 50 to shillings 60 which resulted into a reduction in quantity demanded of commodity X from 70kg to 40kg.

i) Calculate cross elasticity of demand between the two commodities X and Y.

ii) What is the relationship between commodities X and Y.

(i) Cross elasticity of demand= $\Delta Qx/\Delta Py X OPy/OQx$

40-70/60-50X50/70

-30/10x5/7

CED=-2.1.

(ii) Commodities X and Y are complements because increase in price of commodity Y reduces demand for commodity X.

The price of beef increased from shillings 1,000 to shillings 1,100 per kg and as a result the demand for pork increased from 150kgs to 195kgs.

(i) Calculate cross elasticity of demand between beef and pork.

(ii) What is the relationship between the two commodities beef and pork?

1. Cross elasticity of demand =$\Delta Qp/\Delta Pb X OPb/OQp$

CED = 195-150/1100-1000X1000/150

45/100X1000/150

450/150

CED=3

2. The commodities beef and pork are substitutes.

This is because an increase in price of beef leads to an increase in quantity demanded of pork.

UNEB 1999

- *Calculate cross elasticity of demand for commodities x and y in the table below.*

Year	*Price of commodity X (in shs)*	*Quantity demanded of commodity Y (in kgs)*
1998	*12,000*	*300,000*
1999	*10,000*	*500,000*

- *State the relationship between commodities X and Y.*

Cross elasticity of demand= ΔQy/ΔPxXOPx/OQy
500,000 -300,000/10,000-12,000x12,000/300,000
Cross elasticity of demand=-4

UNEB 2012

Given that an increase in the price of commodity X from shs 1,500 to shs 1,800 resulted into a change in quantity demanded for commodity Y from 600units to 570 units.

i) Calculate the cross elasticity of demand (02marks)
ii) State the relationship between commodities x and y (02marks)

Solution.

1. Cross elasticity of demand =ΔQy/ΔPxXOPx/OQy
   570-600/1800-1500x 1500/600
   -30/300x1500/600
   Cross elasticity of demand= -0.25
2. Commodities X and Y are complements.

UNEB 2002.

Given that the price of commodity Y decreased from shs 15,000 to shs 10,000 and quantity demanded of a related commodity increased from 200,000kg to 600,000kg.

i) Calculate cross elasticity of demand for commodity Y and Z (02 marks)
ii) State the relationship between commodities Y and Z (02 marks)

Solution.

(i) Cross elasticity of demand=ΔQz/ΔPyXOPy/OQz
600,000-200,000/10,000-15,000x15,000/200,000
400,000/-5,000X15,000/200,000
Cross elasticity of demand =-6

iii) commodities Y and Z are complements.

POINT ELASTICITY OF DEMAND

Point elasticity of demand is the measurement of elasticity at one point on the demand curve. It is assumed that changes in price and demand are too small or invisible.

Point elasticity of demand=(-)ðQ/ðPXOP/OQ

Where,ðQ=a very small change in quantity and ðP=a very small change in price.

A very small proportionate change in quantity demanded results into a very small proportionate change in price.

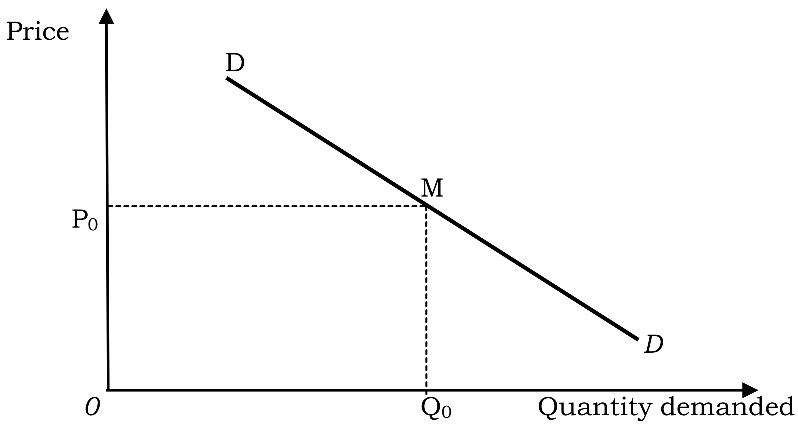


Figure 2.34: point elasticity of demand.

ARC ELASTICITY OF DEMAND

Arc elasticity of demand is the measure of the average elasticity between two points on the demand curve. It is the measure of average elasticity.

Arc elasticity of demand= (-) ΔQ/ΔP X AP/AQ.

Where, ΔQ= change in quantity, ΔP=change in price, AP=average price and AQ=average quantity.

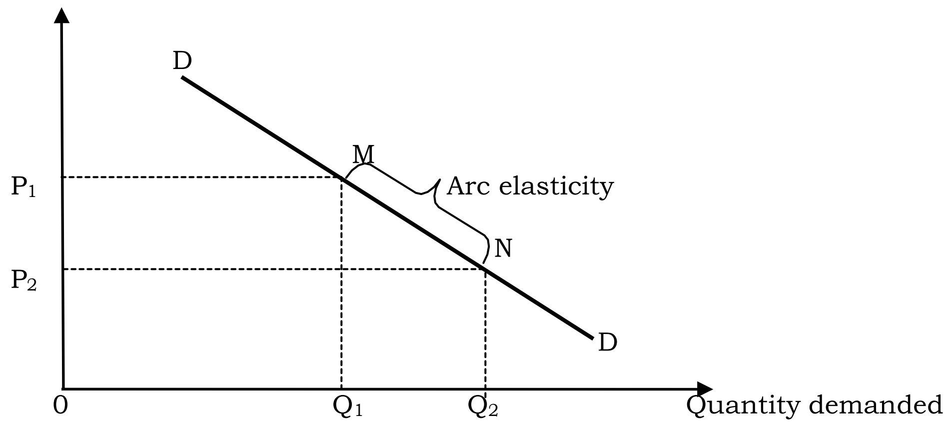


Figure 2.35. Arc elasticity of demand.

ELASTICITY OF SUPPLY

Elasticity of supply is defined as the measure of the degree of responsiveness of quantity supplied of a commodity due to a change in any of the factors that affect supply.

Elasticity of supply is measured by changes in price i.e price elasticity of supply.

PRICE ELASTICITY OF SUPPLY

Price elasticity of supply refers to the measure of the degree of responsiveness of quantity supplied of a commodity to a change in commodity"s own price.

Price elasticity of supply = $\dfrac{\text{\%change in quantity supplied}}{\text{\% change in price of the commodity.}}$

Or ΔQs/OQsX100

ΔP/OPX100 Or. ΔQs/ΔPXOP/OQs.

Examinable examples.

(i) The price of the commodity increased from shillings 700 to shillings 1,500 which resulted into an increase in quantity su[plied from 200kg to 800kg, calculate price elasticity of supply.
Price elasticity of supply= ΔQs/ΔPXOP/OQs.
800-500/1500-700/500
3/8x7/5
<u>Price elasticity of supply=0.53</u>

Study the table below and answer the questions that follow.

	A	*B*	*C*	*D*
Price of rice (in shillings)	10	20	30	40
Quantity of rice supplied (in kgs)	50	100	150	200

Calculate price elasticity of supply from point A to D.
Price elasticity of supply=Qs/PXOP/OQs.
200-50/40-10x10/50
PES=150/30x10/50
300/300
Price elasticity of supply=1

(ii) The price of rice reduced from Ug shillings 2,000perkg to shillings 1,800 per kg and quantity supplied reduced from 200kg to 100kgs. Calculate price elasticity of supply.
Price elasticity of supply=ΔQs/ΔPXOP/OQs.
100-200/1800-2000x2000/200
-100/-200x10
Price elasticity of supply=5

CATEGORIZATION OF PRICE ELASTICITY OF SUPPLY.

(i) Elastic supply.

Elastic supply is where price elasticity of supply is greater than one but less than infinity. **Or**

This is where a very small percentage change in price results into a very big percentage change in quantity supplied of a commodity. A given change in price brings about a more than proportionate change in quantity supplied.

The percentage change in price is less than the percentage change in quantity supplied.

PES is between 1 and infinity. 1< PES< infinity.

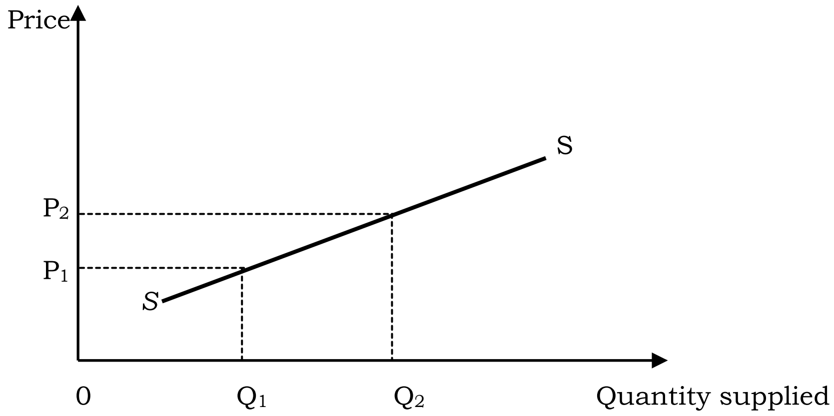


Figure 2.36: elastic demand curve.

A small proportion of an increase in price from OP_1 to OP_2 leads to a greater proportion of an increase in quantity supplied from OQ_1 to OQ_2.

(ii) Inelastic supply.

Inelastic supply is where price elasticity of supply is greater than zero but less than one.

Or

This is where a very big percentage change in price results into a very small percentage change in price brings about a less than proportionate change in quantity supplied of a commodity.

The percentage change in price is greater than the percentage change in quantity supplied of a commodity.

PES is greater than zero but less than one.

O <PES< 1.

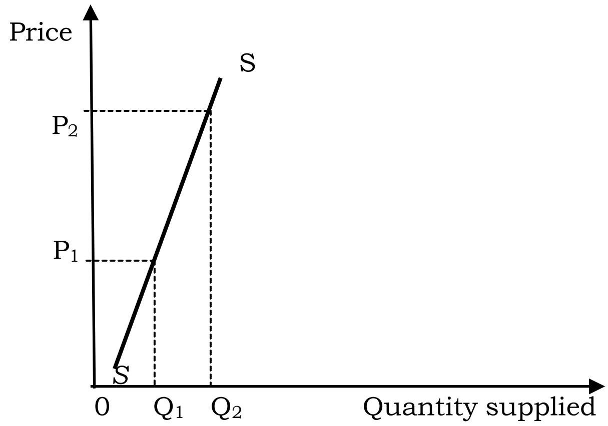


Figure 2.37: inelastic supply curve.
A very big increase in price from OP_1 to OP_2 results into a small increase in quantity supplied from $OQ_1$to OQ_2.

(iii) Perfectly elastic supply
Perfectly elastic supply is where price elasticity of supply is equal to infinity.
Or

This is where at a constant/fixed price quantity supplied of a commodity changes. At no percentage change in price, quantity supplied changes, price is fixed at all levels of quantity supplied.

PES is equal to infinity.
PES = infinity.

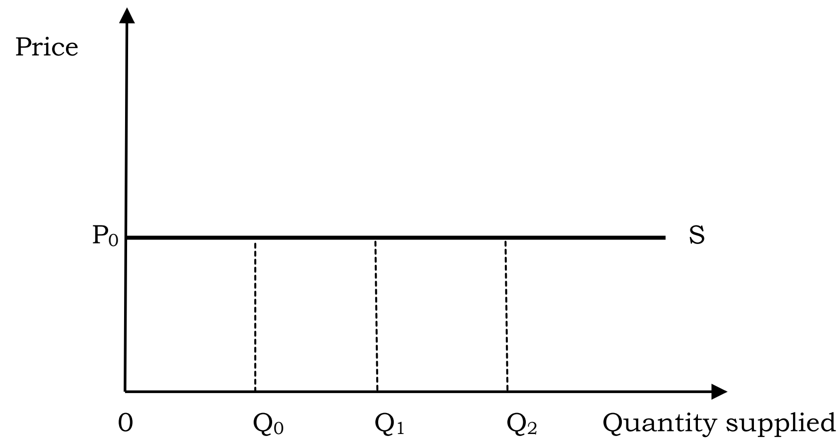


Figure 2.38: perfectly elastic supply curve.
At a constant price OPo quantity changes between OQ1 OQ1and OQ2.

(iv) Perfectly inelastic supply.
Perfectly inelastic supply is where price elasticity of supply is zero.
Or
This is where an given percentage change in price has no effect on quantity supplied of a commodity. The percentage change in price leads to no percentage change in quantity supplied.
PES= O

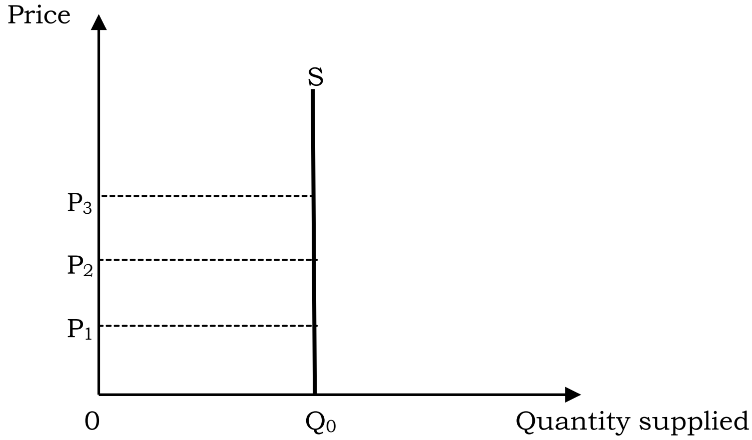


Figure 2.39: perfectly inelastic supply curve.

Changes in price from OP_1 to OP_2 up to OP_3 have no effect on quantity supplied OQ_0.

(v) Unitary elasticity of supply.
Unitary elasticity of supply is where price elasticity of supply is equal to one.
Or
This is where a given percentage change in price is exactly equal to the percentage change in quantity supplied of a commodity.

A given change in price leads to the same proportionate change in quantity supplied.

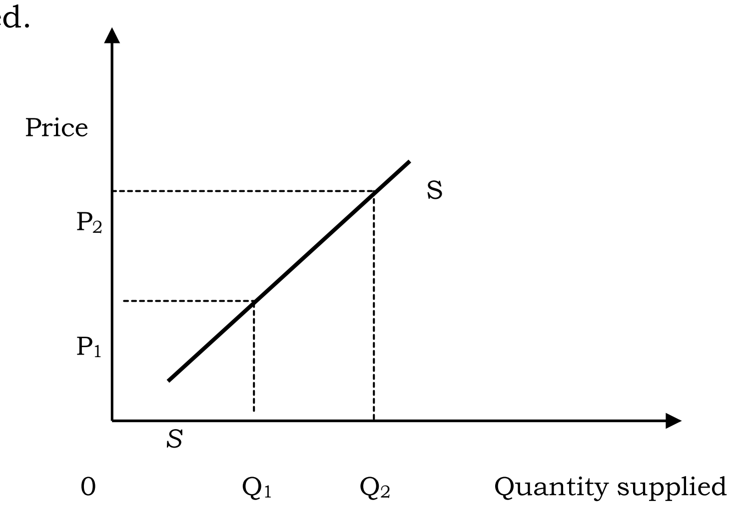


Figure 2.40: unit elasticity of supply.

- Change in price from OP_1 to OP_2 is equivalent to change in quantity supplied from OQ_1 to OQ_2.

FACTORS THAT INFLUENCE/AFFECT PRICE ELASTICITY OF SUPPLY/DETERMINANTS OF PRICE ELASTICITY OF SUPPLY

NB. Neutral points must be presented and each point should be explained in two sides showing an element elastic supply and inelastic supply.

1. **Gestation period.** Short gestation period for a commodity leads to elastic supply because a very slight increase in price makes producers respond quickly more while long gestation period for a commodity leads to inelastic supply.
2. **Method of production/level of technology used.** A commodity produced with cheap and simple technology has elastic supply because it can easily be produced in case price changes slightly while a commodity which requires complicated technology has inelastic supply because it is difficult to increase supply when price increases rapidly.
3. **Government policy on production.** Elasticity of supply is inelastic whenever government restricts production and importation of a commodity and whenever there is free trade price elasticity of supply

becomes elastic because whenever price increases slightly more of a commodity is produced and traded.

4. **Cost of production.** High cost of production makes it expensive to produce a commodity hence inelastic supply while low cost of production makes it cheap to produce a commodity which leads to elastic supply.
5. **Availability of spare or excess capacity/extent of capacity utilization in producing a commodity.** If a firm is producing at its maximum capacity, supply becomes inelastic because an increase in price does not increase supply in the short run. However, if a firm is producing at excess capacity, supply becomes elastic because as price increases production can be expanded to increase supply.
6. **Expectation of future price changes.** If price changes are expected to last longer supply tends to be elastic, but when price changes are expected to last for a very short period supply becomes inelastic.
7. **Type/nature of the commodity.** A durable commodity has elastic supply because it can be stored incase price reduces slightly while a perishable commodity has inelastic supply because benefit price reduces greatly, it cannot be stored for along time to be brought to the market when price increases.
8. **Time period.** In the short run, elasticity of supply is inelastic because producers can only change few factors of production while in the long run elasticity of supply is elastic because as price increases slightly more is supplied because producers can change all the factors of production.
9. **Availability of factors of production.** Presence of factor inputs which are cheap makes it easy to produce which leads to elastic supply and on the other hand if factor inputs are scarce and difficult to acquire supply becomes inelastic.
10. **Number of producers.** Large number of producers increases output leading to elastic supply while limited number of producers limits production levels leading to inelastic supply.

Practical application of price elasticity of supply.

- Helps the producer in determining revenue and prices. A commodity with inelastic supply is sold at a high price to get more revenue.
- Useful in devaluation policy. Devaluation becomes successful when the supply of exports is elastic.
- It is important in taxation policy by government.
- Helps in determining tax incidence.
- It is important in determining wages for workers. Workers with elastic supply of labour get low wages while those with inelastic supply of labour get higher wages.

- Helps the government tio determine the nature of goods to export and earn more foreign exchange.
- Helps to explain price instability of agricultural products. Prices rise when supply of agricultural products is inelastic and prices fall when supply is elastic.

CONSUMER'S SURPLUS AND PRODUCER'S SURPLUS.

i) Consumer's surplus.

Consumer's surplus refers to a difference between what a consumer is willing to pay for a particular commodity and what he actually pays for that commodity.

Consumer"s surplus= total willingness to pay (planned expenditure)- total actual expenditure (number of units purchased x market price).

For example

The consumer goes to the market and he is able and willing to pay shillings 150 for the commodity but he is lucky enough to find the commodity at the market price of shillings 100. The consumer"s surplus will be 150-100=shillings 50.

This implies that the consumer gets more satisfaction/total utility from the commodity than what he pays for that commodity.

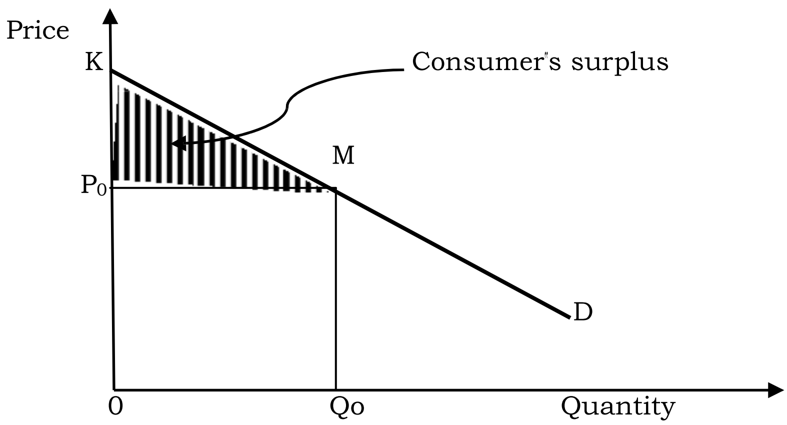


Figure 2.41: consumer"s surplus.

The consumer is willing to pay for output OQ_o any price equivalent to the area $OKMQ_o$. However he only pays OP_oMQ_o, the difference shown by the shaded area represents consumer"s surplus.

For example

i) Calculate consumer's surplus if 4 units were purchased at shillings 150.

Price the consumer is willing to pay	Units purchased
300	1
250	2
200	3
150	4
100	5
50	6

Consumer‟s surplus= planned expenditure- actual expenditure

(300+250+200+150)-(150x4)

900 - 600

<u>Consumer‟s surplus= shillings 300</u>

Or (300-150)+(250-150)+(200-150)+(150-150)

150+100+50+0

<u>Consumer‟s surplus=shillings 300.</u>

ii) Calculate the consumer‟s surplus when the market price is shs 700.

Quantity in kgs	Price (shs)
1	1500
2	1300
3	1150
4	950
5	700
6	530
7	420

Consumer‟s surplus = planned expenditure- actual expenditure

1500+1300+1150+950+700-(700x5).

5600-3500

<u>Consumer‟s surplus =shs 2100</u>

Or 1500-700+1300-700+1150-700+950-700+700-700

800+600+450+250+0

<u>Consumer‟s surplus = shs 2100</u>

Determinants of consumer’s surplus.

1. Price levels (market price).
2. Consumers knowledge about market conditions.
3. Bargaining power of the consumer.
4. Price elasticity of demand for a commodity.

UNEB 2013

(i) Distinguish between producer"s surplus and consumer"s surplus. (02 marks)

(ii) Given that the market price of a commodity is Uganda shs 65,000, calculate the producers surplus in the table below. (02 marks)

Price (Ug x)	*30,000*	*35,000*	*40,000*	*45,000*	*50,000*	*55,000*	*60,000*	*65,000*
Supply	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*

ii) Producer's surplus

Producer's surplus is the difference between what a producer is expecting to receive from the sale of given amount of a commodity and what he actually receives. **Or**

It refers to the excess earnings between what a producer is willing to charge for a commodity and what he actually receives after selling it.

Or

It is the difference between the minimum amount at which a producer is willing to sell his commodity and the amount he actually receives.

This means that he must cover the marginal cost.

Producer's surplus= actual earning/ revenue (market price x number of units sold)- planned earnings/ revenue.

For instance if the producer is willing to accept shillings 10,000 for his commodity but he is lucky enough to sell it at shillings 15,000. The producer"s surplus = 15,000-10,000=shs 5,000

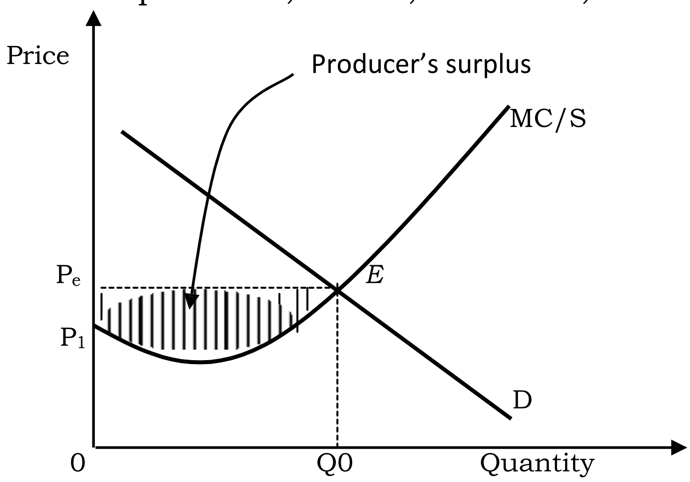


Figure 2.4342442: producer"s surplus.

The producer needs to cover his marginal cost in order to produce, therefore he must be paid a given minimum price to cover marginal cost.

For the producer to produce and sell output OQe, he has to be paid a minimum amount equivalent to the area below the supply curve i.e.

OP1EQe. But he sells at the market price and receives OPeEQe after selling output OQe therefore, producers surplus= OPeEQe-OP1EQe=shaded area (P1PeE).

Worked example.

1) Calculate the producer"s surplus when the market price is shillings 50.

Price	10	20	30	40	50
Quantity/supply	1	3	3	4	5

Producer"s surplus= actual earnings (market price X number of units sold)- planned/expected earnings.

Producer"s surplus= (50x5)-(10+20+30+40+50)

250-150.

<u>Producer"s surplus = shillings 100.</u>

Or 50-10+50-20+50-30+50-40+50-50

<u>Producer"s surplus=Shs 100</u>

2) Calculate the producer"s surplus when the market price is fixed at shs 530.

Quantity sold in kgs	Price (shs)
1	210
2	230
3	420
4	530
5	700
6	950
7	110
8	1300
9	1500

Producer"s surplus= actual earnings/revenue (market price x number of units sold)- planned earnings /revenue.

530 x 4- (210+230 +420+530)

2120-1390

<u>Producer"s surplus = shs 730</u>

Or 530-210 + 530-230+530-420+530-530

320+300+110=0

<u>Producer"s surplus = shs 730</u>

3) Given that the market price of a commodity is Uganda shs 65,000,

Calculate the producer"ssurplus in the table below.

Price (Ug x)	30,000	35,000	40,000	45,000	50,000	55,000	60,000	65,000
Supply	1	2	3	4	5	6	7	8

Producer"s surplus= actual revenue- expected revenue/earnings.

65,000x8-30,00035,000+40,000+45,000+50,000+55,000+60,000+65,000

Producers surplus=520,000-380,000

Producers surplus= 520,000-380,000

Producer's surplus=shs 140,000

CONSUMER'S BEHAVIOUR

A consumer is a person who uses goods and services to satisfy his wants. His major aim is utility maximization. In economics we measure utility in imaginary units called utils.

The theory of consumer"s behavior tries to answer the question when a consumer reachesequilibrium.

Consumer"s behavior /equilibrium is explained by two approaches.

- **(i) Marginal utility approach/cardinal approach.**
- **(ii) Indifference curve approach/ordinal approach.**

***A.* MARGINAL UTILITY APPROACH**

It was developed by Maslow and the basic concept in this theory is utility. Utility is the satisfying power that goods and services consumed possess.

Assumptions of marginal utility approach

- A consumer is assumed to be rational. He aims at maximizing utility subject to income constraint.
- The consumer is able to measure and tell exactly the amount of satisfaction he gets form the commodity.
- The consumer is assumed to use a single commodity that gives him or her satisfaction.
- It is based on the law of diminishing marginal utility.
- The consumer"s utility function is independent of other consumers utility functions i.e he does not buy because he has seen others buying. is fixed
- Assumes that the commodity is perfectly divisible.
- Assumes that the consumer"s income.

CONSUMER'S EQUILIBRIUM UNDER MARGINAL UTILITY APPROACH

Assuming that the above assumptions hold, a consumer reaches equilibrium where marginal utility derived from the commodity such as x is equal to the price of that commodity.

MUx=Px. This is the necessary condition for a consumer to be in equilibrium in a single commodity situation.

B. INDIFFERENCE CURVE APPROACH/ORDINAL APPROACH.

This approach refutes the assumption that utility is measured numerically. In this approach, the consumer is confronted with two commodities such as A and B from where he has to make choice. This is based on an indifference curve.

An indifference curve.

An indifference curve is a graph showing a combination of two commodities that can give the same level of satisfaction to the consumer.

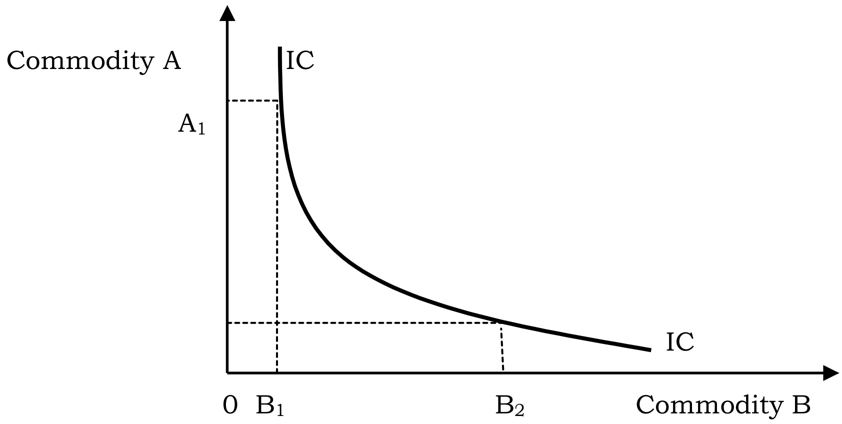


Figure 2.43: An indifference curve.

Utility derived from combination A_1B_1 is the same as utility derived from combination A_2B_2.
The slope of the indifference curve is called marginal rate of substitution.

Marginal rate of substitution.

Marginal rate of substitution refers to the amount of one commodity a consumer could give up to get an extra unit/one more unit of another commodity while leaving the level of satisfaction unchanged. It looks at the number of units of a commodity that must be foregone to get an additional unit of another commodity to ensure that the consumer maintains the same level of satisfaction.

Assumption of the ordinal approach.

- Assumes that the consumer is rational. He chooses combinations that have more units of commodity X and Y.
- Assumes diminishing marginal rate of substitution because of the negative slope of the indifference curve.
- There are two commodities such as x and y and their prices are known.
- Utility is ordinal. The consumer can rank his commodities in order of preference.

- The consumer is consistent in regard to choices. If he prefers commodity A to B, then the same consumer should not prefer commodity B to A.

PROPERTIES/CHARACTERISTICS OF INDIFFERENCE CURVES.

- They are convex to the origin due to diminishing marginal rate of substitution i.e adding an extra unit of commodity A, you must give up a given unit of commodity B.
- Combination of two or more indifference curves is called an indifference map.
- Indifference curves are negatively sloping (have a negative slope) such that if a consumer increases the quantity of commodity x, he must reduce on the units of commodity if he is to remain at the same level of satisfaction.
- Indifference curves should not intersect. If they intersect, then it implies that there are two different levels of satisfaction.
- Between two or more indifference curves, there can be other indifference curves provided they do not intersect.
- Indifference curves should not touch either axis. If it does so, it would mean that the consumer is willing to have satisfaction from one commodity.
- Indifference curves can shift either to the right or to the left implying an increase or a decrease in consumption of both commodities depending on changes in consumer's income.

THE BUDGET LINE/CONSUMPTION POSSIBILITY CURVE.

A budget line is a graph showing various combinations of two commodities that a consumer can purchase using his fixed income.

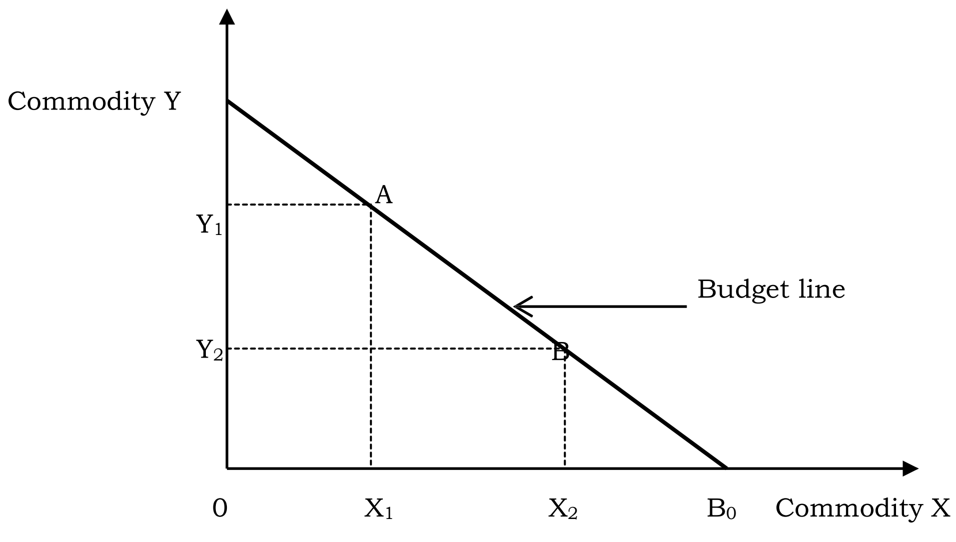


Figure 2.44: a budget line.

Points A and B can be affordable by the consumer and can exhaust his fixed income. Using his fixed income, a consumer can only afford those combinations of two commodities that lie a long the budget line.

Combinations outside the budget line are not attainable and those that lie below the budget line are attainable but they do not utilize the fixed income of the consumer optimumly.

EQUILIBRIUM OF THE CONSUMER USING THE INDIFFERENCE CURVE APPROACH.

The consumer reaches equilibrium at a point where his budget line is tangent to his indifference curve.

The consumer‟s equilibrium is attained at the highest indifference curve using his fixed income.

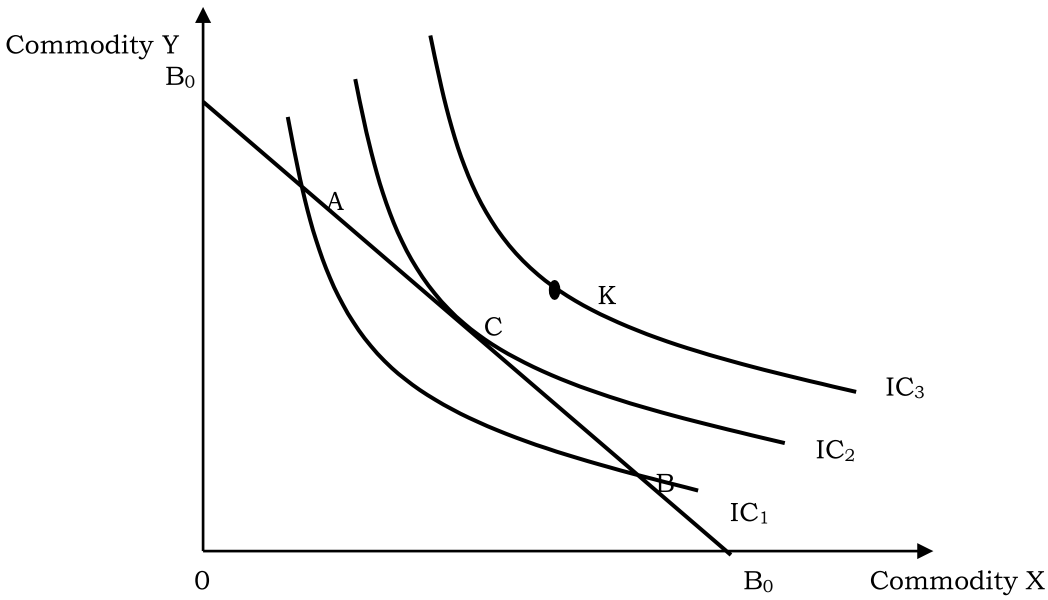


Figure 2.45: consumer‟s equilibrium under the indifference curve approach.

Points A and B can exhaust the consumer‟s fixed income but combinations on such points offer the lowest satisfaction and a rational consumer would not purchase them.

Point C represents the consumer‟s equilibrium where the highest indifference curve is tangential to the budget line BoBo. Point K is beyond the consumer‟s budget line.

The consumer prefers the combination of the two commodities which provides the highest degree of satisfaction but this combination should be affordable and lies on the budget line and this is necessary to maximize satisfaction.

Chapter 3: PRODUCTION THEORY

Production is defined as a process of transforming inputs into final goods and services to create utility. **Or**

It is the creation of utility in goods and services to satisfy human wants.

The process of production is complete after goods and services reach the final consumer.

TYPES OF PRODUCTION.

i) Direct production.

Direct production is the production of goods and services for one‟s own use or consumption. It is also called subsistence production or household own account production. For instance making of table for personal use.

ii) Indirect production.

Indirect production is production of goods of services for exchange in the market. It involves specialization and the use of money as a medium of exchange. In other wards, indirect production involves the creation of goods and services for sale.

LEVELS OF PRODUCTION

a) **Primary production.**

Primary production is the extraction of raw materials form nature to be used for further production process.

It involves production activities such as mining, fishing, farming and lumbering. The output is in form of raw materials used as inputs for further production of finished goods.

b) **Secondary production.**

Secondary production is the process of transforming raw materials form primary production into finished products to satisfy consumers wants.

During this process, value is added on raw materials so that output can provide higher satisfaction. It involves processing activities such as manufacturing and construction.

c) **Tertiary production.**

Tertiary production is a stage of production which involves provision of services which are either personal or commercial. It starts after producing the final output or products. The movement of goods to the final consumers involves offering of different services which are referred to as tertiary services. It includes services such as legal services, teaching, insurance, treating patients, singing, banking, transport, hotel and accommodation services.

FACTORS/TOOLS/AGENTS OF PRODUCTION.

Agents of production are basic or necessary resources used in production process to create good and services in order to satisfy human wants.

These factors include land, labour, capital and entrepreneurship. For their services rendered in product they are given factors of production have derived demand, are limited in supply, are combined in different proportions to produce goods and services.

Factors of production are categorized into:-

1. **Specific factors of production.** These are factors of production which are highly specialized or restricted to one or a few functions/uses.
2. **Non-specific factors of production.** These are factors of production which can be diverted to many alternative uses conveniently in production. **Or**

The factors of production which can easily be used for other purposes and therefore not specialized in use.

For instance unskilled labour is capable of performing several activities, allocating land from farming to industrial use.

NB. Factor specificity. This refers to the extent to which a factor of production is restricted to a particular use.

UNEB 2006

i) What is meant by factor prices. (01 mark)

ii) Name any three different factor prices in an economy. (03 marks)

FACTOR PRICES

Factor prices are monetary rewards or payments to factors of production for their services rendered in production process.

A factor price refers to a monetary payment to a factor of production for its services rendered in production process.

Examples of factor prices in an economy may include.

i) Wage or salary for labour.
ii) Interest for capital.
iii) Rent for land.
iv) Profit for entrepreneurs.

LAND AS A FACTOR OF PRODUCTION

Land refers to a resource made available by nature and used to produce commodities which can satisfy human wants.

It is a resource of nature found on, above and underneath the earth‟s surface.

It includes vegetation, water bodies, air, minerals, plants and soil.

Land provides space where all economic activities take place.

MAIN FEATURES OR CHARACTERISTICS OF LAND

- It‟s supply is fixed i.e. perfectly inelastic supply.
- It is a free gift of nature whose supply price is zero.
- Land is geographically and occupationally immobile.
- It has no opportunity cost.
- The payment for land is rent.

PAYMENT OR FACTOR PRICE FOR LAND.

The factor price for land is economic rent. All rent paid for land is economic rent. This is because land is fixed in supply.

ECONOMIC RENT.

Economic rent means extra payment to a factor of production over and above it‟s supply price/transfer earnings.

UNEB 2000

i) *Distinguish between quasi rent and economic rent (02 marks)*

ii) *Why is payment to land considered as economic rent (02 marks)*

REASONS WHY REWARD FOR LAND CONSTITUTES ECONOMIC RENT.

- Land has perfectly inelastic supply. Its supply is fixed regardless of the price.
- Land is a free gift of nature which has got zero supply price.
- Land is geographically and occupationally immobile.

UNEB 2002

i) *Distinguish between quasi rent and economic rent (02 marks)*

ii) *State any two factors which influence the level of economic rent. (02 marks)*

FACTORS THAT DETERMINE/AFFECT/INFLUENCE THE SIZE OF ECONOMIC RENT

NB. Neutral factors are presented and explained in two sides showing high economic rent and loweconomic rent.

1. **Degree of specificity of a factor of production.** Highly specialized/specific factor earns high economic rent while less specialized/specific factor earns low economic rent.
2. **Elasticity of supply of a factor of production.** Elastic supply of a factor leads to low economic rents but inelastic supply of a factor leads to high economic rent.
3. **Elasticity of demand for a factor of production.** Inelastic demand fore a factor of production leads to high economic rent whereas elastic demand for a factor leads to low economic rent.
4. **Degree of substitutability of a factor of production.** A factor which can easily be replaced by other factors of production receives low economic rent while a factor which cannot easily be replaced receives high economic rent.
5. **Level of supply of a factor of production.** Low supply of a factor leads to high economic rent while high supply of a factor leads to low economic rent.
6. **Level of demand for a factor of production.**High demand for a factor leads to high economic rent while low demand for a factor leads to low economic rent.

SUPPLY PRICE/TRANSFER EARNINGS.

Supply price is defined as minimum payment to a factor of production which is necessary to keep it in its present/current use or employment. Supply price is defined as the minimum payment or reward a factor of production can accept for its continuous use in production.

Economic rent= actual earnings- transfer earnings.

For instance. Is a worker is willing to supply his labour at shillings 500,000 but he is paid shillings 530,000. Calculate his economic rent.

Economic rent= actual earnings –transfer earnings
530,000-500,000
Economic rent= shillings 30,000

Other types of rent.

1. **Commercial rent.** This is price/payment made to hire a durable asset in production. For instance for a house.
2. **Quasi rent.**This refers to extra payment to a factor of production which is over and above its supply price/transfer earnings that is earned when the factor has relatively inelastic supply in a short run but with elastic supply in a long run.
3. **Site rent.** This refers to extra payment to land as a factor of production for its unique locational advantages for instance urban land is paid more than rural land.

NB. Supply price of labour refers to a minimum payment necessary to maintain a unit of labour in its present employment.

LABOUR AS A FACTOR OF PRODUCTION

Labour is defined as human effort both mental and physical directed towards the production of goods and services to satisfy human wants. Labour does this with a view of obtaining a reward known as wage.

Characteristics of labour.

- Labour is provided by human beings.
- Labour is the most mobile factor of production both occupationally and geographically.
- It cannot be separated from the owner i.e the worker himself must be present and willing to work.
- It is not of homogenous units i.e. labour can be skilled, semi-skilled or un-skilled depending on the level of education and training.
- Labour earns wage as its monetary reward for its contribution to the production process.

UNEB 2004

i) Differentiate between marginal product of labour and average product of labour. (02 marks)

ii) Mention any two factors which may increase the average product of labour (02 marks)

MARGINAL PRODUCT OF LABOUR.

This refers to additional output yielded when an extra unit of labour is employed.

FACTORS THAT MAY INCREASE AVERAGE PRODUCT AND MARGINAL PRODUCT OF LABOUR

- Increased level of education/training of labour.
- Improved working conditions.
- Increased wage rate/remuneration level.
- Improved level of technology in production.
- Improved attitude of labour towards work.

- ❖ Improved quality of management and supervision.
- ❖ Increased level of specialization and division of labour.
- ❖ Improvement in political climate.
- ❖ Increased experience/expertise of labour.
- ❖ Improvement in health conditions of a worker.
- ❖ Improved availability and quality of cooperant factors of production.

LABOUR PRODUCTIVITY AND LABOUR EFFICIENCY

a) **LABOUR PRODUCTIVITY**

Labour productivity refers to the amount/quantity of output produced perunit of labour employed in a given period of time.

Labour = Total output / Total number of workers employed.

Example.

Number of workers	**Kilograms produced**	**Labour productivity**
14	560	40
55	11000	200
480	96000	200

b) **LABOUIR EFFICIENCY**

Labour efficiency is defined as a measure of the quantity and quality of output a unit of labour can produce in a given period of time. **Or**

It refers to the ability of labour to achieve greater output in a shorter time without any decline in quality of work or output.

It refers to the extent to which a unit of labour is able to produce the maximum quality and quantity of output expected from it in a specified period of time.

UNEB 2003

i) What is meant y the term productivity of labour. (01 marks)

ii)Mention any three factors which determine the productivity of labour in your country. (03 marks)

FACTORS THAT DETERMINE/AFFECT LABOUR PRODUCTIVITY AND LABOUR EFFICIENCY.

NB. Neutral points must be presented and explained in two sides showing high labour productivity and efficiency.

1. **Age level/remuneration levels.** Timely high wage rate creates an incentive for hard work leading to high labour productivity and efficiency while low wage rate is a disincentive to hard work which lowers labour efficiency and productivity.
2. **Quality and availability of cooperant (complementary) factors of production.** If other factors of production are readily available and of high quality such as land, capital and inputs, labour productivity and

efficiency are high while when other co operant factors are not readily available, labourproductivity and efficiency are low.

3. **Level of education and skills/training of labour.** Highly skilled and trained workers tend to be highly productive and efficient while les trained workers tend to be less productive and efficient.
4. **Physical ability and health conditions of a worker.** Workers who are energetic, mentally alert, health and physically strong are more productive and efficient on work than old and unhealthy workers who are less productive and efficient at work.
5. **Working conditions in production.** In places where working conditions are favourable and pleasant, it creates morale among workers thus labour is more productive and efficiency of labour are low.
6. **Labourer's attitude towards work and management.** In case labour has negative attitude towards work and management, there is limited team work hence low labour productivity and efficiency compared to when labour has positive attitude towards work and management where productivity and efficiency are high.
7. **Length/number of working hours.** Working for very long hours without resting makes workers more tired which consequently reduces the productivity and efficiency of labour of labour while labour that is not over worked is more efficient and productive.
8. **Degree of specialization of labour.** Highly specialized labout tends to be more productive and efficient because of doing an activity repeatedly while less specialized labour tends to be less productive and efficient.
9. **Degree of experience possessed by labour.** Workers who have worked for so long tend to be very long experienced, more productive and efficient than less experienced workers who are less productive and efficient at work.
10. **Quality of management and supervision of labour at work.** where management is very poor and unable to supervise workers properly, labour productivity and efficiency tend to be low compared to where management and supervision of workers are very effective leading to high labour productivity and efficiency.

UNEB 2009, 2005

i) Define the term labour efficiency.(01 marks)

ii) Give any three factors that determine labouhr efficiency in an economy.(03 marks)

FACTORS THAT DETERMINE/INFLUENCE LABOUR EFFICIENCY IN AN ECONOMY

- ❖ Level of education and training/kills.
- ❖ Quality of management and supervision.
- ❖ Health conditions of the worker.
- ❖ Worker"s attitude towards work.

- ❖ Level of specialization/division of labour.
- ❖ Level of inventions and innovations of individuals.
- ❖ Availability and efficiency of other cooperant factors of production/level of technology.
- ❖ Physical ability and natural ability/talents.
- ❖ Working conditions.
- ❖ Level of wages.
- ❖ Degree of experience/expertise.
- ❖ Political climate.

LABOUR SUPPLY

Labour supply is the measure of number of hours of work which are offered at a given wage rate and at a given period of time.

Or

It is the total number of people of working age able and willing to work in a given period of time and at a given wage rate.

It is measured in terms of total hours that workers wish to work in a given period of time at a given wage rate. High labour supply necessitates a cut in the amount of leisure that workers enjoy.

UNEB 2013.

a) *Distinguish between labour supply and labour force. (04 marks)*
b) *Examine the factors that determine labour supply in an economy. (16 marks)*

DETERMINANTS OF LABOUR SUPPLY IN AN ECONOMY (FACTORS THAT AFFECT LABOUR SUPPLY).

Nb. These are presented as neutral points and explained in two sides showing a favourable element in the factor which inceases labour supply and unfavourable element which leads to low labour supply.

1. **Age composition of the population/population distribution by Age.** Where majority of people are between working age, supply of labour is high while where the majority are below and above working age, labour supply is low.
2. **Level of education and traioning of labour/level of skills required on a particular job.** Supply of highly skilled and educated labour tends to be low thus low labour supply compared to the supply of less educated and unskilled labouhr.
3. **Nature of the jobs available/degree of occupational hazards.** Where jobs are attractive with reduced risks, labour supply is high while unattractive jobs with increased risks attract low labour supply.
4. **Number of working hours/length of the official working day.** Limited hours of work where official working hours in a day are limited, labour supply is low while prolonged official working hours in a day lead to high labour supply.
5. **Level of technology used in production.** High level of technology through use of capital intensive technology leads to low labour supply while low technology level in production leads to high labour supply.

6. **Working conditions.** Better working conditions lead to high labour supply due to increased morale among workers while poor working conditions lead to low labour supply.
7. **Wage rate offered.** High wage rate motivates workers which leads to high labour supply while low wage rate leads to low labour supply.
8. **Population size.** A large population size implies increased labour supply while a small population size leads to low labour supply.
9. **Level of discrimination in the labour market.** High level of discrimination in the labour market leads to low labour supply while limited discrimination in the labour market leads to high labour supply.
10. **Political climate.** Favourable political climate increases security for life which increases labour supply while unfavourable political climate creates uncertainty for which leads to low labour supply.
11. **Rate of migration of labour/emigration policies of the country.** Liberalized policies on emigration reduce labour supply while restricted policies on emigration increase labour supply.
12. **Health conditions of the worker/mental and physical ability.** Better health conditions of the workers increases labour supply while poor health conditions reduce labour supply.
13. **Attitude of labour towards work.** Positive attitude of labour towards work increases labour supply while negative attitude of labour towards work reduces labour supply.
14. **Influence of trade unions.** Where trade union activities are very influential in agitating for higher wages and better conditions of work, labour supply tends to be low in periods of strikes, demonstration.
15. **Level of labour mobility.** High level of labour mobility reduces labour supply while reduced labour mobility increases labour supply.
16. **Legal working age.** Where legal working age is set at a low level, labour supply increases but increased legal working age reduces labour supply.
17. **Sex composition of the population.** Where the population is dominated by females, labour supply becomes low while where the population is dominated by males, labour supply increases.

DEMAND FOR LABOUR/LABOUR DEMAND.

Labour demand is defined as the number of workers that employers are able and willing to offer jobs and retain/maintain in employment at a given wage rate for a given period of time.

Demand for labour is derived demand i.e it depends on demand for the products which labour is going to produce.

DETERMINANTS OF LABOUR DEMAND/DEMAND FOR LABOUR.

- Level of demand for final products produced by labour.
- Marginal productivity of labour.
- Proportion of cost of labour to the total cost of the product.
- Wage rate in the labour market.
- Degree of substitutability of labour for other factors.

- ❖ Availability and price of other co operant factors of production.
- ❖ Skills of workers and level of training acquired.

UNEB 2008, 2006

i) Define the term labour force. (01 mark)

ii) Give any three determinants of the size of labourforce in your country. (03 marks)

LABOUR FORCE

Labour force refers to the total number of people of working age group that are available for employment in country at a given time. It comprises of the working age both unemployment and employed.

Or

It is the proportion of the population that is made up of working age group excluding fulltime students and house wives.

It falls in the age bracket of 15-64years. It includes all the employed, the unemployed but it excludes inactive groups such as full time students, housewives and completely disabled people.

Working population refers to the age group of 15-64 years from where labour is extracted.

FEATURES/CHARACTERISTICS/STRUCTURE OF LABOURFORCE IN LDCs.

- ❖ It is predominantly unskilled and semi-skilled especially in rural areas where more than 70% are employed in agriculture.
- ❖ Labour generally has low productivity due to low motivation, poor health conditions and low levels of technology used.
- ❖ It is dominated by the young between 15-30 years of age due to low life expectancy and high population growth rate.
- ❖ Labourforce is predominantly illiterate i.e. does not know how to read and write.
- ❖ There is high degree of unemployment and under employment.
- ❖ It is basically organized into poor and weak trade unions.
- ❖ The occupational distribution of labour is such that the majority of labourforce are employed in agriculture and petty businesses.
- ❖ High rate of rural urban migration which worsens open urban unemployment. This is because of wage and economic activity variations between rural and urban areas thus high rate of labour mobility geographically.
- ❖ It is generally growing at a very high rate due to high population growth.
- ❖ Most of the labour force has irrelevant education and training. Has high desire for white collar jobs due to the nature of education system offered.

DETERMINANTS OF LABOURFORCE IN AN ECONOMY.

- ❖ Retirement age.
- ❖ Period of training labour/number of full time students.
- ❖ Sex composition of the population.

- Legal Population size.
- Age structure of the population.
- Number of full time house wives.

UNEB 2003.

i) What is meant by factor mobility. (01 mark)

ii) Give any three barriers to factor mobility in your country (03 marks)

FACTOR MOBILITY.

Factor mobility refers to ease with which a factor of production can move from one occupation or geographical area to another.

Or

Factor mobility refers to the ability of a factor of production to move from one occupation or geographical area to another. It is both geographical factor mobility and occupational factor mobility.

FACTOR IMMOBILITY.

Factor immobility refers to inability/difficulty of a factor of production to change from one occupation or geographical area to another.

It can be occupational factor immobility or geographical factor immobility.

LABOUR MOBILITY.

Labour mobility refers to ease with which labour can move from one occupation or geographicallocation to another.

Or

It refers to the ability/the degree/the ease with which labour moves either geographically or occupationally.

CAUSES OF LABOUR MOBILITY.

- Differences in the level of skills and education. Labour with better skills easily moves to other occupations.
- Better skills possessed by labour which encourages such labour to change jobs.
- Differences in wages. Labour moves to other places or jobs where wages paid are high.
- Differences in working conditions. This forces labour to move to areas of better working conditions.
- Availability of employment opportunities in other areas. Rapid industrialization attracts labour from rural areas.
- Differences in political atmosphere. This leads movement of labour from affected area to secure areas.
- Nature of the jobs. Unpleasant jobs encourage labour to move to pleasant jobs.
- Prospects of promotion elsewhere. This encourages labour to move to such areas.

CATEGORIES OF LABOUR MOBILITY.

1. Geographical mobility of labour.
2. Occupational mobility of labour.

1) GEOGRAPHICAL MOBILITY OF LABOUR.

This refers to the ease with which labour can move from one geographical area to another. For instance a worker moving from Kampala to Mbarara for employment.

BARRIERS/LIMITATIONS TO GEOGRAPHICAL MOBILITY OF LABOUR OR FACTORS LIMITING GEOGRAPHICAL MOBILITY OF LABOUR. (CAUSES OF GEOGRAPHICAL IMMOBILITY OF LABOUR)

1. High transport costs involved especially in monetary terms because of long distance to travel to a new place of work.
2. Shortage of accommodation in new places where labour intends to settle for employment.
3. Fear of breaking social ties due to social cultural influence. i.e some people fear to leave their families and friends behind/strong-family attachment.
4. Ignorance about the existence of job opportunities in other places because of low rate of advertising of existing jobs in given areas.
5. Political instability in places where labour intends to migrate for employment.
6. High cost of living in alternative places such as towns and therefore labour is not willing to move to such areas.
7. Possession of permanent investments in a certain area and one may wish to keep monitoring them closely.
8. Low wages paid in other areas.

2) OCCUPATIONAL MOBILITY OF LABOUR.

This is the ease with which labour can move from one occupation or job to another. It has two types. i.e.

a) Vertical occupational mobility of labour.

This is where labour changes forma lower grade job to a higher grade job. For instance from being an accountant assistant to a chief accountant, teacher to ahead teacher.

b) Horizontal occupational mobility of labour.

This is where labour changes from one occupation or job to another but of the same grade with in different institutions. Forinstance an banker moving from Stanbic Bank to Centenary Bank.

UNEB 2007, 2001.

i. *Define the term occupational mobility of labour (01 mark)*
ii. *Give any three factors that limit occupational mobility of labour in your country. (03 marks)*

BARRIERS TO OCCUPATIONAL MOBILITY OF LABOUR OR FACTORS LIMITING OCCUPATIONAL MOBILITY OF LABOUR.
(CAUSES OF OCCUPATIONAL IMMOBILITY OF LABOUR).

1. Long period of training required for an alternative job.
2. Social restrictions such as culture, religion and old age.
3. Prospects of promotion on the current job.

4. High level of formalities involved in acquiring a new job such as photocopying academic documents, interviews.
5. Long experienced gained by labour on the current job.
6. High level of specialization on the current job i.e. labour being highly specific.
7. Better wage rate or remuneration on the current job.
8. Barriers by trade unions and professional bodies/trade unions and professional bodies" restrictions which limit entry of new workers in given occupations.
9. Better working conditions on the current job.
10. High costs of training needed for another job.
11. Limited knowledge and information about existing jobs elsewhere.

UNEB 2010.

i) What is meant by the term labour mobility. (01 mark)

ii)Suggest any three ways of increasing geographical mobility of labour in your country. (03 marks)

Ways of increasing geographical mobility of labour in Uganda.

- Improve on political climate.
- Encourage infrastructure development.
- Advertise existing employment opportunities.
- Improve working conditions in other areas.
- Increase wages in areas with low wages.
- Subsidize transport for workers.
- Improve health conditions of the worker.
- Fight social prejudices/discrimination in the labour market.

LABOUR IMMOBILITY

Labour immobility refers to inability/difficulty of labour to change from one occupation or geographical areato another.

It can be occupational labour immobility or geographical labor immobility.

CAPITAL AS A FACTOR OF PRODUCTION

Capital refers to a stock of manmade physical and non-physical assets capable of creating further goods and service to satisfy human wants. For example liquid capital, buildings, roads, factories and railways.

Or

It can as well be defined as a stock of wealth created by man used in production of more wealth to satisfy human wants. Capital is rewarded with interest for its contribution in production of goods and services.

FORMS OF CAPITAL

a) **Human capital.** This is accumulated knowledge and skills by labour through training to increase labour productivity.

b) **Real capital.** This is a stock of fixed assets capable of producing goods and services. It is not for satisfying human wants directly for instance factor machinery, buildings, production plants.

c) **Social overhead capital.** It refers to capital in form of economic and social infrastructure which is collectively owned by the society. It helps production process to take place and aims at increasing labour productivity. For instance roads, school, railways, hospital.

d) **Nominal/liquid/money capital.** This is monetary form of capital in terms of paper money and coins used in production process.

e) **Specific/sunk capital.** This refers to specialized capital which cannot easily be used for alternative purposes. For instance maize milling machine.

f) **Reserve capital.** This refers to assets put aside to meet specific obligations of individuals or firms during unexpected problems/circumstances in production process.

UNEB1999

a) *Explain the role of capital in economic development.(10 marks)*
b) *Discuss the factors that influence capital accumulation in your country.(10 marks)*

ROLE/USES OF CAPITAL IN DEVELOPMENT PROCESS.

1. It increases productive capacity of the economy (mass production). Capital in form of machines helps to expand the utilization of idle resources which increases output thus economic growth.
2. Improves the quality of final output hence standardizing the production process. This helps to realize high and stable prices which encourages monetary production.
3. It promotes specialization in production process. It is used to establish specific production lines according to comparative advantage.
4. Facilitates exchange or trade to take place both home trade and foreign trade. This encourages easy exchange of commodities through the use of liquid capital.
5. Facilitates infrastructural development. Human and liquid capital is used to establish roads, railways, telecommunication lines, schools, power supply projects, banking institutions which makes transportation easier.
6. Capital facilitates research. Capital enables a country to invest in research leading to creativity, innovativeness and inventions thus better methods of production.
7. Capital facilitates industrialization. Liquid capital is used to buy input and finance all related activities such as buying machinery necessary for industrial development of a country.
8. It increases employment opportunities. Capital is used to finance and establish different projects and employ the existing labour force. This increases people‟s income, savings and purchasing power.
9. Means of technological development. Capital is used to finance the development of new, better and efficient production techniques leading to technological development.

10. Increases efficiency and productivity of other factors of production such as labour, land, entrepreneurs when it is combined with such factors in appropriate proportions. This leads to higher productivity.
11. It is used as collateral security to acquire bank loans. Capital in form of buildings is mortaged for loan from money lending institutions. Commercial banks in most cases prefer fixed capital as security while giving out loans for investment.
12. It facilitates further capital accumulation. Capital earns interest which increases savings hence increased investment and capital accumulation.

UNEB 2008.

i) What is meant by the term capital accumulation. (01 mark)

ii) State any three factors that limit capital accumulation in an economy. (03 marks)

CAPITAL ACCUMULATION/CAPITAL FORMATION.

Capital accumulation is a process of increasing the stock of capital/producer goods over time in an economy.

Such capital goods include machines, production plants, transport facilities such as roads and railways, insurance companies and housing facilities.

It is the process of diverting part of the country"s available resources for the purpose of increasing more producer goods. Capital accumulation is achieved through taxation, borrowing from internal and external sources, capital inflow by foreigner investors, increasing the volume of real savings ratios, mobilizing savings through financial institutions.

UNEB 2009

1. *Distinguish between capital formation and capital appreciation. (04 marks)*
2. *Explain the factors that determine the level of capital formation in your country. (16 marks)*

FACTORS THAT INFLUENCE CAPITAL ACCUMULATION IN AN ECONOMY OR DETERMINANTS OF CAPITAL ACCUMULATION IN AN ECONOMY

NB. Neutral points should be presented and explained in two sides showing both high capital accumulation and low capital accumulation.

1. **Level of income.** High income level increases savings leading to high investment and capital accumulation while low income level limits level of savings and reduce capital accumulation.
2. **Level of infrastructure development.** High level of infrastructure development in form of better roads, railways, banking institutions facilitates production leading to an increase in capital accumulation while low level of infrastructure development limits mobility of factors of production which discourages investment leading to low capital accumulation.
3. **Size of available market.** A large market size both domestic andn foreign for a country"s output stimulates more production which leads to

high capital accumulation while a narrow market size limits further investment and capital accumulation.

4. **Political atmosphere/climate.** A stable political atmosphere encourages both local and foreign investment since it builds investors confidence in the country leading to a high rate of production and capital accumulation while political instability scares away potential investments because of business uncertainty which reduces level of capital accumulation.
5. **Level of savings.** High level of savings increases investment hence high level of capital accumulation while low level of savings discourages increased investment leading to low capital accumulation.
6. **Size of existing capital stock.** A large size of existing capital stock encourages exploitation of existing resources leading to high investment and capital accumulation while a small size and inefficient existing capital stock reduces investment which limits capital accumulation.
7. **Population growth rate.** High population growth rate leads to high dependence burden which reduces savings and in turn reduces capital accumulation whereas a low population growth rate encourages savings for further investment which leads to high capital accumulation.
8. **Level of capital inflow and outflow.** High level of inflow of capital into the country than capital outflow encourages more investment leading to high capital accumulation while high level of capital outlow limits further investment which reduces production and capital accumulation.
9. **Government policy on investment (investment climate).** Favourable government investment policysuch as tax holidays, tax exemptions and subsidies to investors stimulates more production leading to high capital accumulation while unfavourable government policy on investment such as high taxation discourages investment which limit capital accumulation.
10. **Size of entrepreneurship class/level of entrepreneurial ability.** A large size of entrepreneur class encourages investment in risky but profitable ventures leading to high capital accumulation while a small size of entrepreneur class leads to poor organization of other factors of production hence low rate of capital accumulation.
11. **Degree/level of public accountability or rate of corruption.** Low level of public accountability due to corruption and embezzlement of public funds and resources, the country‟s resources are wasted leading to low investment and capital accumulation while high rate of public accountability in resource allocation leads to high investment and high accumulation of capital.
12. **Rate of inflation.** A low rate of inflation encourages savings which increases investment leading to high capital accumulation while a high rate of inflation reduces the value of money thus low investment leading to low capital accumulation.
13. **State of technology used in production.** Modern technology in production increases resource utilization hence more capital

accumulation but poor technology limits investment and capital accumulation.

14. **Interest rate on loans.** High interest rate on borrowed capital discourages increased borrowing for further investment which limits capital accumulation while low interest rate on borrowed capital increases investment and capital accumulation.

NB.

Capital appreciation.

Capital appreciation refers to a rise/an increase in value of capital goods in process of production.

Capital stock.

Capital stock refers to the total amount of physical goods existing at a given time and in production of other goods.

ENTREPRENEUR AS A FACTOR OF PRODUCTION.

An entrepreneur is an individual who employs, organizes and directs other factors of production during the production process.

Or

An entrepreneur is an ultimate organizer of all factors of production in different proportions to make production possible.

Entreprenurship refers to the act of undertaking risjks of initiating and financing a business with the aim of making profits.

An entrepreneur undertakes the risks of introducing both new products in the market and new ways of making the products.

The factor price for an entrepreneur is profit.

FUNCTIONS OF AN ENTREPRENEUR

- ❖ Undertakes decision making and control of the working of production process.
- ❖ Bears all insurable and non-insurable risks such as fire, theft, accidents and any other loses expose to the business.
- ❖ Mobilizes, organizes and coordinates other factors of production to yield higher productivity.
- ❖ Carrier out innovations and inventions in production process through introducing new combinations factors of production and new techniques of production.
- ❖ Administers the enterprise and ensures efficiency in production process thus he is responsible for both profits and losses of the firm.
- ❖ Organizes payments for other factors of production such as land, labour and capital.

THE CONCEPT OF PROFIT

Profit refers to the difference between the firm‟s total revenue and total cost.

Profit= total revenue-total cost.

Or

Profit is the monetary reward to an entrepreneur for risking his capital in production.

Profit is categorized as follows.

1. **Normal profit/zero profit.**
It is a profit level earned where average revenue is equal to average cost=(AR=AC).

Or

This is a reward to an entrepreneur/firm which is just sufficient to cover total cost. It keeps it in production without inducing new firms to join the industry.
It is just enough to cover total cost. AC=AR and Cost=Price.

2. **Super-normal/pure/abnormal/economic profit.**
It is a profit level earned where average revenue ios greater than average cost (AR>AC).

Or

This refers to excess earnings to a firm or entrepreneur over and above the normal profit.
It is sufficient enough to induce new firms to join the industry or production.
AR is greater than AC implying that price>cost.

3. **Sub-normal profits/economic losses.** These are actual losses incurred by an entrepreneur or a firm where average cost is greater than average revenue. This may discourage continued existence of a firm in production.
Average revenue is less than average cost and price <cost.

UNEB 2007.

i) Distinguish between normal profit and pure profit. (02 marks)
ii) How is normal profit determined under perfect competition. (02 marks)

CHARACTERISTICS OF PROFITS

- Profits are residual payments. They are earned after all other factors of production have been paid.
- Profits may be negative.
- Profits are uncertain i.e. they may or may not be realized.
- Profits fluctuate more than any other factor payment. During a boom profits rise further and during an economic depression profits reduce.
- Profits act as payments to other factors of production.

UNEB 2005

i) Distinguish between normal profit and supernormal profit. (02 marks)
ii)Mention any two determinants of profits in your country (02 marks)

UNEB 2013

i) Distinguish between economic profits and normal profits. (02 marks)
ii)Mention two factors that influence the level of profits in your country. (02 marks)

FACTORS DETERMINING/AFFECTING THE LEVEL OF PROFITS IN AN ECONOMY

- ❖ Price level in an economy.
- ❖ Cost of production/cost of sales.
- ❖ Number of producers in the industry/degree of competition.
- ❖ Level of output/turn over.
- ❖ Size of the market.
- ❖ Degree of risks involved in production.
- ❖ Level of entrepreneurship ability/skills or organizational ability.
- ❖ Goal/objective of the producer.

POSITIVE ROLE OF PROFITS IN A FREE ENTERPRISE ECONOMY.

- ❖ Abnormal profits induce risk bearing. Supernormal profits induce investors to take up risks and uncertainties of investment leading to increased production.
- ❖ Abnormal profits provide capital resources for expansion of firms, so they are a source of investment capital.
- ❖ Supernormal profits are a measure of efficiency in production by firms.
- ❖ Abnormal profits stimulate research thus innovations, inventions and enterprise development.
- ❖ Profits provide government tax revenue in form of corporate tax imposed on profits of the company.
- ❖ Abnormal profits are a source of government revenue through taxation of firms.
- ❖ Abnormal profits attract new firms to enter the industry which leads to increased production.
- ❖ Safe guard producers from competition such as normal profits which does not attract new firms into the industry.

NEGATIVE ROLE OF PROFITS IN A FREE ENTERPRISE ECONOMY.

- ❖ Profits lead to income inequality. i.e. producers who get abnormal profits and non-profit earners.
- ❖ Profits lead to misallocation of resources. Firms concentrate on production of luxurious commodities where high profits are enjoyed and ignore the production of cheap commodities to benefit the poor.
- ❖ Profits lead to inflation because of excessive need for high profits where producers tend to charger higher prices for commodities to reap high profits.
- ❖ Abnormal profits increase production thus leading to unmanageable surplus output which leads to dumping and resource wastage.
- ❖ High profits force trade unions to demand for increased wages since production is profitable. This in turn increases costs of production and results into cost push inflation.
- ❖ Profits lead to over exploitation of workers and suppliers of raw materials. Produces pay low wages to workers and low prices to suppliers of raw materials so as to reduce on costs of production and reap higher profits.

SUBSISTENCE PRODUCTION / NON-MARKETED OUTPUT/HOUSEHOLD OWN ACCOUNT PRODUCTION

Subsistence production refers to production mainly for producer‟s own consumption.

Production is mainly aimed at personal consumption, it is carried out on a small scale and in case of any surplus output, it is traded out mostly by barter system of exchange.

CHARACTERISTICS OF SUBSISTENCE PRODUCTION.

- Family labour is basically used in production.
- Simple tools are mainly used in production such as hand hoe, pangas and axes.
- There is limited specialization in production since the producer tries to produce everything for himself.
- The quality of output is generally low because production is not competitive.
- Low output is generally produced since it is aimed at meeting the personal needs of the producer himself.
- There are limited innovations and inventions in production because of limited materials needs of the producer.
- Production basically depends on nature.

ADVANTAGES OF SUBSISTENCE PRODUCTION.

- Limited resource wastage. What is produced is meant for specific consumption needs of the producer.
- Uses cheap labour. There ios limited demand for skilled labour hence affordable labour is employed.
- Simple techniques of production are used. These techniques can easily be acquired even by low income producers.
- It is the main source of food. This is because what is produced is basically meant for domestic consumption.
- It is more flexible. One can easily shift from one line of production to another.
- Provides self-employment i.e. use of family labour in production.
- Simplifies exchange of goods and services. This is because of barter trade system which is quicker in case of accidental surplus output.
- It doesn‟t cause inflation. This is due to the fact that money is not used as a medium of exchange.
- Low costs are incurred in distribution of final output. This is because no marketing is required.
- Limited possibility of over exploiting the available resources. This is because production is on a small scale thus continuous production.

UNEB 2002,2010

(i) What is meant by subsistence production. (01 mark)

(ii) *Give any three demerits of large subsistence sector in your country. (03 marks)*

DISADVANTAGES OF SUBSISTENCE PRODUCTION.

- ❖ Limited employment opportunities. Productivity is low due to persistent disguised unemployment.
- ❖ There is limited inventions and innovations in production. This is because of use of poor techniques of production without aiming at profit maximization.
- ❖ Leads to production of low quantity of output/low economic growth rate.
- ❖ It leads to low tax revenue to the government. This is because of a low tax base.
- ❖ Leads to underutilization of resources leading to underdevelopment.
- ❖ Limited specialization and trade.
- ❖ Low quality of output due to limited competition.

NB. ***Subsistence output*** refers to output meant for the producer"s own consumption.

MONETARY PRODUCTION/COMERCIAL PRODUCTION.

This is production where output is meant for sale in the market. The system of production is highly monetized involving the use of money as the medium of exchange.

It is production which takes place in the modern sector and it is intended for exchange though the use of money to maximize profits and it is characterized by high level of specialization.

FEATURES OF COMMERCIAL PRODUCTION.

- ❖ There is high degree of specialization in production.
- ❖ High quality output is produced due to high degree of competition.
- ❖ Production is mainly aimed at profit maximization.
- ❖ Large-scale production is realized.
- ❖ A lot of research is undertaken to improve the quality of output.
- ❖ Hired or wage labour is mostly used.
- ❖ The medium of exchange is on monetary basis. i.e. use of money as a medium of exchange.
- ❖ Involves the use of capital intensive technology.

ADVANTAGES OF MONETARY PRODUCTION.

- ❖ Encourages specialization.
- ❖ Facilitates infrastructural development.
- ❖ Leads to production of variety of commodities.
- ❖ High quality output is produced.
- ❖ Economies of scale are enjoyed such as marketing economies.
- ❖ Increases employment opportunities.
- ❖ Widens the country"s tax base.
- ❖ Increases output.

- Promotes the use of idle resources hence reducing production at excess capacity.
- Encourages diversification in production.

DISADVANTAGES OF MONETARY PRODUCTION.

- It is very costly because it involves research and distribution of final ooutput.
- Leads to wastage of resources due to over production.
- Leads to quick depletion of non-renewable resources.
- Causes inflation which results form use of money as a medium of exchange.
- Causes food shortage. Encourages production of more cash crops at the expense of food crops which gives rise to food insecurity.

STOCK EXCHANGE MARKET.

Stock exchange market is a market where already issued shares and stocks are bought and sold. It is only members of the stock exchange market that are allowed to buy or sell securities at the stock exchange.

Uganda capital market is tremendously growing and has witnessed a substantial increase in trading volume at the Uganda securities exchange (USE).

The Uganda securities exchange was licensed to operate as an approval stock exchange in June 1997 by the Uganda capital markets authority.

Over the last 10years, the Uganda securities exchange has raised trillions of money from equities, corporate bonds and government bonds and the number of shareholders has also registered an impressive growth.

The various listings on the Uganda securities exchange has been largely a product of privatization and liberation which has attracted several privately owned businesses and companies on board.

Members of stock exchange may be jabbers or stock brokers.

UNEB 2006.

i) *What is meant by stock exchange.* *(01 mark)*
ii) *Give there functions of stock exchange in your country.* *(03 marks)*

FUNCTIONS OF STOCK EXCHANGE.

- To provide mechanism for easy marketing of securities to individuals and organizations seeking to invest their savings.
- To regulate prices of traded securities.
- To mobilize domestic savings for long term investment.
- To assist in publishing useful information about performance of various companies and this guides investors wishing to trade on stock exchange.
- To monitor the financial affairs of every quoted company on the stock exchange.

UNEB 2002.

a) *Distinguish between a firm and an industry.* *(04 marks)*

b) *Assess the role of small-scale industries in the development of your country.* *(16 marks)*

THE THEORY OF A FIRM

A firm is a production unit under a unified control and management. It employs factors of production to produce goods and services.

Or

It is a unit which employs factors of production to produce goods or services for sale. Modern firms are characterized by separation of ownership from management.

An industry is a combination or a collection or a group of firms producing similar or closely related products. For instance, the plastics industry with firms such as nice house of plastics, the soda industry with firms such as crown bottlers and century bottling company, hotel industry with firms such as Sheraton hotel, lake view hotel, Golf course hotel, transport industry with firms such as pioneer bus company, swift safaris, rift valley railways.

OBJECTIVES OF FIRMS.

Different firms engage in production to achieve various objectives.

1. To maximize profits and this is at a point where MC=MR i.e. TR-TC.
2. To maximize sales revenue by producing high output and selling at low prices.
3. To maintain good public image by producing high quality output on the market.
4. To limit the entry of other firms in production by creating unfavourable conditions to discourage competition from other firms such as use of limit pricing.
5. To maximize employee welfare i.e. provide better conditions of work, high wages and make workers contented and increase labour efficiency.
6. To increase the market share by supplying more output on the market for other firms.

EQUILIBRIUM OF A FIRM.

Equilibrium of a firm is where a firm earns normal profits such that marginal cost =marginal revenue. This is the condition for profit maximization and it applies to all firms in all market structures.

EQUILIBRIUM OF AN INDUSTRY.

Equilibrium of an industry is where all firms in an industry are earning normal profits and at this point existing firms have no tendency to leave the industry or new firms are not attracted to enter production.

Marginal cost= marginal revenue.

THE SIZE AND GROWTH OF A FIRM.

Firms differ in size with some firms being so big while other are medium and small-scale firms.

UNEB 2004.

a) *Explain the factors which determine the growth of a firm in an economy. (10 marks)*
b) *Why may a firm continue to produce even when its average variable costs (AVC) are greater than its average revenue (AR)?(10 marks)*

FACTORS THAT INFLUENCE/AFFECT/DETERMINE THE SIZE AND GROWTH OF A FIRM.

NB. Neutral points must be presented and explained showing a favourable/positive part that enlarges the size of a firm and a negative part that limits the size and growth of a firm.

1. **Availability/supply of raw materials.** Presence of enough raw materials encourage more production and a firm grows bigger in size while scarcity of raw materials limits production which limits the size and expansion of a firm.
2. **Availability of finance/amount of capital employed by the firm.** A firm with large capital operates on a large scale since it is able to mobilize other factors of production while limited amount of capital limits further production and expansion of a firm.
3. **Size of market for a firm's output.** Large market size for output of a firm encourages further production which expands and enlarges the firm while a small market size discourages further production which limits the growth of a firm.
4. **Level of internal efficiency and quality of management of the firm.** High level of internal organization and high quality management allow effective coordination among workers which helps the firm to grow bigger and expand in size while poor internal organization and management limit the expansion and size of a firm.
5. **Level of development of infrastructure.** High level of infrastructure development especially transport facilities, banking facilities leads to further production which encourages a firm to operate on large scale while low level of infrastructure development discourages expansion and growth of a firm.
6. **Objectives of the firm.** A firm that aims at maximizing sales grows bigger and expands in size while firm that aims at profit maximization remains small in size since it keeps output low to maximize profit.
7. **Possibility of merging with other firms.** Increased possibility of merging enables a firm to grow and expand in size while limited possibility of merging of firms limits the expansion and size of a firm since output produced remains low.

8. **Government policy of taxation and subsidization.** Unfavourable government policy inform of high taxation on activities of the firm and limited subsidies reduce its capacity to invest and expand while favourable government policy through subsidization of firm‟s activities together with fair taxes reduce production costs thus increased capacity of the firm to expand in size.
9. **Level of technology employed by the firm.** Advanced state of technology facilitates more production and expansion of a firm while poor state of techniques of production discourage more production and expansion of a firm.
10. **Availability of skilled labour.** Increased use of skilled labour increases the amount and quality of output leading to growth and expansion of the firm while limited skilled labour reduces production which limits the growth of a firm.
11. **Availability of land for expansion.** Presence of enough land for expansion enhances growth of a firm while limited land for expansion limits the growth of a firm.
12. **Political climate.** Favourable political climate creates certainty for life and property which increases production and a firm grows bigger in size while unfavourable political climate discourages production which limits expansion a firm.
13. **Nature of goods and services produced by the firm.** The nature of commodities produced have a great influence on how the firm is likely to expand. Some commodities may only be produced on a small and therefore making it difficult for a firm to expand.

GROWTH AND EXPANSION OF FIRMS.

There are basically two methods through which a firm expands its scale of production. i.e.

1. Natural/internal growth of a firm.
2. Integration/merging/amalgamation of firms or external growth.

1. **NATURAL/INTERNAL GROWTH OF A FIRM.**

This is where a firm expands its scale of production through its profits ploughed back in the firm in order to expand its internal production base. This is achieved through,

- Improving level of technology used in production.
- Employing highly skilled manpower.
- Under taking extensive research on better methods of production.
- Borrowing funds from a financial institution to make necessary improvements.
- Selling part of its shares to generate more capital.
- Ploughing back the profits earned to expand production.

2. INTERGRATION/MERGING/AMALGAMATION OF FIRMS OR EXTERNAL GROWTH OF A FIRM.

This is coming together of two or more firms to form one bigger firm in order to enjoy economies of scale. This is intended to acquire a strong market share, increase profits and generally enjoy economies of scale.

Merging of firms is divided into the following:-

a. **Vertical merging of firms**. This refers to coming together of two or more firms in the same industry but at different stages of production. This is intended to enjoy economies of scale.

Usually one of the firm"s inputs is an output of another firm. For instance wheat miller firm merging with a hot loaf bread firm.

Vertical merging of firms takes two forms.

I. *Backward vertical merging.* This is where merging of firms bends towards the source of raw materials. For instance Kakira sugar works merging with sugarcane out growers.

II. *Forward vertical merging.* This is where merging of firms bends towards the market of a firm"s output in order to gain control over the market of a given product. For instance a large oil company merging with a petrol station.

b. **Horizontal merging.** This is the coming together of two or more firms at the same stage of production and in the same industry. This is intended to enjoy economies of scale .

For instance Barclays bank merging with Stanbic bank, Pepsi cola firm merging with coca-cola firm, Hima cement industry merging with Tororo cement industry.

c. **Conglomerate/diversified merging.** This is the coming together of two or more firms producing commodities which are not related at any stage of production to achieve diversification of activities.

For instance coffee processing firm merging with a book publishing firm, insurance company merging with a hotel.

d. **Lateral merging.** This is the coming together of two or more firms producing related products which do not compete for the same market but can be conveniently marketed together.

For instance Bata shoes company merging with Kiwi shoe polish, paper manufacturing firm merging with pen manufacturing firm.

UNEB 2010

i) Distinguish between lateral integration and conglomerate integration of firms. *(02 marks)*

ii) Give any two conditions necessary for the success of lateral integration of firms. *(02 marks)*

Conditions necessary for successful lateral integration of the firms.

- Firms should have the same capital base.
- Firms should almost be of equal size.
- Sirms should have related objectives.

- ❖ Firms should be producing related goods.

UNNEB 2009, 2008, 2006, 2003, 2011

i) *Distinguish between horizontal and vertical merging of firms. (02 marks)*
ii) *Give any two reasons for merging of firms in your country. (02 marks)*

OBJECTIVES OF MERGING OF FIRMS/REASONS FOR MERGING OF FIRMS/WHY IS IT NECESSARY FOR FIRMS TO MERGE IN PRODUCTION

- ❖ To encourage efficiency in management.
- ❖ To reduce competition for factors of production/ factor inputs.
- ❖ To achieve monopoly powers/to control the market which enables firms to enjoy abnormal profits.
- ❖ To increase output/enjoy economies of scale.
- ❖ To attain ability to exploit available resources.
- ❖ To reduce unnecessary duplication of goods and services thus minimizing resource wastage.

UNEB 2005, 1999.

a) *Distinguish between horizontal and vertical merging of firms in an industry. (04 marks)*
b) *Explain the merits and demerits of integration of firms in an economy. (16 marks)*

ADVANTAGES OF MERGING OF FIRMS IN AN ECONOMY.

1. **Research becomes possible and easy among firms**. Research is undertaken by all firms/joint research which increases productivity and innovations thus better quality products.
2. **Widens capital base of firms which increases output.** All firms pool their capital resources together which increases the financial position of firms and promotes more investment.
3. **Reduces duplication efforts in production.** Resources are efficiently utilized by merged firms hence limited resource wastage.
4. **Expands market for output of merged firms/reduces competition for market.** There is increased monopoly powers enjoyed by merged firms thus encouraging more production.
5. **Increases access to better technology.** Merged firms are able to employ advanced technology which increases the quality and quantity of output to compete favourably on the market.
6. **Leads to easy accessibility to skilled man power.** Merged firms are able to employ highly skilled labour and this leads to increased efficiency in production of mergers due to specialization.
7. **Creates easy accessibility to loans.** There is increased bargaining power of merged firms to acquire financial resources/loans from banking institutions due to a large amount of fixed assets. This increases production hence expansion of firms.

8. **Enables firms to share risks in production.** Risks arising out of production are shared by all firms which guarantees long-term survival of all firms in business which limits the extent of losses.
9. **Reduces advertisement costs.** This is due to the removal of unnecessary competition for market among firms thus low operational costs.
10. **Increases efficiency in management of merged firms.** Firms enjoy low administrative costs due to joint management and increased specialization in management.
11. **Reduces stiff competition for raw materials** and this lowers production costs. This happens effectively where there is horizontal merging of firms.
12. **Leads to increased profits due to increased output.** This arises from large scale operations that tends to reduce average cost of production thus increased investment.

DEMERITS OF MERGING OF FIRMS IN AN ECONOMY.

1. **It gives rise to monopoly and its disadvantages.** Firms become a single entity which restricts output to sell at very high prices.
2. **It leads to rise of unemployment.** After ,merging, firms adopt capital-intensive technology and in addition, some top managers are laid off to reduce managerial costs.
3. **Leads to loss of independence/identity by individual firms.** When big firms merge with small-scale firms, the big firms tend to dominate the decisions making process leaving small firms with low sovereignty.
4. **Leads to inefficient management.** Excessive bureaucracy complicates management since it requires high level of consultation of all departments and there is reduced competition hence delaying decision making.
5. **Leads to increased taxation of firms by government.** As a result of merging, the level of output increases which attracts government's intervention through taxing highly the profits of firms.
6. **Results into over production which leads to resource wastage.** In situations where the market size is small large scale production leads to resource wastage.
7. **Leads to over exploitation of resources.** Existing raw material sources are over exploited by merged firms and this leads to quick resource depletion especially where resources are non-renewable.

UNEB 2003.

i) *Distinguish between horizontal integration and vertical integration of firms. (02 marks)*

ii) *Mentions any two advantages of horizontal merging of firms. (02 marks)*

Advantages of horizontal integration of firms.

- Widens market.
- Increases accessibility to loans.
- Improves management.
- Leads to access to better technology.
- Increases output/profits.
- Reduces cost of persuasive advertising.
- Leads to access to skilled labour.
- Enables firms to share risks in production.
- Reduces competition for raw materials.

LIMITATIONS OF MERGING OF FIRMS IN AN ECONOMY.

1. **Fear of diseconomies of large scale production** such as problems of marketing, excessive output. This leads to production at losses.
2. **Fear of losing personal contact with customers.** Big firms fail to offer personal attention to their customers on issues regarding product quality.
3. **Fear of hardships in management of large enterprises.** Merged firms require the presence of high managerial skills which are limited in most cases.
4. **Fear of high taxation on large scale firms.** Large firms normally attract high taxation of their profit by the government and firms may not be willing to pay such high taxes.
5. **Fear of unemployment of some top managers.** After merging, it's becomes necessary to reduce on the number of top managers in order to reduce production costs and some top managers are not willing to lose their jobs.
6. **Fear of loss of independence by small scale firms.** As firms merge, there is a need for high level of interdependence in decision making by all top managers of merged firms and this is likely to slow down decision making.
7. **Fear to undertake high risks exposed to large- scale firms**. In situations of political instability, larger scale firms are normally targeted for bombing and rooting by insurgents and in case of industrial accidents as a result of fire heavy loses may be incurred.
8. **Unfavourable government policy towards merging of firms**. This involves use of anti-monopoly laws which prohibit firms from merging to prevent the development of monopoly.
9. **Different goals or objectives of firms that do not favour merging**. Firms have different objectives such as sales maximization, profit maximization, provision of employment which are very difficult to incorporate.
10. **Existence of enough market for a firm's output/competition may favour market potential**. Thisforces a firm to remain independent since competition may favour the independent firm.

11. **Firms may be in unrelated fields of production**. This requires different fields of specialization which implies independent production.

UNEB 2008.

a) Account for the survival of small-scale firms alongside large-scale firms in your country. (10 marks)

b) What are merits of small-scale firms in your country? (10 marks)

UNEB 2010.

a) Differentiate between internal economies and external economies of scale. (04 marks)

b) Account for continued existence of small-scale firms in your country. (16 marks)

REASONS FOR CONTINUED SURVIVAL OF SMALL SCALE FIRMS ALONG SIDE LARGE SCALE FIRMS.

Despite the economies of scale enjoyed by large-scale firms through merging, small-scale firms continue to exist alongside large-scale firms due to the following reasons.

1. **Simple techniques are required in production.** Small scale firms require cheap technology in production and this enables the firm to continue producing for a long time on a small scale.
2. **Existence of s small market size for products.** Limited market does not necessitate large-scale production and in such a situation, small-scale firms operate better and remain small.
3. **Production according to special order and need for personal services.** Firms providing special services to customers always remain small in order to cater for special needs of their customers hence remain small.
4. **Limited sources/supply of some inputs.** Where the firm"s inputs are limited, it is bound to remain small for along period of time.
5. **Fear of heavy risks associated with large scale firms.** Large –scale firms are exposed to heavy risks in case of industrial accidents and in periods of political instability. This forces some firms to remain small.
6. **Limited managerial/entrepreneurial skills hence easy management of small scale firms.** Some firms remain small since they are easy to manage and where the owner has limited managerial skills which are only suitable for small-scale management of production.
7. **Fear of heavy taxation associated with large-scale production.** Some firms remain small in order to dodge high taxes that are normally imposed of large-scale firms and such firms prefer to remain small.
8. **Some scale firms are experimental units/research projects and they thus bound to remain small.** Established firms to carry out given activity for a short period of time remain small since there is no reason for expansion and therefore keep small.

9. **Small scale firms allow flexibility in production.** Small-scale firms are flexible in their line of production depending on changes in tastes and preferences of customers and are therefore able to survive in production for a long time on a small scale.
10. **Small scale firms tend to use the bi-products of large scale firms (small scale firms are interdependent with large firms).** For instance sweets industry and sugarcane processing firm and therefore such firms do not compete for the same market. This enables small-scale firms to keep operating.
11. **Government policy aimed at supporting small scale firms.** This is through fair taxes or at times subsidizing their activities since majority of them use local resources and hence continue operating on a small scale.
12. **Infancy stage of firms in production/they are beginner or new firms.** Some firms are small because they have just joined production and are still infant and have hope of expanding in future.
13. **Limited capital for business expansion.** Firms remain small because of limited capital required for them to produce and their find it difficult to expand their scale hence remain small.
14. **Fear of diseconomies of scale.** This is normally faced by large scale firms and this forces firms to remain small.

MERITS OF SMALL SCALE FIRMS IN UGANDA.

- They are easy to mange and control. Since Uganda has limited entrepreneur class to manage large scale firms, small scale firms become suitable.
- They are flexible thus less resource wastage. They are able to change production depending on changes in demand thus low resource wastage.
- They are less costly since they need little capital to start. Many entrepreneurs have limited capital in Uganda and this makes small-scale firms suitable.
- They encourage the use of local resources. Most of small –scale firms do not involve importation of intermediate inputs and rely on domestic raw material sources.
- Encourage fair income distribution. Because they are easily spread across the whole country, owned by both the business community in rural and peri urban areas and help to distribute income fairly.
- Produce cheap/affordable goods to the population. Which is not catered for by large- scale firm. They use simple technology and generally production costs are low which reduce final prices for their products in the market.
- Promote the use of local technology/use simple techniques of production. They depend on domestic techniques of production and do not involve importation of heavy machinery.

- ❖ They are appropriate for small markets existing. The domestic market in Uganda is still limited due tom low purchasing power among the existing consumers and foreign markets are highly competitive. This makes such firms suitable since output is limited.
- ❖ Provide personal services to customers due to personal contact. This leads to high quality service provision since they are able to deal with customers directly.
- ❖ Produce a wide variety of commodities hence widening consumers' choice. Small-scale firms have limited specialization and therefore engage in production of several commodities.
- ❖ They are not associated with heavy losses/risks. Losses are limited due to small-scale production.
- ❖ Decision making is easy. There is limited bureaucracy in management of small scale firms.

LOCATION OF INDUSTRIES/FIRMS.

Location of an industry refers to setting up an industry in a given geographical area/place. This is done by taking into account production costs. It is the establishment of an industry or firm ina given geographical place.

FACTORS FOR THE LOCATION OF AN INDUSTRY.

1. **Availability of raw materials.** Industries tend to be located near the source of raw materials in case the raw materials are bulky such as Tororo cement, Hima cement industries in Uganda.
2. **Availability of market.** It is economical to locate an industry near the market to reduce transport costs especially where the product is bulky, perishable and delicate.
3. **Availability of power supply.** Industries especially those that require high power supply are located near areas with access to enough power supply. For instance steel industries in Uganda are located near the source of power supply.
4. **Availability okf labour supply.** Labour intensive industries tend to be located in areas where there is availability of cheap labour especially in densely populated areas. That‟s why many industries tend to locate near urban areas with easy access to labour.
5. **Availability of land for expansion.** An industry is usually established in areas where there is enough land for future expansion. This is meant to encourage further production.
6. **Government policy on industrialization.** Government at times determines areas where some industries should be established for various objectives such reducing rural urban migration, providing employment opportunities and stimulating utilization of given resources.
7. **Availability of means of transport.** An industry is located in areas where there is well developed transport systems inform of roads, railways

to ease transportation of factor inputs and distribution of output to reduce on costs of transport.

8. **Availability of water supply.** Some industries need a lot of water as an input for production such as steel industries for refreshing machines, brewing industries, soft drinks industries and such industries are normally located near water sources. For instance Nile breweries in Jinja.
9. **External economies of scale.** An industry is located where other industries are located to enjoy services such as banking, insurance, advertising agencies and warehousing facilities are in place and exploit economies of scale.
10. **Political climate.** An industry is located in a n area where there is political stability to enhance workers ability to concentrate on production activities and ensure certainty for life and property. This is meant to attract more local and foreign industrialists.

Industrial inertia.

Industrial inertia is the tendency of an industry to remain located in an area or a new one being attracted in the area even after locational advantages are no longer significant.

Or

This is a tendency for an industry to remain located in an area or a new one being attracted in the area even after the factors influencing location in that area are no longer significant.

The firm is forced to remain in the area due to established infrastructure and high costs of relocating.

UNEB 2008.

i) Define the term industrial inertia.. (01 marks)

ii) Why should the government influence the location of an industry. (03 marks)

WHY MAY GOVERNMENT INFLUENCE THE LOCATION OF INDUSTRIES IN AN ECONOMY

- To ensure regional balance in development by fairly distributing industries.
- To redistribute incomes fairly by fairly balancing industries in the country.
- To fulfill political interests of the government through distributing industries fairly.
- To reduce rural urban migration.
- To reduce negative effects of locations of industries.
- To promote creation of employment opportunities in all regions of the country.
- To promote exploitation of idle resources in regions which are underdeveloped.
- To control private monopoly tendencies in given regions.

Industries are categorized into various types.

a. ***Rooted industries.*** These are industries located in an area due to the existence of locational advantages/factors. For instance strategic and major inputs required by such industries. For instance cement industries in Uganda are rooted industries.
b. ***Tied industries.*** These are industries that are linked to the market centres in terms of their location.
c. ***Foot looses industries.*** These are industries which are freely set up in any place regardless of locational factors. These industries can be easily shifted from one region to another. For instance confectionaries, grain milling industries.
d. ***Weight losing industries.*** These are industries whose raw materials are bulky and lose weight during manufacturing process.
   These industries are located in their strategic sources of bulk raw materials to manufacture light final products which can easily be transported to market centres.
e. ***Weight gaining industries.*** These are industries whose final products gain weight during manufacturing process.
   These industries are normally linked to market places and normally use light inputs/raw materials to manufacture bulky final products. For instance ship building industries and assembling industries.
f. ***Infant industries.*** Infant industries are firms in the industrial sector that have just started operating and therefore have limited markets, low output levels and thus have high average costs (not enjoying economies of scale). **Or**
   These are newly established industries producing low output and operating at high average costs of production.
   They are industries that are in the early stages of development, producing low output at high average costs of production and without enjoying economies of scale.

UNEB 2002.

i) *What are infant industries. (01 marks)*
ii) *Suggest any three ways of protection infant industries in your country. (03 marks)*

WAYS OF PROTECTING INFANT INDUSTRIES IN AN ECONOMY.

- Imposition of high import duties on substitutes.
- Banning imported substitutes.
- Import quotas on imports similar to what is produced.
- Giving tax incentives/concessions to infant industries.
- Quality controls.
- Depreciation of the local currency.
- Administrative controls.

UNEB 2014

a) *Differentiate between location and localization of an industry. (04 marks)*
b) *Assess the impact of localization of industries in your country (14 marks)*

LOCALIZATION OF INDUSTRIES OR FIRMS

Location of industries is the concentration of many industries in a given locality or area to maximize locational advantages or reap external economies of scale. For instance Namanve industrial area, Nakawa industrial area, Ntinda industrial area in Uganda. It is a tendency for both the major industries and subsidiary industries to concentrate in a particular area to enjoy external economies of scale.

ADVANTAGES OF LOCALIZATION OF INDUSTRIES IN AN ECONOMY

- Leads to development of basic infrastructure. It leads to establishment of hospitals, roads, banks due to increased concentration of industrial activities.
  There is increased growth of service sector due to specialized institutions. These institutions are inform of banks, insurance companies, ware housing facilities and advertising agencies. This supports further production.
- Increased employment opportunities. This is due to mash rooming supporting activities which offer jobs to labour thus reducing unemployment.
- Encourages specialization by commodity. Different industries that are specialized in production of various commodities are set up in an area. This leads to greater production.
- Development of subsidiary industries. They include industries that supply inputs for production in large-scale firms and those that use the bi-products of those major industries as their raw materials.
- Provision of better services to the localized area by the government. Public services such as security and water supply are provided to the localized area.
- Increased supply of skilled labour with relevant skills needed by industries in the localized area.
  Localization of industries attracts high supply of labour especially the skilled.
- Encourages efficiency of firms in production. This is due to increased competition among firms in the region of localization thus high quality output.
- External economies of scale are enjoyed by the entire industry. This leads to a reduction in avarege costs of production.
- Leads to development of organized markets since it allows easy exchange in the area.
- Leads to development of additional services needed by workers for instance shoe repair.

UNEB 1999.

i) *Distinguish between forward linkages and backward linkages. (02 marks)*

ii) *Give any two examples of backward linkages in your country. (02 marks)*

FORWARD LINKAGES

Forward linkages occur when setting of an industry results into establishment of another industry that provides market to the products of the already existing industry. **Or**

Forward linkages occur when the establishment of an industry leads to the emergence of another industry to use to products of the main industry as its raw materials.

BACKWARD LINKAGES

Backward linkages occur when the existence of an industry results into the establishment of a new industry to provide inputs for the existing industry.

Examples of backward linkages.

1) Sugarcane outgrowers to sugar processing industries.
2) Tea out growers to tea processing industries.
3) Cotton growers to textile industry.
4) Food producers to industrial food processors.

DISADVANATGES OF LOCALIZATION OF INDUSTRIES.

1. **Leads to regional imbalances in development.** Concentration of industries in an area leads to uneven development of regions where localized regions develop at the expense of other regions.
2. **Increases rural urban migration and its disadvantages.** Many people are attracted to localized areas from rural areas leading to slum development, high crime rates and congestion.
3. **Leads to external diseconomies of scale.** Localization of industries leads to shortage of power supply, shortage of raw materials because of high competition among firms.
4. **Leads to shortage and overstraining social infrastructure.** The available schools, roads, housing facilities are over utilized due to over population in the localized area.
5. **Results into over exploitation of resources where industries are localized.** This leads to quick naturalresource depletion due to increased demand for such resources which is dangerous for future development.
6. **Leads to high social costs in the area of localization.** This is inform of water pollution and air pollution which makes the public to suffer.
7. **Increases cost of living and cost of accommodation with in the localized area.** This results from increased demand for goods and services such as accommodation due to large population which leads to inflation.
8. **Limits employment opportunities to a particular type of labour.**

DELOCALIZATION OF INDUSTRIES

Delocalization of industries refers to a deliberate policy by the government to relocate or redistribute industries from where they are concentrated to other areas where they are few or don"t exist to avoid concentration of industries in a particular area.

UNEB 2002.

a) *Distinguish between a firm and an industry. (04 marks)*
b) *Assess the role of small-scale industries in the development of your country. (16 marks)*

SMALL SCALE INDUSTRIES

There are manufacturing units with a small capital base and employ relatively fewer labour/people. These include hand craft industries, metal fabrications, furniture workshops, grain milling industries.

ROLE OF SMALL SCALE INDUSTRIES IN THE DEVELOPMENT OF AN ECONOMY.

Positive Role Of Small Scale Industries In An Economy.

- ❖ Provide employment opportunities since they are established even in rural areas with abundant labour. This reduces the rate of unemployment.
- ❖ They lead tio acquisition of skills for local labour. They are mainly owned by local investors thus acquisition of skills.
- ❖ Provide a variety of goods and services. They engage in production of a variety of activities thus increased consumers choice.
- ❖ They create backward and forward linkages. Contribute to industrialization in the long run when they expand and start enjoying economies of scale.
- ❖ Encourage the use of idle local resources. They depend on local sources of raw materials thus increased resource utilization in the long run.
- ❖ Promote local entrepreneurial development. This is because they are mainly owned by local investors thus increased entrepreneur skills.
- ❖ Act as aground for technological development. The intermediate technology used is expanded in the long run thus technological improvement.
- ❖ Source of government tax revenue. They help to widen the tax base.
- ❖ Produce cheap and affordable goods for the population. This is because they incur low production costs thus low price level for such output.
- ❖ They increase development of infrastructure. They facilitate establishment of roads, railways to support them.
- ❖ Promote self sufficieny/sustainance. This is because they are mainly owned by local investors.
- ❖ Increase commercialization and diversification. This leads to a reduction in subsistence production.

- ❖ They reduce income disparities/inequalities. This is because they tend to be widely spread.
- ❖ They increase incomes/GDP. This is important for further investment.
- ❖ Improve on balance of payment position. They produce mainly for local market which reduces the level of expenditure on imports.

Negative Role Of Small Scale Industries In An Economy.

- ❖ Produce low quality output thus limited demand on the international market.
- ❖ Lead to wastage of resources due to unnecessary completion and duplication of commodities.
- ❖ Lead to increased administrative costs by the government.
- ❖ They create congestion in peri-urban centres.
- ❖ Contribute less to employment creation.
- ❖ They lead to resource underutilization due to excess capacity production.
- ❖ Low output is realized hence limited contribution to GDP.
- ❖ They lead to increased social costs such as pollution.
- ❖ Lead to low government tax revenue because of producing on small scale.
- ❖ They lead to growth of slums in peri urban areas.

THE THEORY OF COSTS

Costs are expenses incurred by the firm during the production process to produce a given unit/level of output.

Costs can be categorized as external/social costs or private costs.

Social costs are not paid by the firm which the society bears on account of production of a commokdity. For instance noise pollution, air pollution, water pollution as a result of production. Such costs do not feature in the cost structure of the firm.

Private costs are monetary expenses incurred by the firm in producing a given level of output. These are self-incurred expenses by the entrepreneur in production process. Private costs are categorized into two-

1. **Implicit costs.** These are expenses which are not included when calculating profits of the firm. They are often over looked when calculating the firm"s production costs. They are self owned costs.

   Examples of implicit costs.

   i) Salary of a sole proprietor.
   ii) Rent for a building personally owned and used.
   iii) interest rate on personal capital invested by the owner of the business.
   iv) Costs of family labour.

2. **Explicit costs.** These are monetary expenses incurred by the firm to acquire factors of production and are included when calculating profits. They are met when a firm acquires factors of production that are not owned by the owner of the business.

   Examples of explicit costs.

Salaries and wages to hire labour, expenses on raw materials, advertising costs, transport costs, interest rate on borrowed capital. Insurance premium, electricity bills.

PRODUCTION FUNCTION

A production function is a functional relationship between the amount of inputs used and amount of output produced in a given period of time. **Or**

Production function is a technical relationship between proportions of factor inputs employed in relation to proportions of output produced in a given time.

Production function can be expressed in two ways.

Graphically, production function can presented by use of an isoquant curve.

An isoquant curve is a curve showing possible combinations of two factor inputs that are used to produce the same level of output.

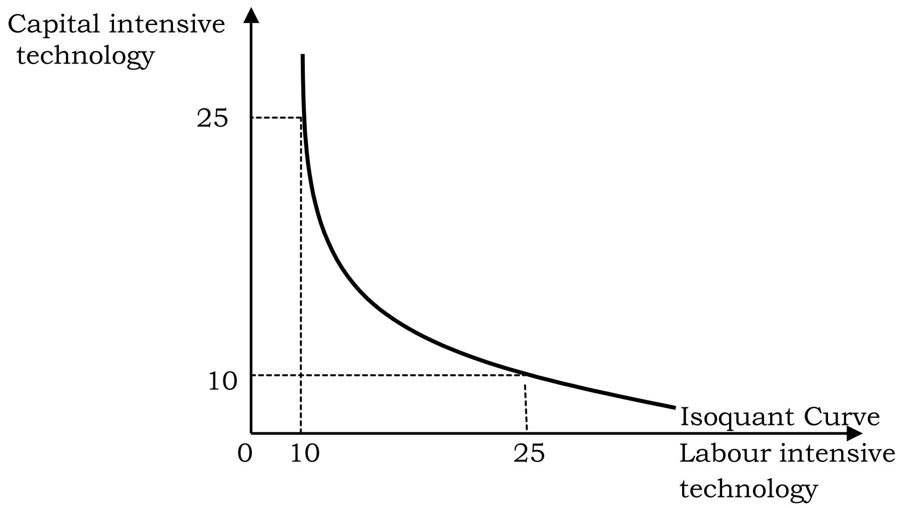


Figure 3.1: an isoquant curve.

Characteristics of an isoquant curve.

- An isoquant curve is downward sloping from left to right.
- It is convergent to the origin.
- Different isoquant curves do not intersect.
- A high isoquant curve that lies above and to the right of another yields a higher level of output.
- In between two different isoquant curves, there can be many isoquant curves as possible as long as they do not intersect.
- The slope of an isoquant curve is called marginal rate of technical substitution.

NB. Marginal rate of technical substitution. This is the rate at which a producer substitutes one factor of production for an extra unit of another factor input so as to maintain the same level of output.

UNEB 2011

i) *Distinguish between an overhead cost and an operating cost. (02 marks)*

ii) *State any two overhead costs in an economy. (02 marks)*

TYPES OF COSTS

a. FIXED/OVERHEAD/INDIRECT/SUPPLEMENTARY/UNAVOIDABLE COSTS

These are expenses/costs of a firm that do not very directly with the level of output produced. They remain constant at all levels of output. Even if there is no output produced, fixed costs still exist. They are the same whether output is zero, 50units,420 units and 600units.

Examples of fixed/overhead costs.

Rent for business premises, interest rate on borrowed capital, insurance premium, salaries of top management, cost of depreciation of machinery.

b. VARIABLE/ PRIME/DIRECT/OPERATING/RUNNING COSTS.

Variable costs are expenses/costs of a firm which may vary directly with the level of output produced. They increase when output increases and reduce when output reduces and they are absent where there is no output produced.

Therefore at zero output levels, fixed costs are also zero.

Examples of variable costs.

Wages and salaries for labour, transport costs, costs of raw materials, advertising and distribution costs.

c. TOTAL COSTS (TCs)

Total costs refer to the sum of a firm‟s fixed and variable costs in production of a particular level ofk output .

Or

These are total expenses incurred by the firm to produce a given level of output. When output is zero, total costs are equal to total fixed fixed costs.

TC=TFC+TVC.

RELATIONSHIP BETWEEN TC, TFC AND TVC.

OUTPUT (Qty)	TFC	TVC	TC
0	50	0	50
1	50	20	70
2	50	36	86
3	50	46	96
4	50	54	104
5	50	85	135
6	50	130	180
7	50	181	231
8	50	246	296

Table 3.1: relationship between total costs.

TOTAL COST CURVES

RELATIONSHIP BETWEEN TFC, TVC AND TC OF PRODUCTION.

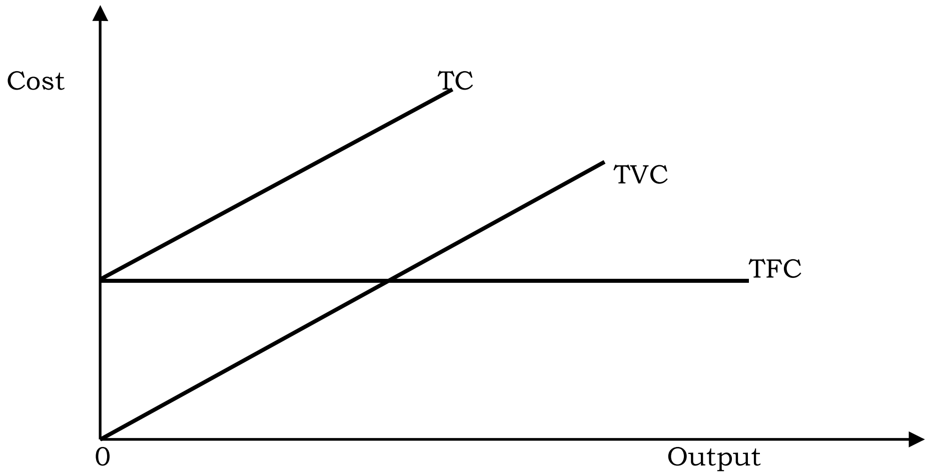


Figure 3.2: relationship between TC, TVC and TFC.

- The TFC curve is a horizontal curve to the axis output because fixed costs are constant at all levels of output. The TFC curve begins from above zero because fixed cost are constant at all levels of output.
- The TVC curve starts from the origin and increases as the level output increases since variable costs vary with the level of output produced.
- The TC curve is above the TCF and TVC curves because total costs are a sum of fixed costs and variable costs of production.
- The TC curve is higher than the TVC curve at zero level of out implying that even at zero level of output fixed costs have to be incurred.
- The TVC and TC curves slope upwards because of variable costs that increase with increase in the level of output.

TOTAL FIXED COST CURVE.

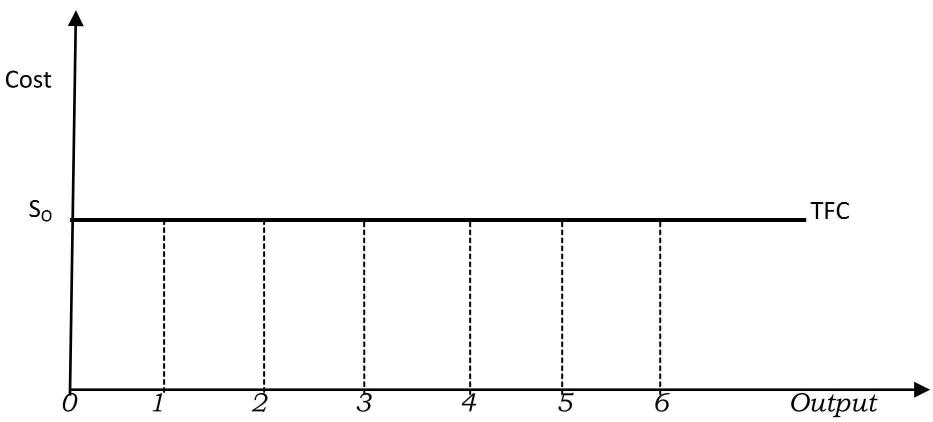


Figure 3.3: total fixed costs curve.

Costs remain constant regardless of changes in the level of output produced.

d. AVERAGE VARIABLE COST (AVC)

Average variable cost is the total variable cost per unit output produced by the firm. **Or**

It is expenditure of the firm on variable factors of production per unit of output produced.

The AVC curve is U shaped since average variable costs first reduce with increase in output, reach maximum point and then start increasing continuously thus the U shaped nature of the AVC curve.

AVC = TVC/Output (Q).

AVERAGE VARIABLE COST CURVE

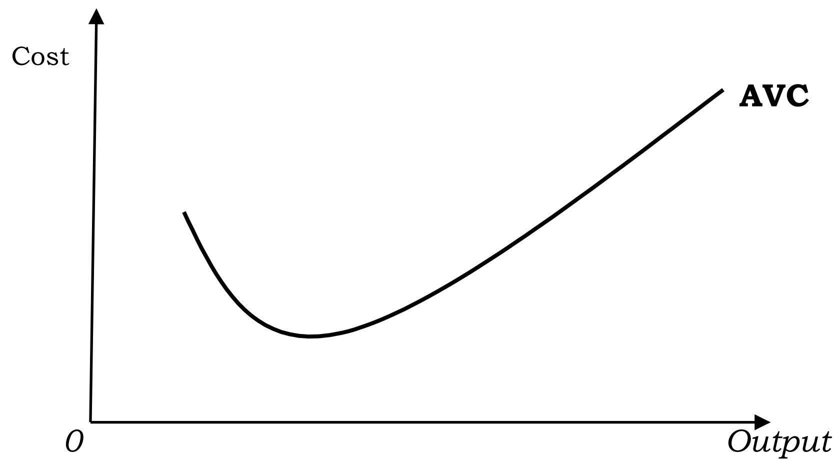


Figure 3.4: average variable cost curve.

e. AVERAGE FIXED COSTS. (AFCs)

Average fixed costs are total fixed costs per unit of output produced by the firm. **Or**

It is expenditure of a firm on fixed factors of production per unit of output produced.

The AFC curve is continuously declining as output produced increases. This is because a constant fixed cost is continuously being divided by an increased level of output.

Therefore, as output increases, the AFCs reduce i.e. the higher the level of output, the lower the AFCs and the lower the level of output, the greater the AFCs. **AFC=TFC/Output (Q).**

AVERAGE FIXED COST CURVE.

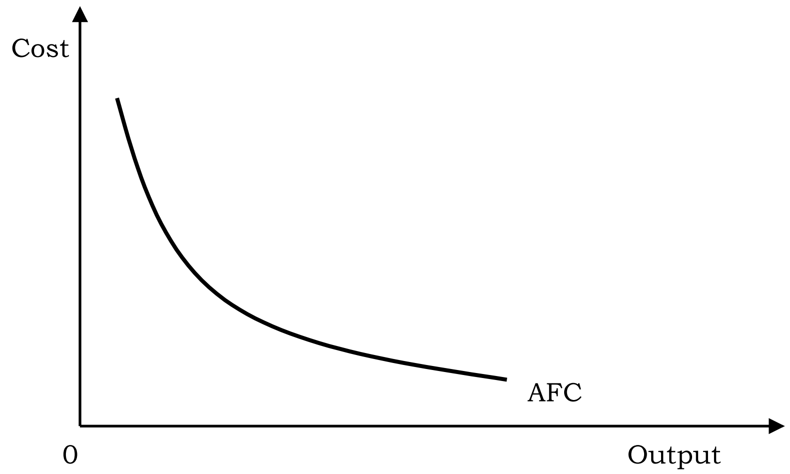


Figure 3.5: Average fixed cost curve.

The AFC curve is downward sloping from left to right but it is never zero since fixed costs are never zero which implied that AFC curve does not touch any of the two axis.

f. Average cost (AC).

Average cost is the total expenses/cost of a firm per unit output produced.

Or

It is expenditure of the firm on both fixed and variable factors of production per unit of output produced.

AC=TC/Output (Q).

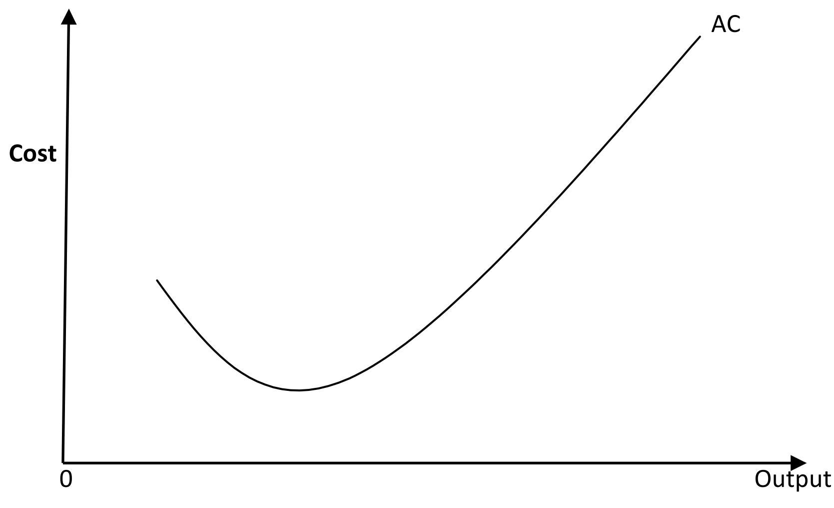


Figure 3.6: Average cost curve.

- ❖ The average cost curve is U shaped in the short run because of the law of admonishing returns and U shaped in the long run because of economies and diseconomies of scale.
- ❖ The AC curve is U shaped indicating that average cost first decreases as output increases, reaches a minimum point and starts increasing continuously. This is because of the law of diminishing returns.

- Below the optimum point of the AC curve, there is less of a variable factor compared to a fixed factor such that as output increases, the cost per unit falls due to better utilization of the fixed factor. This is referred to as increasing returns. The firm is said to be producing at excess capacity implying that resources are underutilized.
- At the optimum/minimum point of the AC curve, the average costs of production are minimal because the fixed factor is efficiently utilized by the variable factor. There is an optimal combination of the fixed factor and variable factor. This produces high output level at lowest average cost implying that all resources are fully utilized.
- Beyond the optimum level of output (minimum point of the AC curve), the cost per unit output increases much faster as compared to the increase in output produced because the variable factor is too much compared to the fixed factor. A fixed is over utilized. This is called diminishing returns.

g. Marginal cost (MC).

Marginal cost is an additional cost incurred by the firm to produce an extra unit of output. **Or**

It is an additional expenditure of a firm as an extra unit of output is produced.

MC=DTC/Quantity or output.

$MC=TC_2-TC_1/Q_2-Q_1$.

MARGINAL COST CURVE.

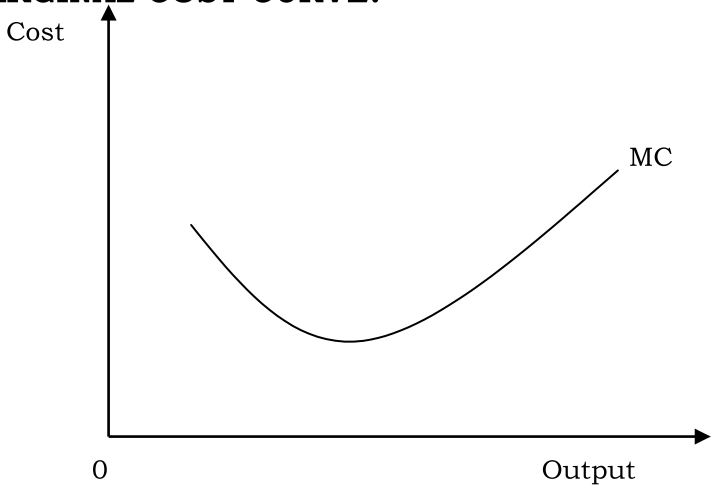


Figure 3.7: Marginal Cost Curve.

The MC curve is also Ushaped in the short run due to the law of diminishing returns. As the level of output produced increases, the MC curve first reduces, reaches the minimum point and then starts increasing continuously.

Since fixed costs do not change with changes in output, the marginal costs are a result of changes in the variable costs of production only.

RELATIONSHIP BETWEEN AVERAGE COST AND MARGINAL COST.

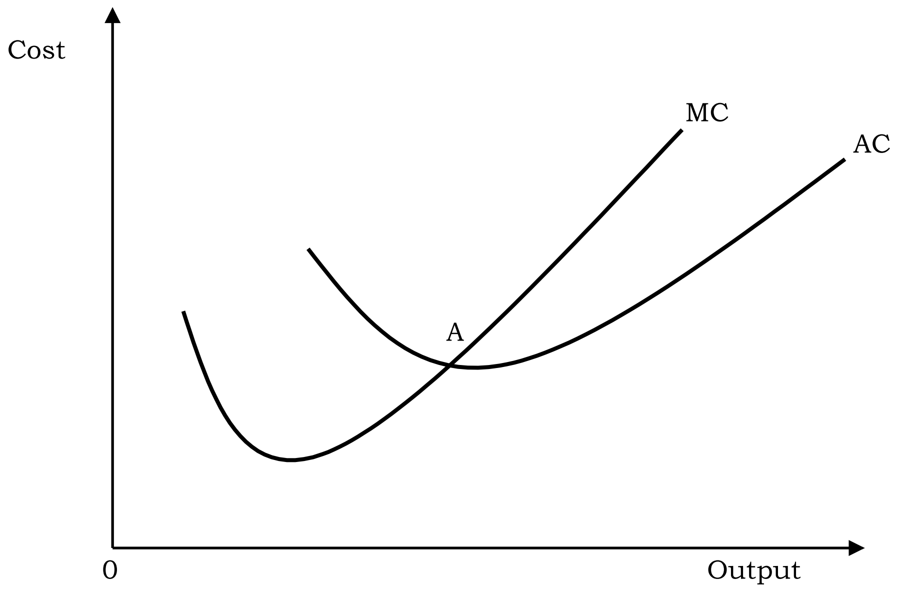


Figure 3.8: average cost curve and marginal cost curve.

- ❖ MC and AC curves are U shaped in the short run because of the law of variable factor proportions.
- ❖ When MC is greater than AC, the AC curve is rising.
- ❖ The MC curve cuts the AC curve at its minimum point A.
- ❖ The AC is greater than MP upto the minimum point of the AC curve at point A which is reached when the firm is operated optimally.
- ❖ The productivity of variable factor increases as more of it is employed at the falling part of the AC curve.
- ❖ Beyond the minimum point at A, marginal costs rise faster than average costs and that is why the MC curve lies above the AC curve beyond the minimum point of the AC curve.
- ❖ The productivity of a variable factor decreases as more of it is employed beyond the minimum point of the AC curve.
- ❖ At point A, the firm is producing high output at the lowest cost and this is the optimal point of a firm.
- ❖ Beyond point A, the cost per unit of output starts to increase because of over utilization of a fixed factor causing diseconomies of scale.

THE CONCEPT OF REVENUE OF A FIRM.

Revenue of a firm refers to the earnings/receipts of the firm resulting from the sale of its output.

FORMS OF REVENUE OF A FIRM

- ❖ **TOTAL REVENUE (TR).** This is the total amount of money received by a firm from the sale of its total output.

  TR=Total output X price of output.
- ❖ **AVERAGE REVENUE(AR).** This refers to the amount of income received by the firm form the sale of each unit of output.

  Or

  This is total revenue per unit output of a firm.

It is the price of each unit of output sold by a firm. Average revenue is the same as price(AR=P).

AR=TR/output.

- **MARGINAL REVENUE(MR).** This is the additional revenue obtained by a firm from the sale of an additional unit of output. MR=ΔTR/Δunits of output sold.

THE CONCEPT OF PRODUCT/OUTPUT.

Output is the amount of a given commodity that a firm produces for sale at a given price.

TYPES OF PRODUCT

1) **TOTAL PRODUCT (TP).**

Total product is the total amount of a given commodity produced by employing all factors of production. i.e. both variable and fixed factors. In the short run where some factors of production are fixed for instance land and others are variable, the total product first increases as units of a variable factor employed to a fixed factor increase, reaches maximum point and eventually declines. This is due to the law of diminishing returns.

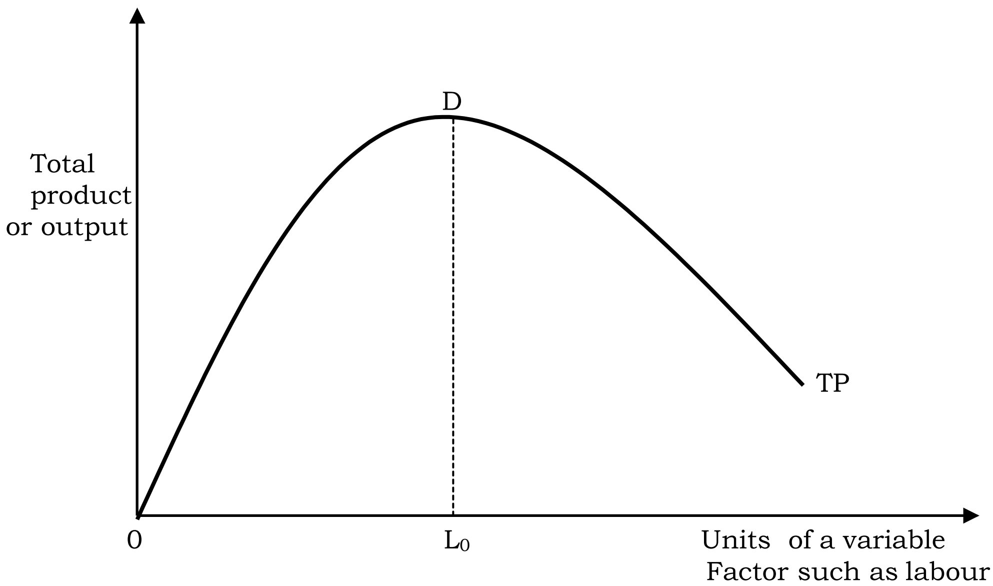


Figure 3.9: total product curve.

D= point of maximum technical efficiency of labour with a fixed factor such as land.

UNEB 2012

i) Distinguish between average product and marginal product. (02 marks)

ii) State any two factors that may lead to an increase in marginal product of labour. (02 marks)

2) **AVERAGE PRODUCT (AP).**

Average product is output produced per unit of a variable factor employed during production process.

$$AP = \frac{\textbf{total product or output.}}{\textbf{total variable factor employed i.e. labour}}$$

The average product first increases, reaches maximum point and eventually declines as more units of a variable factor are applied to the fixed factor.

3) **MARGINAL PRODUCT (MP).**

Marginal product refers to additional unit of output resulting from employing an extra unit of a variable factor in production.

MP=ΔTP/Δunits of a variable factor.

Marginal product first increases as more units of a variable factor are applied to a fixed factor, reaches maximum point and then starts diminishing. The maximum point of the marginal product is called the point of diminishing marginal productivity of labour.

TABLE SHOWING VARIATIONS IN OUTPUT IN THE SHORT RUN.

Units of a fixed factor such as land	Units of a variable factor such as labour.	Total product (TP)	Average product (AP)	Marginal product (MP)
10	0	0	0	0
10	1	10	10	10
10	2	22	11	12
10	3	39	13	17
10	4	50	12.5	11
10	5	60	12	10
10	6	60	10	0
10	7	56	8	-4

Table 3.2: variations in output in the shortrun.

As more units of the variable factor are added to a fixed factor TP, AP and MP first increase , reach maximum point and then reduce.

Total product reaches maximum when 6 units of labour are employed and begins reducing. Beyond the optimum combination level of factors okf production i.e. beyond 6units of labour, any further additions leads to negative marginal product.

A GRAPHICAL RELATIONSHIP BETWEEN TOTAL PRODUCT, AVERAGE PRODUCT AND MARGINAL PRODUCT.

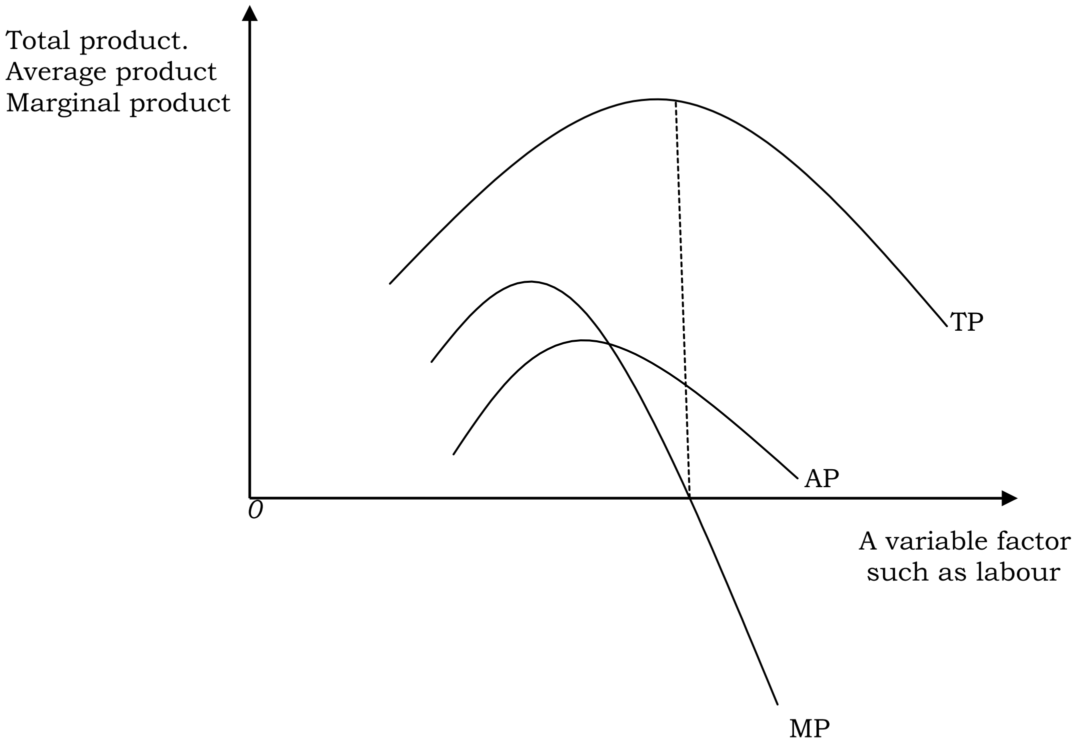


Figure 3.10: Relationship between TP, AP and MP.

- When TP is at maximum, MP is zero.
- When TP starts falling MP becomes negative.
- When AP is at maximum, it is equal to MP.
- MP cuts AP at its maximum.
- AP curve starts falling after meeting the MP curve.
- MP reaches maximum before AP.
- MP curve cuts AP curve at its maximum.
- MP begins falling before AP starts falling.

UNEB 2007, 2000

i) *State the law of variable proportions. (01 marks)*

ii) *Mention any three assumptions underlying this law. (03 marks)*

THE LAW OF VARIABLE FACTOR PROPORTIONS/LAW OF DIMINISHING RETURNS

The law of variabnle factor proportions states that as more and more units of a variable factor are applied to a given fixed factor, marginal product of a variable factor first increases, reaches maximum point and then diminishes or reduces.

The marginal product of labour falls not because it is less efficient variable factor being employed but because more of a variable factor is being employed on a fixed amount of a factor, the variable factor has less and less of a fixed factor to work with as more units are employed. Thus, MP diminishes due to over utilization of a fixed factor and the variable factor is underutilized.

The law of variable factor proportions can be illustrated as below.

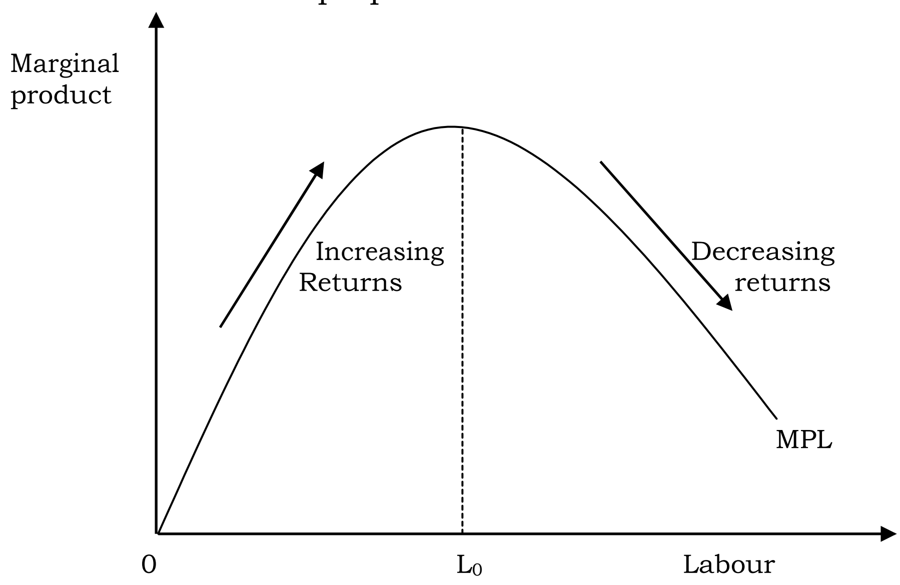


Figure 3.11: marginal product curve.

Assumptions underlying the law of diminishing returns.

- ❖ Assumes existence of a variable factor such as labour.
- ❖ Assumes existence of a fixed factor such as land.
- ❖ Technology is given and assumed constant.
- ❖ Assumes homogenous units of a variable factor. i.e. labour is equally efficient and divisible into small units.
- ❖ The factor prices such as rent, wages are assumed constant.
- ❖ Assumes short run period of production.

Importance of the law of diminishing returns.

- ❖ Helps the producer to determine the optimum amount of the variable factor which can yield maximum output.
- ❖ Helps the producer to determine profit maximization point of a firm and this is where MP is at maximum.
- ❖ Helps the producer to determine wages to labour according to the theory of marginal productivity of labour.
- ❖ Helps to explain low standard of living in developing countries due to increasing population on fixed land which reduces MP of labour and the overall output.
- ❖ Helps the producer to identify the most desired employment level. This is especially when marginal product is positive.

PRODUCTION IN THE LONG RUN

In the longrun, time is long enough to enable a firm expand production by varying all factors of production.

In the longrun, the law of diminishing returns turns out to be called the law of returns to scale. While the law of diminishing returns applies to the short run period when analyzing changes in output (marginal product) as one factor is held constant and another one varied, they law of returns to scale applies to the longrun periods when analyzing changes in output as all factor inputs are changed by the same proportion.

The law of returns to scale explains the relationship between output and scale of inputs in the longrun if all inputs are increased in the same proportion. After varying all factors of production, the firm"s average cost curve first decreases with increasing returns, becomes constant, and later increases with decreasing returns.

RETURNS TO SCALE

This shows the relationship between the proportionate change in factor inputs and output. It measures how much output is produced from a given quantity of factor inputs.

It refers to output produced when all the existing combination of factors of production is increasing in order to change the scale of operation with the aim of reducing the average cost of production hence realize higher profits of the firm.

- When the AC of the firm decreases as output increases, the firm is said to be experiencing **increasing returns to scale/ economies of scale.** This is where a change in factor inputs leads to a more thanproportionate change in output. When factor inputs are doubled output more than doubles meaning that output increases more than inputs.
- When AC of a firm remains constant as output increases, the firm is said to be experiencing constant returns to scale/constant costs. This is where a change in factor inputs leads to an equal proportionate change in output. When factor inputs are doubled, it leads to a constant change in output.
- When AC of the firm increases as output increases, the firm is said to be experiencing decreasing returns to scale/diseconomies of scale. This is where a change in factor inputs leads to a less than proportionate change in output. Factor inputs are doubled but output less than doubles. This can be illustrated either by using average cost curve or the marginal product curve.

ECONOMIES OF SCALE

Economies of scale are advantages of large-scale production which a firm enjoys in form of reduced average costs of production. This can be due to better internal organization of the firm or due to the existence of other firms in a given locality. Output increases at decreasing cost per unit of output.

Economies of scale can be distinguished into:-

REAL ECONOMIES OF SCALE

These are advantages enjoyed by a large-scale firm in form of savings on the quantity of inputs used to produce each unit of output. For instance as savings on the quantity of cement used to make each brick when a firm doubles its output. Less input are used to produce the same unit of output.

PECUNIARY/MONEY ECONOMIES OF SCALE

These are advantages of monetarynature enjoyed by a large scale firm when it pays lower costs for its inputs for a particular level of output. For instance a 20% discount on the quantity of inputs bought in bulk. Lower costs are incurred for the same unit of output.

Economies of scale can either be internal economies of scale or external economies of scale.

INTERNAL ECONOMIES OF SCALE

Internal economies of scale are advantages of large scale production enjoyed by a firm inform of reduced average costs of production due to favourable conditions within the firm itself.

Or

These are advantages enjoyed by a firm as it expands due to favourable conditions within the firm itself.

These advantages are enjoyed by a large- scale firm due to better internal organization which results into power costs of production per unit output.

TYPES OF INTERNAL ECONOMIES OF SCALE

- **Technical economies of scale.** A large scale firm can use better equipment and techniques of production which result into increased efficiency hence lower costs per unit output.
- **Transport economies of scale.** Raw materials and final products are transported in bulk and transport costs per unit reduce.
- **Financial economies of scale.** A large firm is capable of raising finance from different sources at a reduced cost/interest rate since it has better collateral security and good reputation and can even issue new shares to the public.
- **Marketing economies of scale.** A large firm can expand and maintain the market via sales men, it can afford to distribute samples at a low cost and can easily change the designs of its output as a method of competing with other firms which reduces average cost.
- **Risk bearing economies of scale.** A large firm can reduce risks of the business and ensure longrun survival by diversifying its production, can take insurance to safeguard against risks in order to survive in production and increase output at low average cost.
- **Research economies of scale.** A large firm can finance research through hiring trained research assistants so as to come up with better methods

of production, improved quality and quantity of output which results into lower average costs of production.

- **Storage economies of scale.** A large firm can afford to set up its own warehouse to use as a store so as to enable it maintain steady supply of the product at low costs whenever it is demanded on the market.
- **Managerial/administrative economies of scale.** A large firm can afford to employ specialists who can supervise and manage various departments; each manager concentrates on his section hence greater output and reduced average cost. Therefore, large-scale production permits for division of managerial tasks.
- **Welfare economies of scale.** A large scale firm is able to provide enough welfare facilities to workers such as medical care which increases output and reduces average costs.

EXTERNAL ECONOMIES OF SCALE/ECONOMIES OF CONCENTRATION

External economies of scale are advantages of large-scale production enjoyed by a firm in form of reduced average costs of production due to expansion of the industry as a whole.

Or

These are advantages of large-scale production enjoyed by the firm due to favourable conditions created for the firm by the entire industry in form of reduced average costs of production.

These are benefits a firm enjoys due to activities of other firms already existing in a given locality.

TYPES OF EXTERNAL ECONOMIES OF SCALE

- **Economies of specialization.** Firms in a localized area may specialize in different activities which results into increased output and lower costs of production for each firm. For instance in textile industry, some firms may specialize in thread production, weaving and dying.
- **Economies of information.** Firms cooperate and provide information jointly at low average cost. A group of firms can easily set up an internet facility to easily access information on market, product quality and improvement at reduced average cost.
- **Welfare economies of scale.** An industry can easily provide welfare facilities to all workers at a much cheaper cost than a single firm. It can set up restaurants for workers in a localized area.
- **Marketing economies of scale.** It becomes easy to carry out joint marketing of products by all firms at a more reduced naverage cost.
- **External financial economies of scale.** New financial institutions are attracted to a place where there are many firms. This reduces interest rate and average cost.
- **Research economies of scale.** An industry can easily set up a research centre, employ skilled researcvhers and obtain information required by each firm at a much cheaper cost than a single firm.

DISECONOMIES OF SCALE

Diseconomies of scale are disadvantages of large-scale production that a firm experiences in form of increased average costs of production. This can either be due to expansion of a firm internally or due to the expansion okf an industry as a whole.

This occurs when a firm produces an excess level of output beyond its optimum point which results into increeased cost per unit output.

Diseconomies of scales are illustrated by the upward sloping portion of the longrun average cost curve.

Diseconomies of scale may be internal or external diseconomies.

INTERNAL DISECONOMIES OF SCALE

Internal diseconomies of scale are disadvantages of large- scale production experienced by a firm in form of increased average cost of production within the firm itself.

Examples of internal diseconomies of scale.

- ❖ **Managerial diseconomies of scale.** A large-scale firm becomes hard to manage and supervise leading to inefficiency and increased average costs of production.
- ❖ **Technical diseconomies of scale.** Due to expansion of the firm, the cost of depreciation of capital equipment used in production increases due to constant tear and wear there by increasing average costs.
- ❖ **Marketing diseconomies ofk scale.** As a firm over expands in size, marketing problems arise and increase average costs. As a firmn over expands its scale of production, it spends more resources on advertising to plromote sales of its excess output through persuasive advertising, and hiring sales men thus high average cost.
- ❖ **Risk bearing diseconomies of scale.** When a firm over expands its scale of production, it gets exposed to risks such as theft of property by both staff and outsiders and insurance costs increase.
- ❖ **Financial diseconomies of scale.** Finances to maintain the expanded production may not be available in required amounts at appropriate time and this leads to constant borrowing which may be at high interest rates hence high average cost.

EXTERNAL DISECONOMIES OF SCALE

External diseconomies of scale are disadvantages suffered by large scale firms in form of increased average cost of production due to expansion of the entire industry. These include.

- ❖ Raw material diseconomies. Increased cost of raw materials due to increased demand for them.
- ❖ Increased expenditure on combating environmental pollution since it pollutes air, water and land. This increases costs of production.

- ❖ Increased cost of labour due to high demand for labourers by competing firms. This increases wages thus high costs of production.
- ❖ Marketing diseconomies of scale. Due to increased competition in market by various firms, it becomes necessary to undertake persuasive advertising which is very costly.

THE LONGRUN AVERAGE COST CURVE, ECONOMIES AND DISECONOMIES OF SCALE.

The average cost curve is U shaped in the short run because of the law of diminishing returns and U shaped in the long run because of economies and diseconomies of scale.

The LAC curve is U shaped because of economies and diseconomies of scale. The firm enjoys economies of scale when AC curve is falling up to the optimum output after which AC curve rises due to expansion and over production and therefore diseconomies of scale set in.

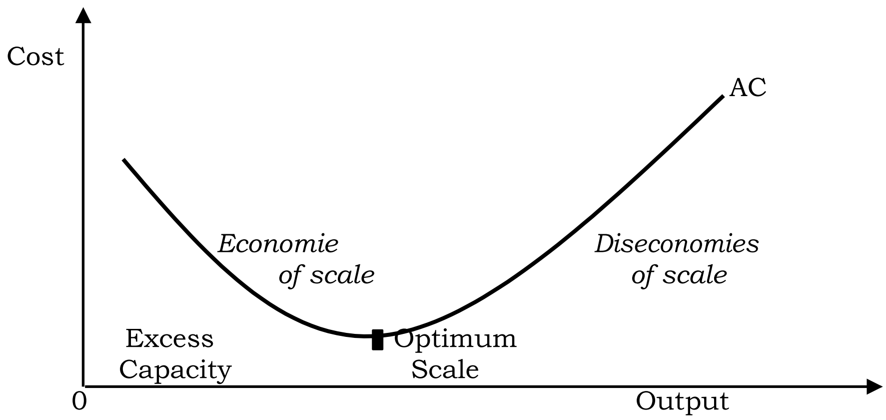


Figure 3.12: average cost curve, economies and diseconomies of scale.

MARKET STRUCTURES

A market structure refers to an economic environment within which firms mobilize and allocate resources in an economy. It is concerned with the number and the type of firms in a particular industry.

It refers to the characteristics which influence the behavior and performance of firms in the market.

There are basically four market structures which are classified according to a set of unique characteristics such as the number of firms/sellers and buyers in the market, nature of products produced and sold, degree of freedom of entry and exit okf firms, types of profits earned both in the short run and longrun, size of firms, nature of demandf curve, level of advertising, influence of firms on price determination i.e. price taking and price making.

These market structures include:-

- ❖ Perfect competiotion.
- ❖ Monopoly
- ❖ Monopolistic competition.
- ❖ Oligopoly.

1) PERFECT COMPETITION

This is a market structure characterised by one ruling price, production of homogenous products, many buyers and sellers.

FEATURES/CHARACTERISTICS OF PERFECT COMPETITIVE MARKET STRUCTURE

1. There are many buyers and sellers so that no single buyer or seller can influence the price in the market.
2. Firms are of the same size and they are price takers, therefore no single firm can iunfluence the price in the market.
3. There is free enntry and exit of firms in production i.e. no barriers to entry into the industry or leaving the industry. When a firm earns abnormal profits, other firms are free to join the market and exhaust the profits and inefficient firmsa are free to leave the industry.
4. Production of purely homogenous products in terms of colour, size and tastes and that"s why there is a single ruling price in the market. No reason for a consumer to prefer the product of one firm to that of other firms.
5. Perfect knowledge about mmarket condiitons. All producers and consumers have full knowledge about market conditions i.e. on price and quality of products, profits of other firms.
6. Demand curve is perfectly elastic. This is because of competition and no single firm has control on the overall price in the market nand the price charged is uniform across the market. It doesnot matter how much output is produced, it must be sold at the same price. AR=PP=DD=MR and price is constant.

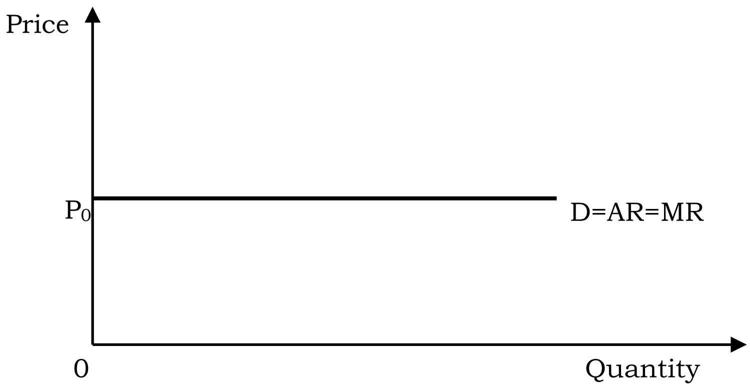


Figure 3.13: Demand curve under perfect competitive market.

7. All sellers aim at profit maximization. The goal of firms is to maximize profits which are maximijzed at a point where MC=MR.
8. No government intervention in production activitiies in form rationing products and price control. Therefore forces of demand and supply operate freely.
9. No advertising costs since the price is the same and products are homogenous. There is no advertising for the commodities produced.

10. Perfect mobility okf factors of production. Factors of production are free to move from wheref they are less paid to where thye are highly paijd.
11. No transport costs. This implies that all sellers, buyer and raw materials are in close proximity or near each other.

UNEB 1999.

i) Define the term marginal revenue. (01 marks)
ii) State the relationship between average revenue and marginal revenue of a perfectly competitive firm. (03 marks)

RELATIONSHIP BETWEEN MARGINAL REVENUE (MR) AND AVERAGE REVENUE AR) OF PERFECT COMPETITION.

In this market structure, MR=AR since price is constahnt. An additional unit of output sold brings the same amount of revenue as that of each unit sold.

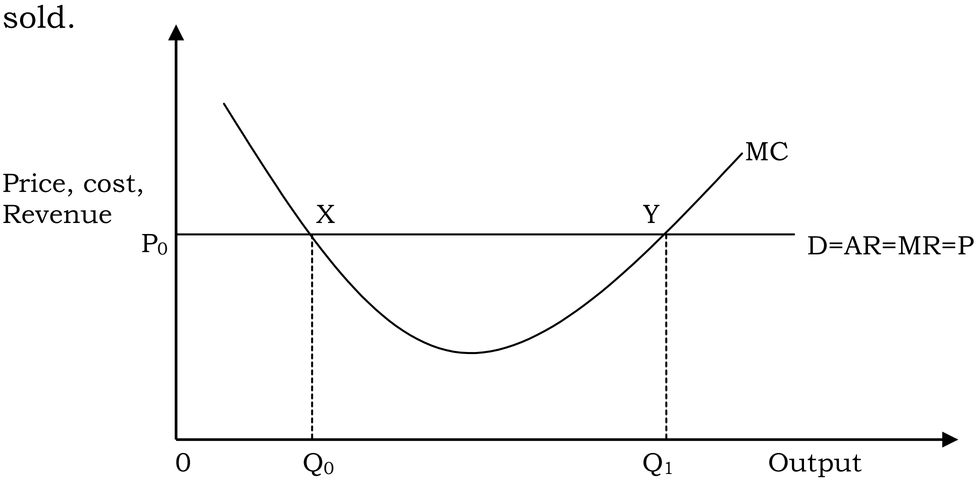


Figure 3.14: Relationship between average revenue and marginal revenue of perfect competitive market.

MC=MR is a necessary condition but not a sufficient condition for profit maximization. At point X, MR=MC but outputh Oqo is low and therefore profits are not maximized.

The sufficient condition is that MC sjhould be equal to MR at the highest level of output i.e. point Y with output OQ1 the conditions apply to all firms irrespective of the market structure.

UNEB 2006, 2003, 1997

a) *How are profits maximized in a perfect competitive market in the short run?(06 marks)*
b) *Examine the advantages and disadvantages of a perfectly competitive market.(14 marks)*

PROFIT MAXIMIZATION IN THE SHORT RUN IN PERFECT COMPETITION

A firm in the short run makes either abnormal (supernormal profits) or incurs sub-normal profits/economic losses.

Shortrun abnormal profits in perfect competition.

Abnormal profits in perfect competition in the shortrun are maximized at a point where marginal cost = marginal revenue (MC =MR) as shown in the diagram below.

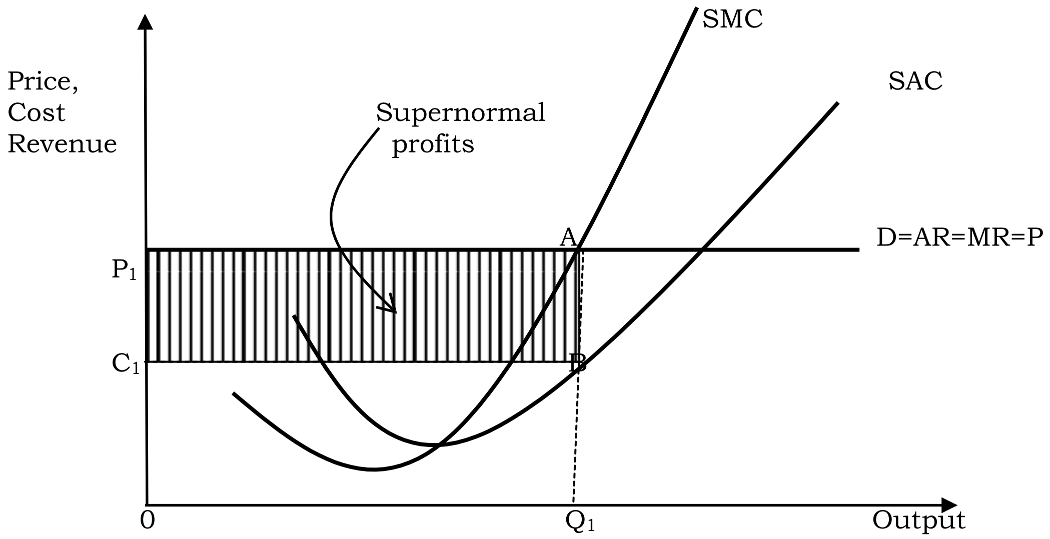


Figure 3.15: short run abnormal profits in a perfect competitive market.

1. Price OP_1 for selling perunit output produced is charged/detrmined at a point where output line meets AR/demand curve at A.
2. Average revenue is greater than average cost (AR>AC) at equilibrium level of output.
3. Abnormal profits are earned shown by the shaded area P_1ABC_1.

NB

- equilibrium is attained at point A where MC=MR and it is where output OQ1 is determined
- cost OC1 for producing output is determined at a poiunt where output line meets AC curve at B.

Short run economic losses/sub normal profits in perfect competitive markete.

Shortrun equilibrium of a firm in perfect competition ijs attained at a point where marginal cost= marginal revenue (MC=MR) as illustrated in the diagram below.

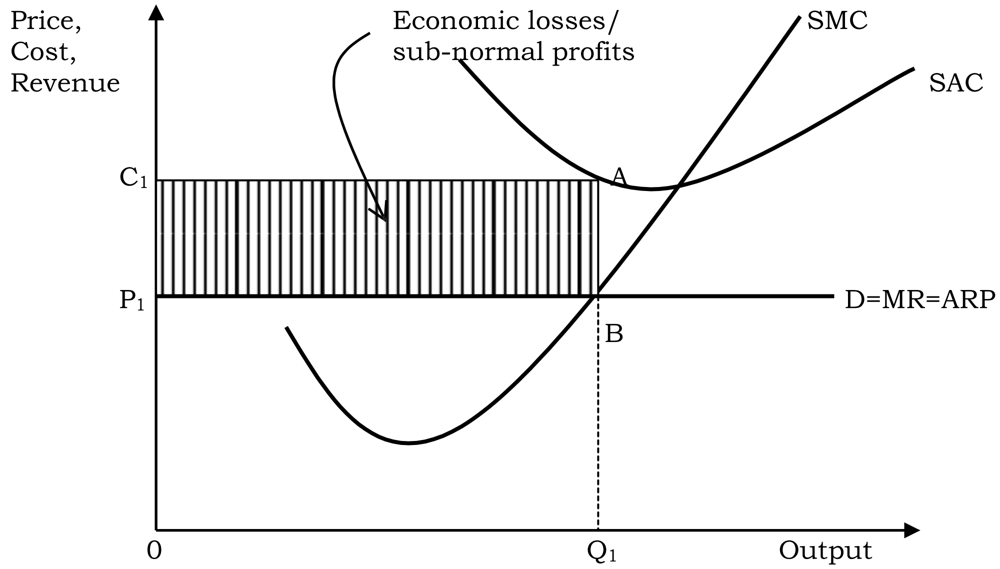


Figure 3.16: short run sub-normal profits in a perfect competitive market.

1. Price OP1 per unit output is charged/determined at a point where output line meets the AR/demand curve at B.
2. Cost OC1 for producing perunit output is determined at a point where outline meets the AC curve at A.
3. Average revenue is less than average cost (AR<AC) at equilibrium level of output.
4. The firm incurs losses shown by the shaded area P1C1AB.

   NB.

   -Equilibrium output OQ1 is determined at point B where MC=MR.

LONGRUN IN PERFECT COMPETITION

REALIZATION of subnormal profits/losses by a firm in the short run is ana indication that such a firm should exit the industry since it is inefficient hence cannot withstand the competitive forces.

However, new firm enter the industry attracted by abnormal profits enjoyed by some efficient firms in the short run.

This results into an increase in supply or output which lowers the price and leads to a fall in profits and this implies that all firms earn normal or zero profits in the long run.

Profit maximization in the long run in perfect competition.

Profits in the long run in perfect competition are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram below.

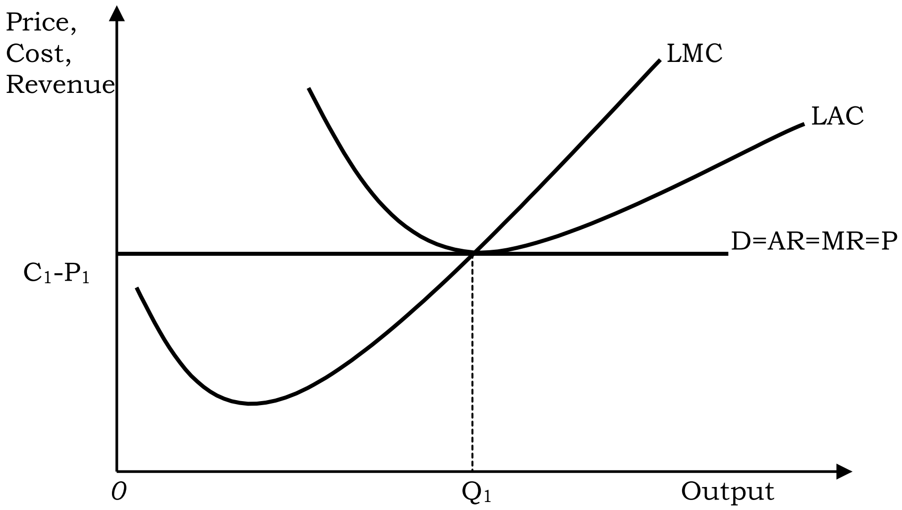


Figure 3.17: long run normal profits in a perfect competitive market.

1. Price OP_1 is charged/determined at a point where output line meets AR/demand curve at A.
2. Normal profits are earned where price is equal to cost (OP_1=OC_1) and AR=AC at equilibrium output.
3. The LMC=LAC=AR=MR because new firms enter the industry and compete away the abnormal profits due to increased supply that leads to a fall in price.

NB. Equilibrium is attained at point A where MC= MR. this is at the lowest point of the long run AC curve which is tangent to AR curve /demand curve. **Cost OC1 for producing output is determined at point A where output line meets the AC curve.**

Price and cost are all determined at point A and (LMC=LAC=AR=MR).

Average cost incurred is OC_1AQ_1 which is equivalent to average revenue OP_1AQ_1.

UNEB 2007.

Distinguish between:

i) Total costs and marginal costs. *(02 marks)*

ii) Breakeven point and shutdown point of a firm. *(02 marks)*

Format of presentation (worked UNEB example).

How are profits maximized in a perfect competitive market in the

1. Short run (06 marks)
2. And long run? (06 marks)

i) **Short run profit maximization in prefect competitive market.**

Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram. *01mark.*

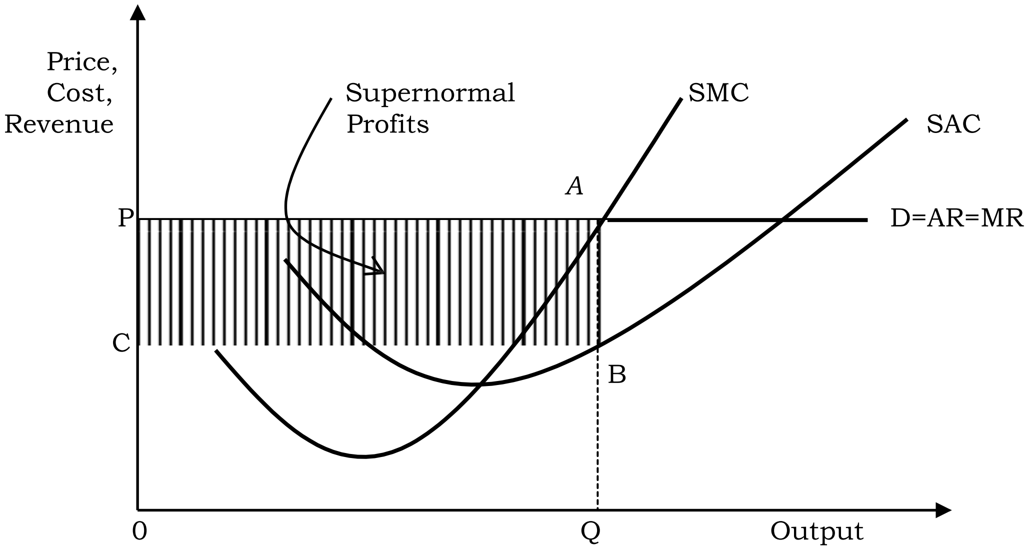


Figure 3.18: Short run abnormal profits in a perfect competitive market. *(02 marks)*

- Price OP is charged where output line meets AR/demand curve at point A *(01 mark)*
- Average revenue is greater that average cost (AR>AC) at equilibrium output. *(01 mark)*
- The firm earns abnormal profits shown by the shaded area PABC 01Mark.

ii) Long run profit maximization in prefect competitive market.

Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram.

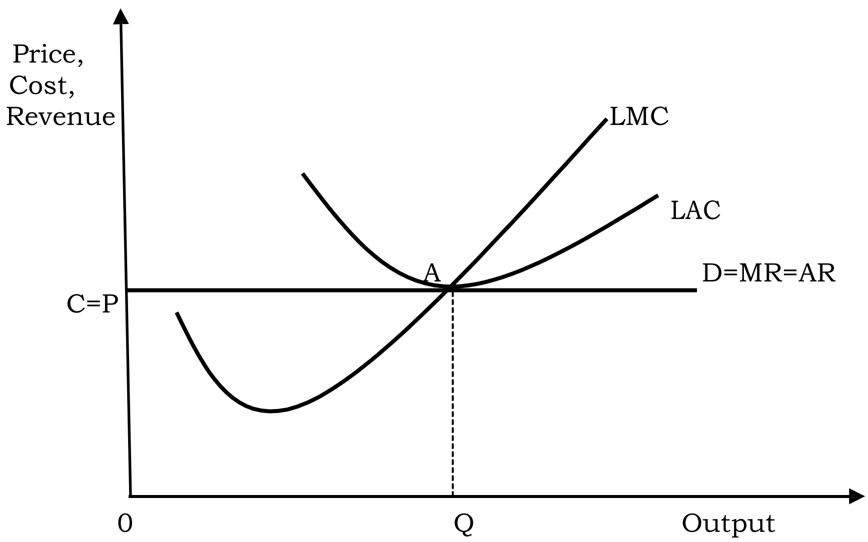


Figure 3.19: longrun normal profits in a perfect competitive market. 02marks.

- Price OP is charged at a point where output line meets AR curve *(01 mark)*
- Normal profits are earned where LMC=LAC=AR=MR because new firms enter the industry and compete away the abnormal profits due to increase in supply. *(02 marks)*

UNEB 2006, 2003 (format of presentation).

How are profits maximized in a perfect competitive market in the short run. (08 marks)

Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram below. *(02 marks)*

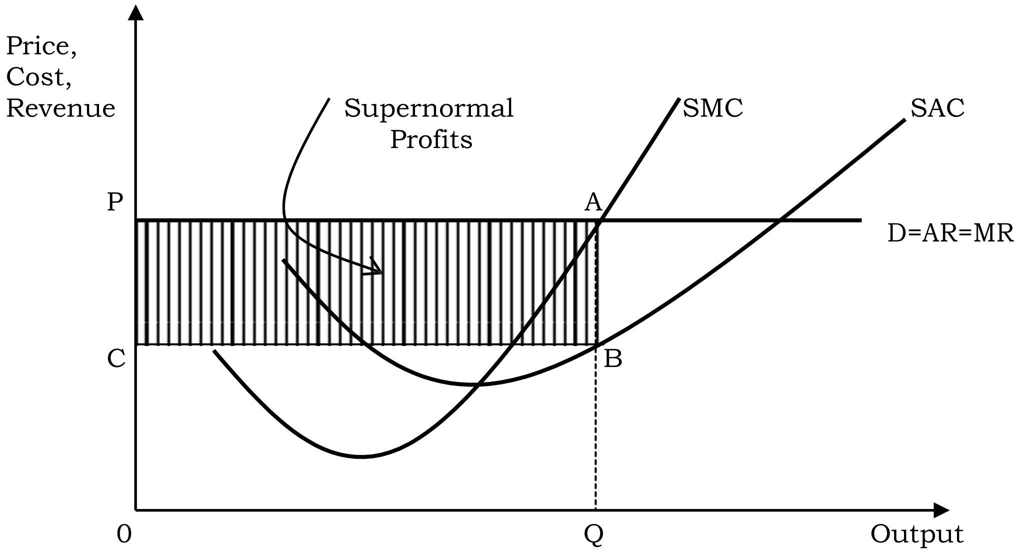


Figure 3.20: short run abnormal profits in a perfect competitive market.

- Price OP is charged/determined where output line meets AR/demand curve at point A *(01 mark)*
- Average revenue is greater that average cost (AR>AC) at equilibrium output. *(01 mark)*
- The firm earns <u>abnormal/supernormal</u> profits shown by the shaded area PABC. *(02 marks)*

BREAK EVEN POINT AND SHUT DOWN POINT OF A FIRM.

Breakeven point is a point where a firm is earning normal profits where average revenue is equal to average cost (AR=AC).

Or

It is a point where a firm neither makes profits nor incurs losses, AR =AC.

Breakeven point is where a firm neither incurs losses nor earns super normal profits. It is a point where the firm is producing at its lowest point of the LAC curve that P=AC and AC=AR.

Shut down point.

Shut down point is a point where a firm only covers average variable costs (AR=AVC). **Or**

It is a point below which a firm cannot cover its average variable costs (AR=AVC).

Below the shut down point, price is less than AVC and therefore a firm would not operate because it cannot cover its variable costs such as costs of raw materials, wages and transport costs and yet they are important for a firm to continue existing.

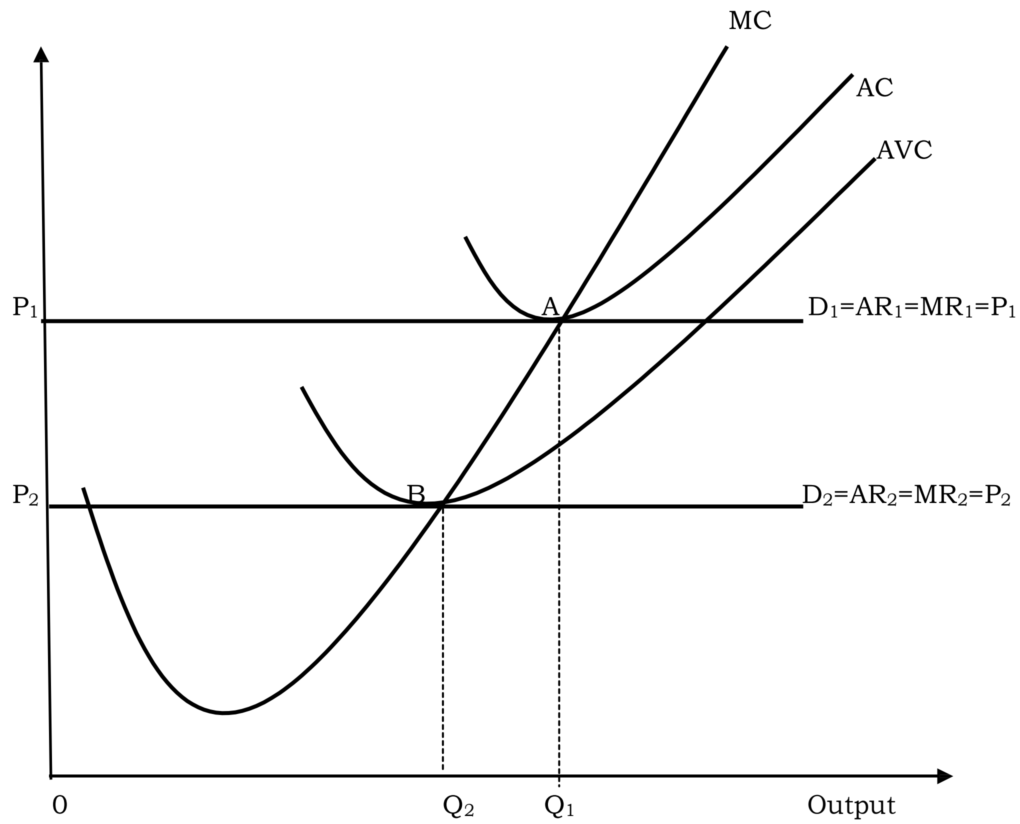


Figure 3.21: breakeven point and shut down point of a firm.

Point A= Breakeven poiunt
Point B= Shutdown point.

UNEB 2014

a) *Distinguish between shut-down point and break-even point of a firm. (04 marks)*

b) *Why may a firm continue operating even if its revenue does not cover the fixed costs? (16 marks)*

UNEB 2003.

i) *Distinguish between breakeven point and shutdown point of a firm. (02 marks)*

ii) *State any two reasons why a firm may continue to operate below the breakeven point. (02 marks)*

REASONS WHY MAY A FIRM CONTINUE TO PRODUCE EVEN WHEN IT IS INCURRING LOSSES/DOESNOT COVER THE TOTAL COST OF PRODUCTION.

In economic theory, a firm will continue in production even if its total revenue is less than its total costs so longer as it can cover its average variable costs in the short run andf therefore may not shut down because of the following.

1. **The firm may be infant in nature/a beginner firm.** A new firm in production can afford to keep in operation expecting to start earning profits in the near future.

2. **A firm may be able to cover short run variable costs** such as paying wages and cost of raw materials even if fixed costsg are not covered in the short run.
3. **Prospects to merge or amalgamate with other firms that are profit making.** When a firm is expecting to combine its activities with other firms in the near future, it can afford to keep operating in losses.
4. **It may be a government owned firm and vital to society.** If the firm is owned by the government and vital to the society, it may keep benfiting from state subsidies and would afford to operate on a loss for instance water supply, electricity supply and road construction projects.
5. **The goal of the firm may be to provide employment opportunities to members of the family.** In such as situation, it would keep operating on a loss in the short run due to fear of unemployment.
6. **Expectations to acquire a loan from financial institutions** so as to make necessary improvements, reduce costs of production and start making profits.
7. **The firm may fear to lose potential supply of raw materials/the firm may be possessing strategic raw materials** such as mineral resources and it may not be willing to lose them and therefore keep operating on losses.
8. **The firm may be an experimental or research firm/pilot project.** Where a firm has been established for experimental purposes on given aspects of the society, it would keep operating regardless of the losses inncurred since it doesnot aim at making profits.
9. **The firm may fear to lose its highly skilled man power which is not easy to replace.** This therefdopre would keep the firm operating on losses due to fear of losing such skilled man power to rival firms.
10. **The firm may be surviving on past supernormal profits.** These are turned into savings in the longrun and are brought back to the firm to make improvements and start earning profits.
11. **The firm may be a branch of an industry.** A loss making firm may be a branch of an inndustry that is making profits and such a firm doeksnot close fown. The firm may be having a chain sister of firms and therefore ability to provide technical and financial support requirefd.
12. **The firm may be facing short run problems which can be solved later.** The high costs of production maybe temporary okr short run in nature. The firm may be expecting to overcome such costs in the near future and starts earning profits.
13. **Fear of high costs on depreciation and re-opening.** The firm may have made a reasonable stock of capital machinery and may not close dokwn because of fear of depreciation okf such assets.
14. **The firm may be hopeful to change management and starts operating efficiently.** It can change the administratyion, reduce the number of workers and adopt capital-intensive technology for necessary improvements.

15. **Fear of losing the already established customers/market to rival frims.** The business owner therefore may want to maintain the market share and will continue operating on losses for given period.

16. **The marginal revenue may be still greater than marginal cost of a firm** and therefore continues producing even if it doesn"t cover total costs.

ADVANTAGES/POSITIVE IMPLICATIONS OF PERFECT COMPETITION.

- **Leads to efficient alloocation of resources in the longrun.** There is optimum/full utilization of resources in the long run since every firm produces at the minimum point of the average cost curve.
- **Ensures increased output on the market.** This is because of large number of firms in the market attracted by abnormal profits in the short run. Encourages mass productioin because of many sellers and high degree of entry of new firms in the industry which reduces shortage of commodities on the market.
- **Ensures equitable distribution of inncome.** The fact that all firms are price takers and they charge a uniform price for thewir output and there are many firms duie to free entry and exit.
- **Ensures fair and stable prices in the market.** This is because all producers sell at the same price and are all price takers due to homogenous products.
- **There is no resource wastage in advertising thus reduced cost of production.** There is no persuasive or intensive advertising, which would lead to high costs of production.
- **Provides an efficient standard for comparison of price determination in other market structures.** perfect completion acts as a guide to other market structures such as oligopoly.

DISADVANTAGES/NEGATIVE IMPLICATIONS OF PERFECT COMPETITION

- **Limits choice of commodities for consumers.** Commodities produced are homogenous and this implies that consumers cannokt enjoy a variety of commodities ion the market.
- **Assumes ideal market conditions that do not exist in real life.** Perfect competition doesnot exist in reality. It is difficult to get typical conditions of such a market such as perfect knowledge in the market, homogenous products, no transport costs and no advertising costs.
- **Lack of economies of scale in the longrun/normal profits are earned in the longrun which limites expanmsion of a firm.** This is because all firms earn normal profits and therefore expansion of firms becomes difficult.
- **Leads to unemployment in the longnrun.** This is because inefficient firms are pushed out okf the industry thus laying workers. In the longrun, some firms close down due to stiff competition.

- **Limits research and innovations in the long run.** This limits the degree of making inventions and innovations since only nokrmal profits aref realized which are not enough for a firm to carryout research.
- **Cannot eliminate natural monopolies and buisiness ownership of capital.** Where large scale firms have got access to capital, they kick weak firms out of production.
- **Leads to duplication of services/economic activities.** This is due to many firms producing similar commodities which leads to resource wastage.

2) MONOPOLY.

Monopoly is a market situation in which there is one producer of a particular commokdity which has no close substitutes. For instance UNEB, National Council of Sports in Uganda.

This means that prices of other goods hardly affetc the quantity demanded of a monopolized commodity.

TYPES OF MONOPOLY

- **Pure/absolute/perfect monopoly.** This is where there is a single seller of a commodity which has no close substitutes at all. For instance a single salt producing plant ion a large market area.
- **Simple/imperfect/relative monopoly.** This is where there is a monopolist but there are possibilities of getting close substitutes.
- **Statutory monopoly.** This is where there a single seller of the commodity due to an act of parliament that establishes the monopolist. For instance uganda national water and sewage corporation and UNEB for "O" and "A" level examinations, national medical stores which supplies drugs to government hospitals, national council of sports in uganda.
- **Collective/merging monopoly.** This is where various firms combine and form a single industry which becomes a monopolist with no rival producers.
- **Natural monopoly.** Thisj is monopoly derived from ownership and control of specific natural resources or unique talents by a particular producer which makes it very difficult for other firms to join the same production.
- **Spatial monopoly.** This is where there is a single seller of a given product in a given area because of long distance factor between sellers of a similar commodity such that a aproducer dominates production in his locality.
- **Discriminative monopoly.** This is a situation where a monopolist has the ability to charge diffirent prices to different classes of customers but on a similar product.
- **Bi-lateral monopoly.** This is a market situation where there is one buyer and one seller of a single commodity.

UNEB 2007.

a) *Account for the rise of monopooly. (10 marks)*
b) *Assess the impact of monopoly in an economy. (10 marks)*

BASIS/ORIGIN/FOUNDATION/RISE OF MONOPOLY IN AN ECONOMY.

NB. The emergence and survival of monopoly is attributed to the factors which prevent entry of other firms into the same industry.

- ❖ **Natural monopolies due to ownership/contorl of strategic sources of raw materials.** A firm possessing given natural resources which are not available to other firms to enter production forms monopoly powers. Forinstance one may not enter the diamond producing industry unless they own diamond as a mineral, lake katwe salt project in uganda.
- ❖ **Spatial monopolies due to long distance between producers of a particular commodity.** Producers of a similar commodity located far away from each other makes each seller in his locality a monopolists thus leading to spatial monopoly.
- ❖ **Existence of patent rights to innovators and copy rights to authors.** These are legal barrials that prevent firms/producers from joining the industry with out prior procedure. This makes the existing producers monopolists for instance copy rights to authors of textbooks which leaves the existing producer as a monopolist.
- ❖ **Existence of a small market size for many firms to operate.** This doesnot require other firms to develop and producer similar goods whose market is limited hence making the existing producer a monopolist.
- ❖ **Statutory monopolies arising fdrom govermemnt through statutes and acts of parliament.** A given firm becomes a monopolist by an act of parliemnt in which it is set up and controlled by the state to provide certain vital public services for social welfare giving rise to statutory monopoly.
- ❖ **Protectionism in international trade leading to sheltered monopolies.** Trade barriers such as total ban are imposed on the product to excluse fioreign competitors and in this case home producers/protected firms become monopolists leading to sheltered monopoly.
- ❖ **Takeovers and mergers of firms.** A given firm may be taken over or various firms may agree to join together in production of a commodity and become a single frim which ends up establishing itself as a monopolist. For example alarm group of companies.
- ❖ **Long period of training required to join a given field leading to professional monopolies.** For instance medical and legal services, charted accountants where training to join such fields takes a long period of time which gives existing professionals an opportunity to become professional monopolies.
- ❖ **Cartel arrangements and common marketing policies among firms.** Firms come together in a formal or informal agreement/cartel to achieve

monopoly powers. They fix quotas for each firm to produce and they set the price very low in order to prevent other firms from joining production. For instance OPEC.

- ❖ **Large initial capitalbn required to start a given production.** Production may require large amount of capital and technology to set up a large frim to match with the existing one and this gives the already existing firm monopoly powers.
- ❖ **Use of limit pricing policy/aggressive price wars.** A firm sets price for output which is very low to discourage the entry of new firms in production of the same commodity, the existing frim becomes a monopolist.

FEATURES OR CHARACTERISTICS OF MONOPOLY.

- ❖ There is na single producer of a commodity in the market and many buyers.
- ❖ There is blocked/restricted entry of new firms into production or industry.
- ❖ A single commodity is sold and does not have close substitutes.
- ❖ There is no persuasive advertising since there are no competitors.
- ❖ The seller is a price maker because he can influence the price in the market.
- ❖ The main goal of production is profit maximization where MC=MR abnormal profits are enjoyed both in the short run annd in the longrun.
- ❖ Monopolists produce at excess capacity both in the short run and in the long run to maximize profits. Therefopre resources are underutilized.
- ❖ The demand curve for a monopolist is inelastic in nature. This is because a commodity does nokt have close substitutes.

DEMAND CURVE UNDER MONOPOLY.

The demand curve for monopoly is inelastic. A monopolist can determine either price or output but nokt both. It is downward sloping form left to right.

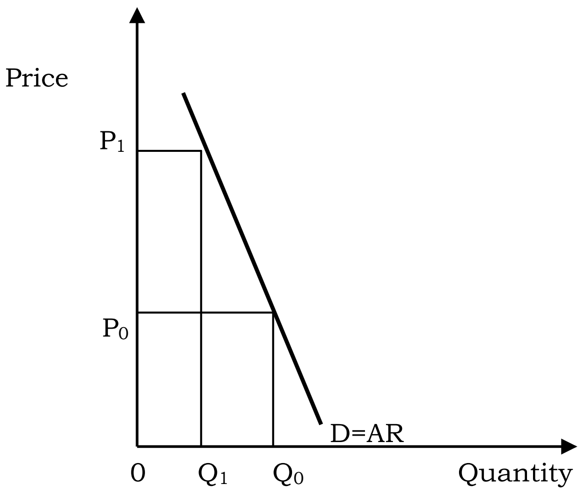


Figure 3.22: inelastic demand curve for monopoly.

MARGINAL REVENUE CURVE FOR A MONOPOLIST.

It is downward sloping from left to right because when more of a commodity is brought in the market, price falls. Therefore extra revenue from additional output decreases as the monopolist sells more units. Marginal revenue diminishes as the level of output increadses because each additional unit of output is sold at a much lower price. This implies that marginal revenue curve lies below the average revenue curve for all levels of output.

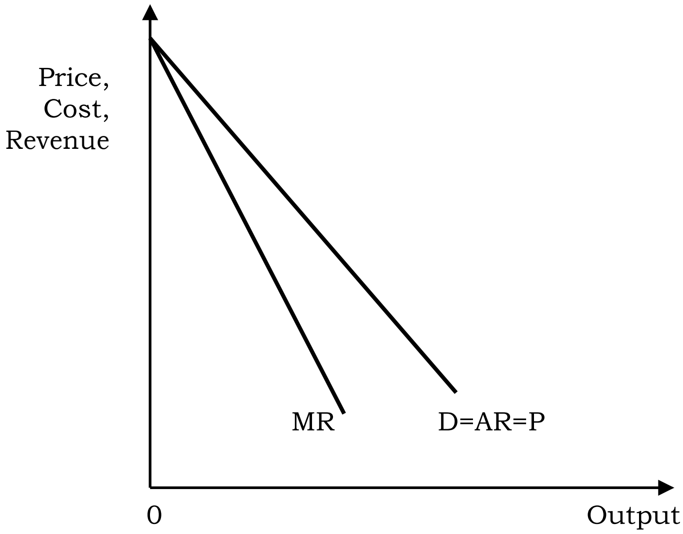


Figure 3.23: Marginal revenue curve for monopoly.

UNEB 2002, 2009,1999.

a) *Illustrate how profits are maximized under monopoly. (08 marks)*

b) *Explain the merits and demerits of monopoly in an economy. (12 marks)*

PROFIT MAXIMIZATION OR EQUILIBRIUM POSITION UNDER MONOPOLY.

Profits in monoloy are maximized at a point where marginal cost= marginal revenue (MC=MR) as illustrated in the diagram below.

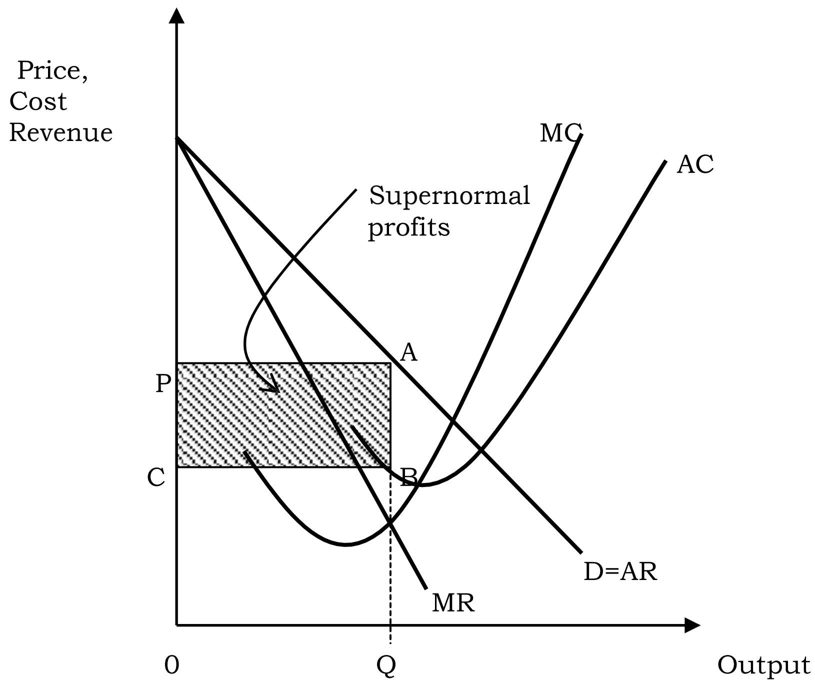


Figure 3.24: profit maximization in monopoly market.

1. Price OP_1 is determined at a point where the output line meets AR/demand curve at A.
2. Average revenue is greater than average cost (AR>AC) at equilibrium level of output.
3. Abnormal profits are earned shown by the shaded area P_1ABC_1 both in the short run and in the longrun because of the ability to exclude competitors.

EXCESS CAPACITY PRODUCTION IN MONOPOLY

Excess capacity refers to a situation where a firm is producing output at less than the installed capacity. Or it is a situation where a firm produces below optimum capacity. It is represented on the AC curve when the firm is producing at the falling part of its AC curve.

A monopolist produces outoput OQ_1 at excess capacity at point B which is below the lowest point of the AC curve (refer to the diagram for profit maximization under monopoly).

Therefore, any production at the falling part of the AC curve is production at excess capacity. This is intended to keeop price high by a monopolist.

UNEB 2001.

i) *Distribute between excess capacity and over production. (02 marks)*
ii) *Give two causes of excess capacity in your country. (02 marks)*

CAUSES OF EXCESS CAPACITY IN PRODUCTION

1 Limited market size for a firm"s products which does not justify firms production at full capacity.
2 Poor infrastructure such as poor road network.

3 Limited supply of raw materials.
4 Political instabilities which result into failure to settle down and expand production.
5 Desire for high profits by monopolists who keep output very low to charge high prices.
6 High taxation which increadses cost of production.
7. Limited cooperant factors of production.

UNEB 2009, 2002, 2004.

a) *Illustrate how profits are maximized under monopoly. (08 marks)*
b) *Explain the mnerits and demerits of monopoly in an economy. (12 marks)*

Format of presentation in an exam.

1. A monopolist maximizes profits at a point where marginal cost=marginal revenue (MC=MR) as shown in the diagram below. *02marks*

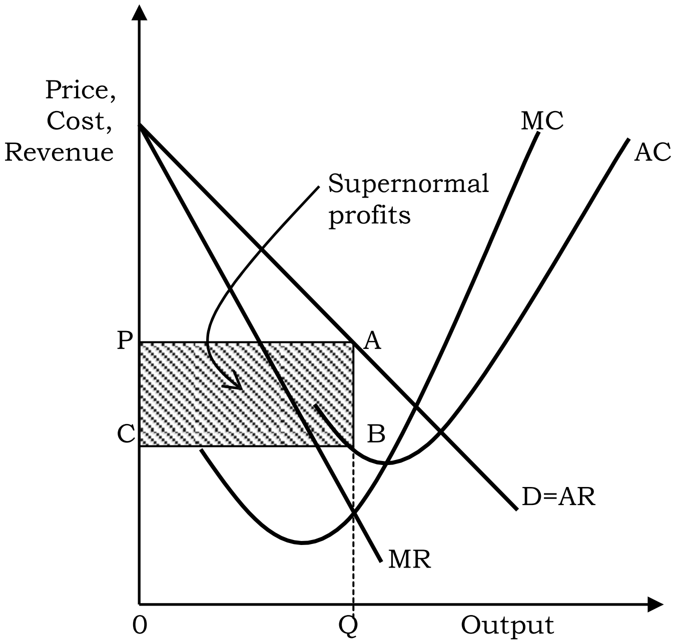


Figure: 3.25: Profit maximization in monopoly market.

1. Price OP is charged/determined at a point where output line meets demand/AR curve at A. 01mark
2. Average revenue is greater than average cost (AR>AC) at equilibrium output. 01mark.
3. Abnormal profits are earned shown by the shaded area CPAB because of the ability to exclude competitors. *02marks*

PRICE DISCRIMINATION UNDER MONOPOLY.

Price discrimination refers to a situatoion where a producer/a monopolist charges different prices for a similar/same commodity to different groups of buyers/consumers.

The reasons for this are not related/associated with differences in costsolf production. **Or**

It is a situation where a producer/a monopolist sells a similar commodity to different groups of consumers at diffeernt prices.

It is also called discriminating monopoly/parallel pricing.

UNEB 2009, 2006.

i) *What is meant by price discrimination? (01 mark)*
ii) *Give any three conditions necessaary for the success of price discrimination in an economy. (03 marks)*

CONDITIONS NECESSARY FOR PRICE DISCRIMINATION TO SUCCEED.

1. **The seller must be a monopolist/there must be one producer of the commodity.** This means that the commodity should not have close substitutes. This is meant to control supply of the commodity, other wise other sellers may undersell him.
2. **The marginal revenue in both markets should be the same.** This is meant to ensure that the seller is compelled to sell all his output in the market where marginal revenue is high.
3. **The consumer should be ignorant about the price charged on other consumers in the same or other markets.** This leads to the success of price discrimination.
4. **There should be no/absence of government intervention in the market.** In a where there is inelastic demand, a high price is charged and in a market where there is elastic demand, a low price is charged.
5. **Price elasticity of demand should be different in different markets.** In a market where there is inelastic demand, a high price is charged and in a market where there is elastic demand, a low price is charged.
6. **The costs of dividing/separating the markets by the producer should be low.** In case of dumping costs of transport should be low which allows easy movement between markets.
7. **It is possible where goods are sold on special orders/contracts.** A monopolist charges different prices for different special orders made since one buyer will not know the price charged on others.
8. **It is possible where personal services are offered.** These services cannot be transferred from one person to another such as medical services, legal services.
9. **There should be geographical separation of markets so that there is no reselling that can take place.** It should be impossible for buyers to transfer the commodity from where a high price is charged to where a lower price is charged.

10. **There should be a high cost of transferring a commodity from one market to another by a consumer.** This leads to successful price discrimination.

ADVANTAGES OF PRICE DISCRIMINATION.

1. Enables low income consumers to access essential commodities at a lower price hence increasing their standard of living.
2. Increases sales and total revenue to the seller by taking away part of the consumer"s surplus.
3. Reduces income inequality since the poor are charged low prices compared to the rich who are charged high prices.
4. Helps the producer to utilize the available resources which would have been useless.
5. Enables the producer to capture a wider market both in the domestic economy and abroad.
6. High prospects for employment opportunities due to increased production and demand for a commodity.
7. Increases the volume of production which leads to economic growth.
8. Enables the producer to dispose off surplus output through dumping hence continuous production.

DISADVANTAGES OF PRICE DISCRIMINATION.

- Promotes income inequality because the producer earns excessive profits especially when high prices are charged on majority of buyers.
- Retards the development of domestic infant industries where price discrimination takes the form of dumping.
- Takes away consumer"s surplus especially on consumers where a high price is charged. This reduces consumer"s standard of living.
- Poor quality services or products are normally offered to low priced submarkets.
- Leads to over exploitation of resources because of the need for high output to satisfy the two markets.
- Leads to consumer exploitation because some consumers are charged high prices compared to others which is very unfair to such consumers.

ADVANTAGES/POSITIVE EFFECTS OF MONOPOLY.

- **Limited duplication of goods and services thus low resource wastage.** Since the producer is alone in the market, the quality of output is maintained thus limited resource wastage.
- **Internal economies of scale are enjoyed.** This is because of abnormal profits enjoyed both in the short run and long run which helps to expands production.
- **Price discrimination is practiced.** This mostly benefits low income earners.

- ❖ **Involves low operational costs.** This is because of absence of intensive advertising which reduces resource wastage in production.
- ❖ **Enables the growth and development of infant industries.** Newly established industries are protected from competition by other low cost producing firms because of patent rights given to monopolists.
- ❖ **Encourages research and innovations.** Abnormal profits are made which enable the firm to carryout extensive research. The firm is able to make necessary innovations and inventions in production. This is possible both in the short run and long run.
- ❖ **Increases government tax revenue.** The abnormal profits made by the firm both in short run and in the longrun implies high capacity of a firm to pay high taxes to the government which increases public revenue.
- ❖ **Statutory monopolies help to cater for public utilities.** Public utilities which provide essential services for social welfare are effectively controlled by government as state monopolies through offering them subsidies which helps to public to enjoy services at a lower cost.
- ❖ **Creates and maintains employment opportunities especially statutory monopolies.** This is because of reduced competition and operation on a large scale hence limited chances of a firm to quit production.
- ❖ **Abnormal profits are enjoyed which are invested to expand production.** This is because a monopolist is alone and can afford to sell his product at high prices and earn abnormal profits both in the short run and longrun.

DISADVANTAGES/NEGATIVE EFFECTS OR IMPLICATIONS OF MONOPOLY.

- ❖ **Leads to provision of low quality products.** This is because of absence of competition in production thus limited efficiency in production.
- ❖ **Excess capacity production both in the long run and short run.** This leads to under utilization of resources.
- ❖ **Leads to consumer exploitation by charging them high prices.** This is because the producer is alone in the market.
- ❖ **Creates shortages or scarcity of output in the times of breakdown.** Incase a monopolist stops producing, there would a shortage of the commodity in the market which makes the public to suffer.
- ❖ **Leads to income/wealth inequality.** This is brought about by abnormal profits made by a monopolist both in the short run and long run.
- ❖ **Monopolists normally exert a lot of pressure on government decisions.** They influence decision making in side of the government because they are the major controllers of production. For instance BAT in Uganda.

- **Leads to unemployment and underemployment of labour.** Since a monopolist produces at excess capacity both in the short run and longrun, it implies limited job creation.
- **Provision of limited variety of goods to consumers.** This is because a monopolist is a sole producer in the market and therefore absence of substitutes. This limits consumers choice hence reducing standard of living.
- **Leads to exploitation of workers.** This is through under paying them, over working, limited fringe benefits and poor working conditions because such workers cannot easily be employed elsewhere since there is only one firm.

MEASURES THAT SHOULD BE TAKEN TO CONTROL MONOPOLY IN AN ECONOMY.

- **Use of price control.** The government fixes a maximum price which reduces the power of monopolists by reducing the abnormal profits.
- **Use of taxation on monopoly firms.** This is where the government imposes a lump sum and a specific tax on monopolists. This reduces output and profit levels of a firm.

  A lump sum tax is a tax imposed regardless of the level of output produced. It is intended to shift the average cost upwards.

  A specific tax is a tax imposed on each unit of output produced by a monopolist. It increases as output increases.
- **Discouraging merging of firms.** These are laws against the rise of monopoly such as anti-merger laws which allows other firms to emerge and compete.
- **Nationalization of private monopoly firms.** This is done by the government to favour public interests which leads to provision of cheaper services to the public.
- **Removing trade restrictions in international trade.** For instance removing tariff and non-tariff barriers on imported goods which encourages free trade and competition.
- **Subsidization of new rival firms by the government.** This will help to create competition in the existing monopoly firms thus reducing the power of monopoly.
- **The government can set up rival firms or parastatals to compete with private monopoly.** This is intended to compete with private monopoly to increase output on the market and reduce price.
- **Use of anti-monopoly legislation s.** this involves passing laws against monopoly firms.

2) MONOPOLISTIC COMPETITION

This is market structure where there are many buyers and many sellers of differentiated commodities. This market structure involves some elements of perfect competition and monopoly. It is in between perfect competition and

monopoly. It is the most common market structure in real business in the world today.
Examples of monopolistic competition.
Bread industry, salon industry, motor repair industry, soap industry, hotel industry, transport industry, television and radio industry, and toothpaste industry.

CHARACTERISTICS OR FEATURES OF MONOPOLISTIC COMPETITION.

- There are many firms and many buyers. This means that each seller controls a small part of the entire market.
- Firms produce differentiated products which enables each firm to enjoy monopoly powers over its brand. The differences are created by the way of shape, colour, trade mark, branding and packaging to cater for different consumer"s tastes and preferences. These products traded are close substitutes but not perfect substitutes for one another.
- There is free entry and exit of firms in production. Firms are free to join production incase abnormal profits are made and are free to leave production when they incur losses.
- There is production at excess capacity by firms implying that resources are under utilized.
- The goal of the firm is profit maximization where MC=MR.
- Firms are price makers to some extent because of product differentiation. Each firm has got some control over the price because each firm has monopoly powers over its brand.
- There is heavy expenditure on persuasive or intensive advertising to capture a wider market. This takes a large percentage of total cost of production.
- There is brand loyalty by consumers. Consumers tend to prefer given brands which they feel are of better quality than other brands. Some customers are made to believe that certain brand of a given firm are more superior than others.
- The demand curve is fairly elastic because of the existence okf close substitutes on the market.

PRODUCT DIFFERENTIATION

Product differentiation is a practice by producers in an imperfect market of creating artificial differences between goods of the same use.
Or
Is then act of making products to appear different from their close substitutes by rival firms in an imperfect market in order to maximize sales.
A producer is form products of other firms in position to make his products look different from products of other firms even when they serve the same purpose. This makes each producer to become a monopolist of his brand to some extent.

FORMS OF PRODUCT DIFFERENTIATION.

Differences in packaging, differences in smell, differences in colour, differences in trade names, differences in design, differences in trade marks.

THE DEMAND CURVE UNDER MONOPOLISTIC COMPETITIVE MARKET.

The demand curve for monopolistic competition is elastic because of the presence of close substitutes. It is also downward sloping from left to right as that of monopoly.

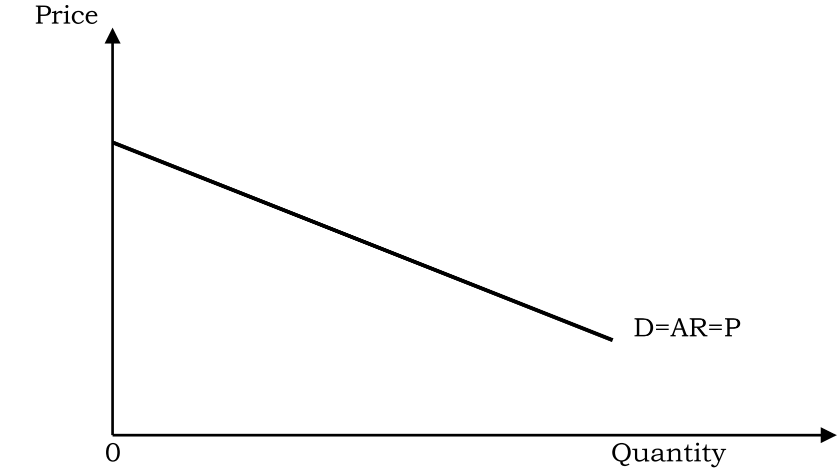
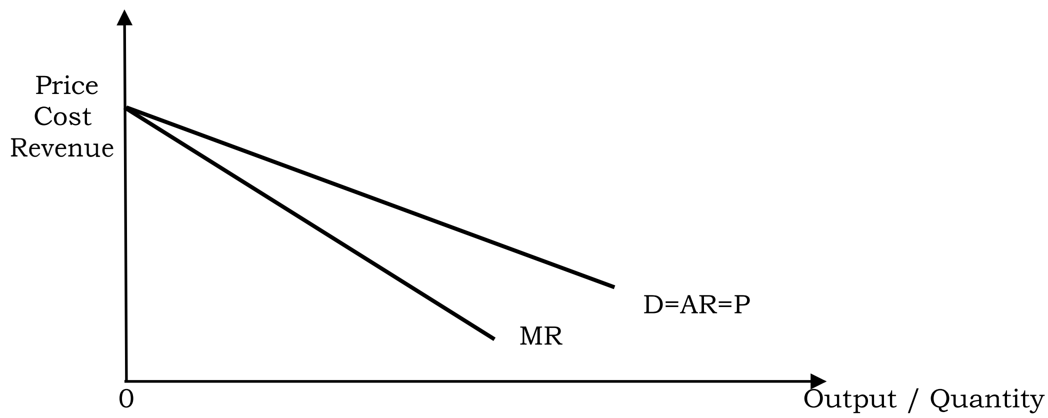


Figure 3.26: demand curve for monopolistic competitive market.

MARGINAL REVENUE CURVE UNDER MONOPOLISTIC COMPETITIVE MARKET.

MR curve is below the AR or demand curve as the case of monopoly.

Each firm to some extent has monopoly powers over its product and it not a price taker implying that firms are price makers to some extent.



3.27: Marginal revenue curve for monopolistic competitive market.

The marginal revenue curve lies below the AR curve/demand curve for all levels of output since each additional unit of output sold fetches less revenue than the price of the previous unit of output.

UNEB 1998.

a) *What are the features of monopolistic competitive market? (08 marks)*
b) *How does a monopolistic competitive firm determine output, price and profit both in the short run and long run. (12 marks)*

UNEB 2010.

a) *Describe the features of monopolistic competition. (08 marks)*
b) *How does the firm under monopolistic competition maximize profits in the*
1. *Short run. (06 marks)*
2. *Long run (06 marks)*

SHORT RUN PROFIT MAXIMIZATION AND EQUILIBRIUM OF A FIRM IN MONOPOLISTIC COMPETITION.

In the short run, firms can either make abnormal profits or incur economic losses/sub-normal profits.

SHORT RUN ABNORMAL PROFITS IN MONOPOLISTIC COMPETITION.

Profits in monopolistic competition are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram below.

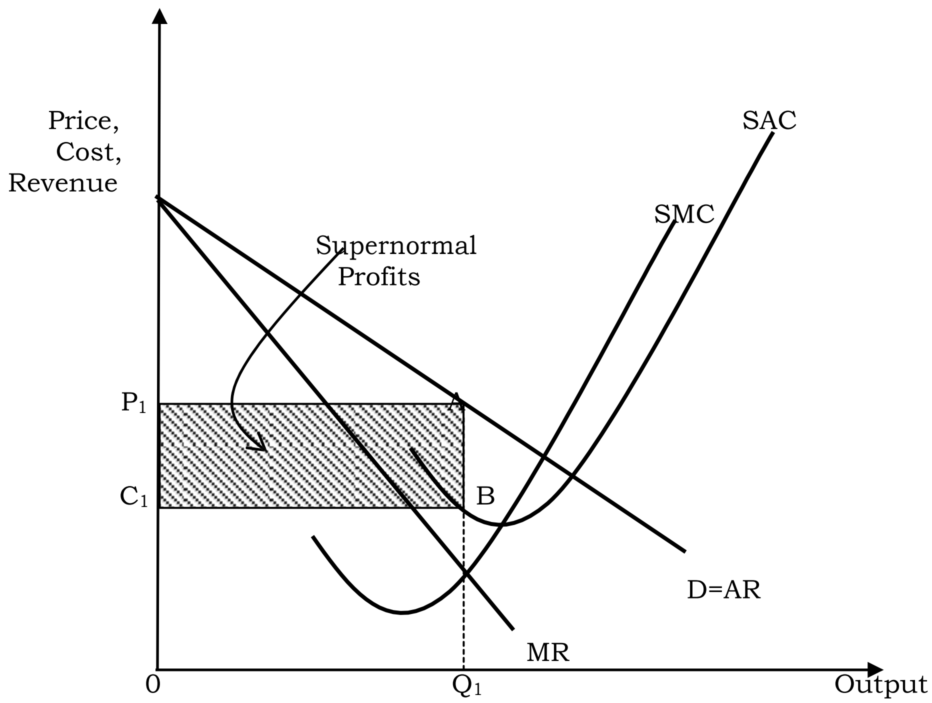


Figure 3.28: short run abnormal profits in a monopolistic competitive market.

1. Price OP_1 is charged/determined at a point where output line meets AR/demand curve at A.

2. The firm"s average revenue is greater than average cost (AR>AC) at equilibrium level of output.
3. Abnormal/economic profits are therefore earned shown by the shaded area P_1ABC_1.

NB

1. Equilibrium point of the firm is attained at point K where MC=MR.
2. Output OQ_1 is determined at a point where MC=MR.
3. Cost OC_1 is determined at a point where output line meets the AC curve at B.

LONG RUN PROFIT MAXIMIZATION AND EQUILIBRIUM OF A FIRM IN MONOPOLISTIC COMPETITION

Because of free entry and exit in production, in the long run, firms will enter the industry attracted by supernormal profits, this will increase output and reduce price which forces all firms to earn normal profits.
Some inefficient firms will leave the industry since they cannot survive the stiff competition in the long run.
Therefore, in the long run firms in monopolistic competition EARN NORMAL OR zero profits.

UNEB 2013

a) How does a firm in a monopolistic competitive market determine output, price and profits in the longrun. (06 martks)
b) Explain the merits and demerits of monopolistic competition. (14 marks)

Normal profits in monopolistic competition in the longrun.
Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram.

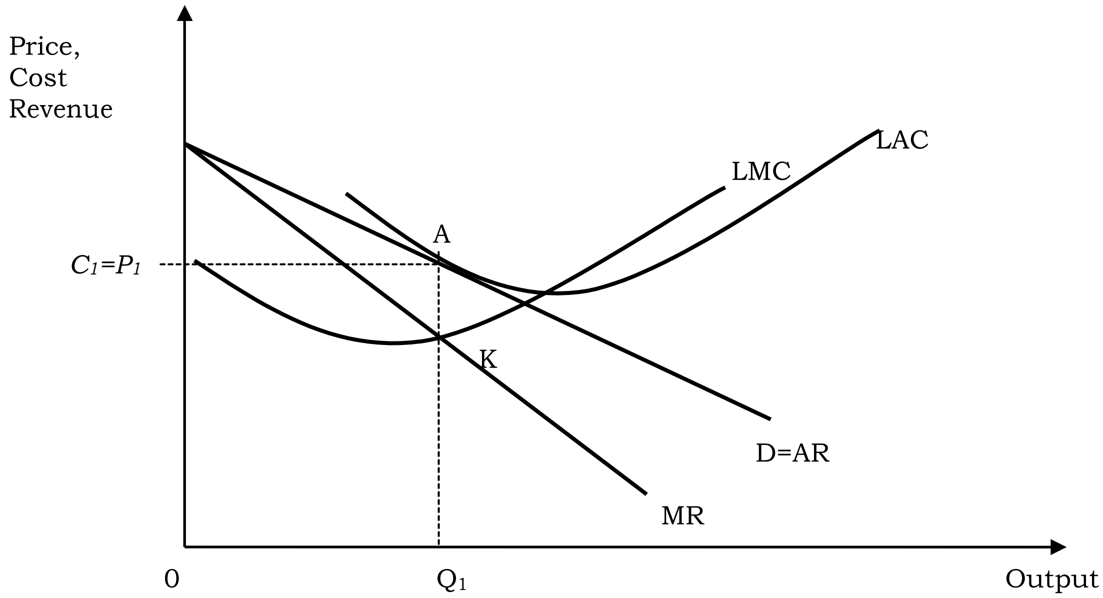


Figure 3.29: long run normal profits in a monopolistic competitive market.

1. Price OP1 is charged/determined at a point where output line meets AR/demand curve at A.
2. Average revenue curve is tangential to average cost curve.
3. Normal/zero profits are earned since average revenue is equal to average cost (AR=AC), because in the longrun. Other firms enter and compete away the abnormal profits.

NB.

1. Output OQ_1 is produced and sold at price OP_1 equivalent to the cost OC_1 and therefore all firms earn normal or zero profits since price= cost and AR= AC at equilibrium.
2. AR curve is tangent to AC curve at equilibrium output/average revenue is equal to average cost at equilibrium level of output.
3. The lowest point of the average cost curve must not touch on the demand curve. What touches the demand curve is the falling part of the AC curve (production at excess capacity).

ADVANTAGES/POSITIVE IMPLICATIONS OF MONOPOLISTIC COMPETITION

1. **A wide variety of products are produced due to product differentiation.** This enables consumers to get several commodities to choose from.
2. **Source of revenue to government through taxation/widens the tax base.** This is because of many economic activities since there are many producers in the market.
3. **Abnormal profits are made in the short run** therefore high chances of expansion of firms.
4. **Increases research and innovations in the short run.** This is because firms carry out research in new brands in order to produce high quality goods and be able to survive the competition especially in the short run where abnormal profits are made.
5. **Leads to production of high quality products.** This is due to competition among firms which increases the standard of living among consumers.
6. **Contributes to increase in output hence economic growth because of many firms in the industry.** This increases output and resource utilization by firms dealing in differentiated commodities.
7. **Increases employment opportunities.** This is due to many firms existing in the industry.
8. **Persuasive advertising enables firms to increase market for products.** This promotes further production.
9. **Low prices are charged.** This is due to staff competition between firms.

DISADVANTAGES OF MONOPOLISTIC COMPETITION.

- **Under utilization of resources both in the short run and in the long run.** This is because of producing at excess capacity.
- **Normal profits are earned in the longrun** and therefore firms do not expand production to enjoy economies of scale since they enjoy normal profits.
- **Increases cost of operation/production.** This because of excessive advertising and product differentiation among firms to capture a wider market.
- **Limited research/innovations and inventions in the longrun.** This is due to normal profits which are not enough to carry out research.
- **Distorts consumer choices.** This because of excessive advertising which misleads consumers who end up making wrong choices.
- **Leads to limited market share among firms.** This is due to existence of many firms in the industry.
- **Leads to unemployment.** This is because of stiff competition since some firms which cannot compete favourably are pushed out of the industry making labour unemployed.
- **Promotes duplication of goods and services thus resource wastage.** Firms tend to produce the same goods using resources which would have been used to produce other goods and this leads to resource wastage.
- **Encourages consumer exploitation/prices charged are higher compared to perfect competition.** This is because of consumer ignorance on product differentiation and they end up paying high prices for the same commodities without knowing that they serve the same purpose.

UNEB 2012.

a) *Explain the differences and similarities between pure monopoly and monopolistic competitive markets. (14 marks)*

b) *How does the existence of monopolistic competitive market affect producers in your country? (06 marks)*

DIFFERENCES BETWEEN PURE MONOPOLY AND MONOPOLISTIC COMPETITIVE MARKETS.

- In pure monopoly market, a firm practices price discrimination which is not the case with firms in monopolistic competitive market.
- In pure monopoly market, a single product without close substitutes is produced whereas in monopolistic competitive market, firms produce differentiated commodities.
- The demand curve in pure monopoly market is inelastic while the demand curve in monopolistic competitive market is fairly elastic.

- In pure monopoly market, there is no persuasive advertising while in monopolistic competitive market there is persuasive advertising.
- In pure monopoly market, a firm earns abnormal profits in the longrun due to absence of new firms while in monopolistic competitive market, firms earn normal profits in the longrun due to entry of new firms.
- In pure monopoly market, entry of new firms is blocked while in monopolistic competitive market, entry of new firms is free.
- In pure monopoly market, there is one seller/produce/firm while in monopolistic competitive market, there are many firms/sellers.

SIMILARITIES BETWEEN PURE MONOPOLY AND MONOPOLISTIC COMPETITIVE MARKET STRUCTURES.

- Both markets produce at excess capacity both in the short run.
- In both market situations, there are many buyers/consumers.
- Both markets attain equilibrium at a point where MR=MC.
- In both markets, the demand/AR curves are downward sloping from left to right.
- In both markets, the producers/sellers/firms are price makers.
- Both market situations earn abnormal profits in the shortrun.

HOW DOES THE EXISTENCE OF MONOPOLISTIC COMPETITIVE MARKET AFFECT PRODUCERS IN UGANDA.

- Firms earn abnormal profits in the shortrun which are ploughed back for firm"s expansion.
- Existence of stiff competition leads to production of high quality products.
- Persuasive advertising enables firms to expand market for their output.
- Wastage of resources due to duplication of activities among firms.
- Firms carryout competitive advertisement which increases production costs.
- Underutilization of resources due to production at excess capacity both in the short run and longrun.
- Firms earn normal profits in the longrun which limits expansion of production.
- Existence of stiff competition leads to collapse of weak or inefficient firms.
- Firms are price makers because of having monopoly powers over their brands.

Format of presentation in an exam (worked UNEB examples).

UNEB 2010, 2013.

How does the firm under monopolistic competition maximize profits in the

- *Short run* *(06 marks)*

- *Long run.* *(06 marks)*

UNEB 1998.

How does a monopolistic competitive firmdetermine output, price and profit both in the short run and longrun. (12 marks)

a) Short run profit maximization in monopolistic competition.

Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown below. (01 mark)

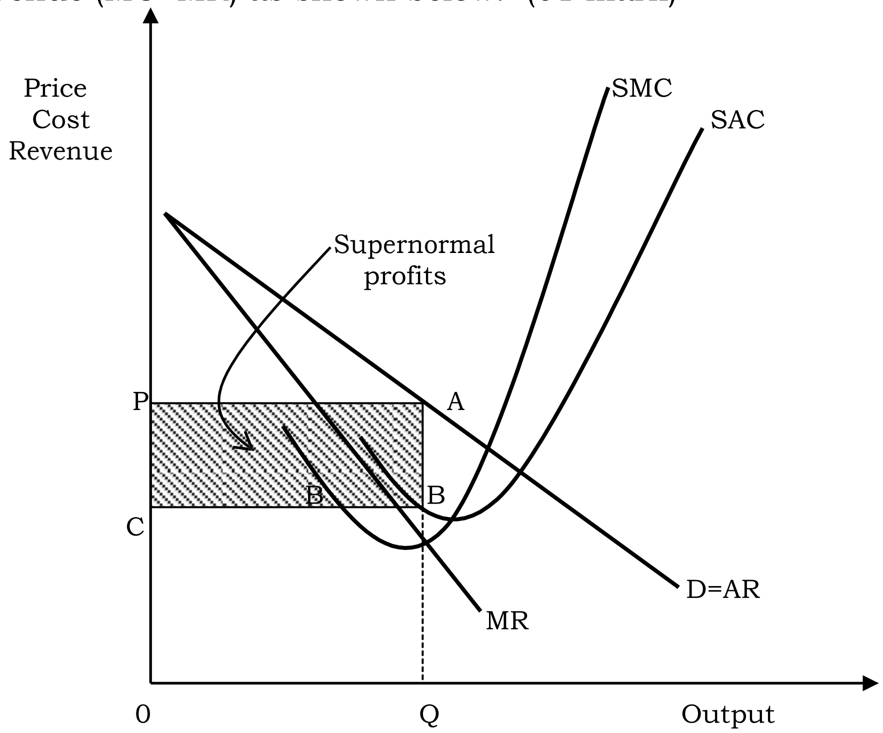


Figure 3.30: short run abnormal profits in a monopolistic competitive market.

- Price OP is charged where output line meets AR/demand curve at point *A. (01 mark)*
- Average revenue is greater than Average cost (AR>AC) at equilibrium output. *(01 mark)*
- The firm earns abnormal profits shown by the shaded area CPAB. *(01 mark)*

b) Long run profit maximization in monopolistic competition.

Profits are maximized at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram below.

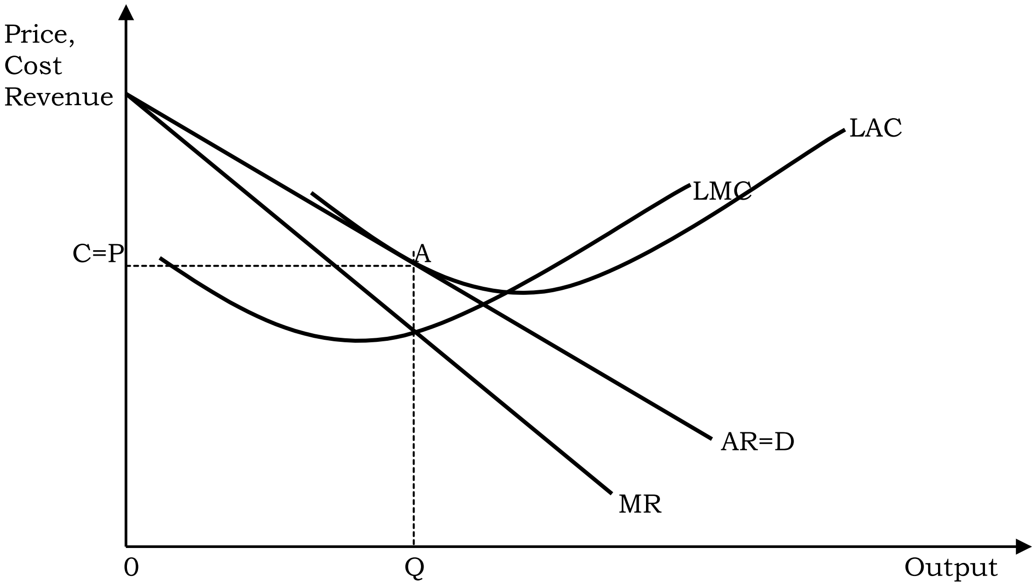


Figure 3.31: Long run normal profits in a monopolistic competitive market.

- Price OP is charged at a point where output line meets AR/demand curve and average revenue curve is tangential to average cost curve. 01mark.
- Normal profits are made since average revenue is equal to average cost (LAR=LAC) because new firms enter the industry and compete away the abnormal profits that existed in the short run. *02marks.*

4) OLIGOPOLY

Oligopoly is a market situation or an industry in which there are few firms of different sizes dealing in either differentiated or homogenous products and with many buyers.

It may be pure/perfect oligopoly or imperfect/differentiated oligopoly.

Perfect oligopoly is a market situation where a few firms deal in homogenous commodities but with many buyers.

Imperfect oligopoly.

Imperfect oligopoly is a market situation where a few firms deal in differentiated commodities but with many buyers.

Examples include.

Petrol dealers, brewing companies, textile firms, mattress industry, press industry, soft drinks industry, mobile phone network providers/telecommunication industry, cement industries.

UNEB 2011

i) *Distinguish between oligopoly and duopoly. (02 marks)*
ii) *State any two advantages of oligopoly market in your country. (02 marks)*

NB.

Duopoly. This is a market situation where there are only two firms/producers and many buyers of a commodity. For instance Tororo and Hima cement works in Uganda. Kakira and Lugazi sugar works in Uganda.

Duopsony. This a market where there are only two buyers but many sellers of a differentiated product.

Oligopsony. This is a market where there are many producers but few buyers of a differentiated product.

Monoposony. This is a market with a single buyer(a monopsonist) of a commodity but with many sellers for instance various out growers of cotton who sell to a single cotton processing firm.

CHARACTERISTICS OF OLIGOPOLY MARKET

1. Few firms and with many buyers and each firm has a considerable portion of the total market share.
2. Firms deal in either homogenous products under pure/perfect oligopoly or differentiated products under imperfect oligopoly.
3. Close interdependence between firms. The decisions of one firm affect the price and output decisions of other firms.
4. Entry of new firms into the industry restricted because of high costs of production involved and cartel arrangements among firms.
5. High degree of uncertainty among firms. Each firm cannot predict accurately the actions of rival firms regarding price and output. For instance when one firm decreases its price, then that actual firm is un aware of the reactions of other firms.
6. Firms of different size exist in the same industry depending on capital invested. Some firms are small while others are big depending on the amount of capital invested.
7. Use of non- price competition/intensive sales promotional activities. This is through branding, persuasive advertising, sponsoring events in order to capture a wider market.
8. Price rigidity which is well explained by a kinked demand curve. Prices remain stable despite changes in cost and demand.
9. The main goal of the firm is profit maximization at a point where MC=MR.
10. The demand curve is kinked because of high level of uncertainty, price rigidity and interdependence among firms.

11. No unique pattern of pricing by firms. There are various ways of pricing such as price leadership, collusive pricing and independent pricing by firms.

A kinked demand curve under oligopoly market.

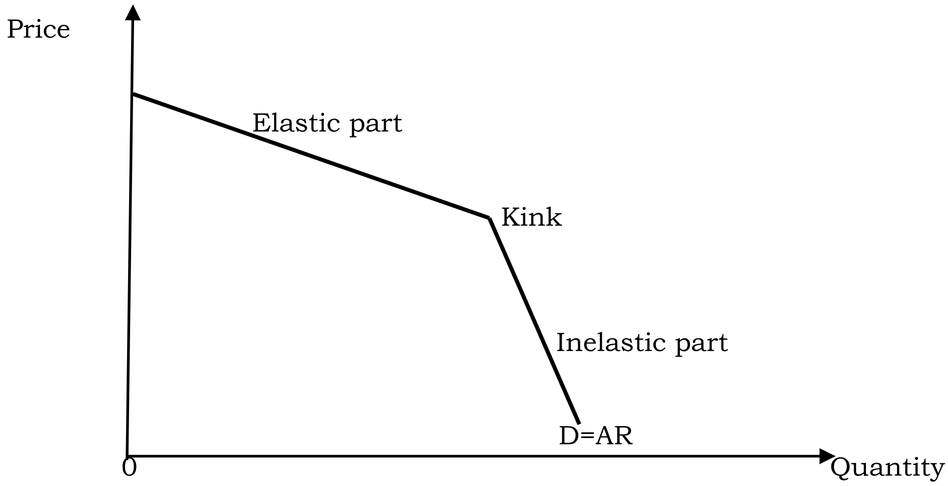


Figure 3.31: a kinked demand curve for oligopoly market.

Above the kink, the demand curve is elastic and below the kink it is inelastic.

NB. Despite changes in the cost of production and demand conditions, firms under oligopoly are not willing to change price. This implies that there is price rigidity.

PRICE DETERMINATION UNDER OLIGOPOLY

a) **Independent pricing**. This is where each firm decides its own price and output without considering its rivals. This results into price wars.
b) **Limit pricing.** This is where a firm sets a very low price for its products to prevent new firms from joining the same production.
c) **Perfect collusion/collusive pricing.** This is where all firms in an industry jointly set a common price for a commodity.
d) **Price leadership/imperfect collusion.** This is where a dominant firm in the industry sets price for other firms in the industry follow that price.
e) **Cut throat competition.** This is where a large firm competitively sets the price below that of others with an aim of out competing them.

PRICE WARS

Price wars refer to a situation where rival firms try to undercut each other in terms of price in order to acquire more customers (increase the volume of sales).

THE DEMAND CURVE UNDER OLIGOPOLY.

The demand curve for oligopoly is kinked because of price rigidity and high level of interdependence among firms.

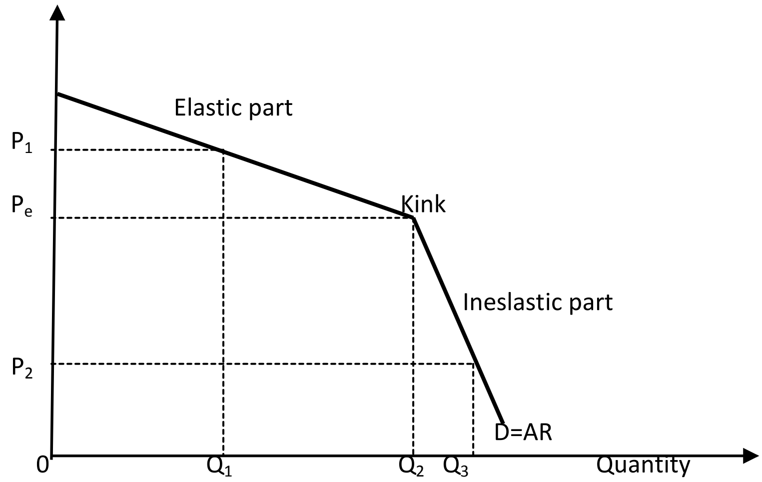


Figure 3.32: the demand curve for oligopoly.

If a firm increases price above the administered price from OPe to OP1. Other firms will not follow the increment price above the administered price. Competitors do not follow an increment in price expecting to attract more customers by maintaining a lower price.

When a firm reduces price below the administered from OP_e to OP_2, other firm will also follow and reduce their price fearing that they would lose customers if they do not reduce and this leads to a relatively low market share gained which almost leaves the market share for every firm constant. Ie. OQ_e to OQ_2. Hence inelastic below the administered price.

OPe is the administered price which all firms in the industry are satisfied with. For any price above OP_e other firms will not follow and for any price below OP_e other firms will follow.

A kinked demand curve.

A kinked demand curve is a demand curve which is elastic at higher price levels and inelastic at lower price level. i.e. elastic above the kink and inelastic below the kink.

THE MARGINAL REVENUE CURVE UNDER OLIGOPOLY MARKET.

The marginal revenue curve in oligopoly market lies below the demand curve with a break/a disjoint directly below the kink of the demand curve.

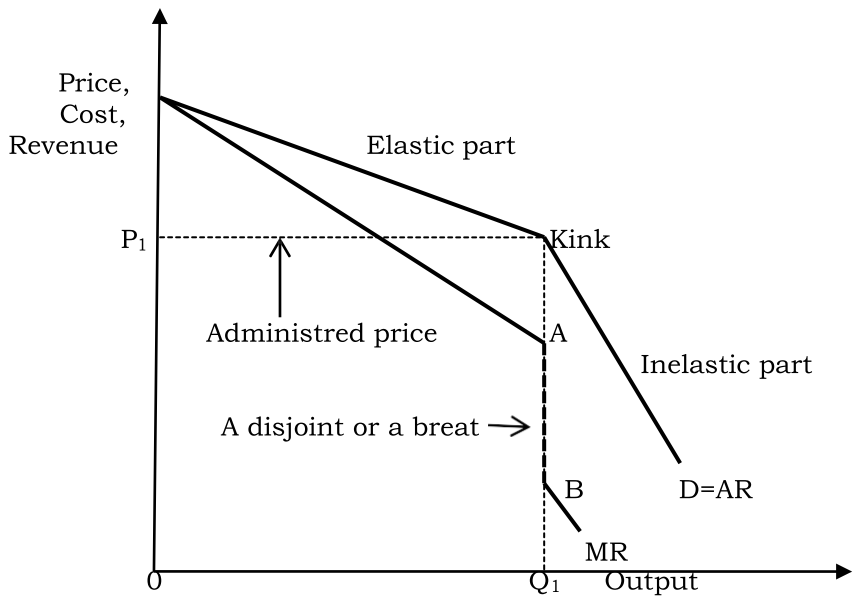


Figure 3.33: the marginal revenue curve in an oligopoly market.

1. Because of the nature of demand curve, the MR curve also has two portions separated by a discontinuous gap/a break/ a disjoint for proper measurement of average revenue. One portion is elastic and another proportion is inelastic as the demand curve.
2. An increase in price above the administered price leads to a large reduction in marginal revenue.
3. A reduction in price below the administered price makes the market share of each firm almost remain constant thus less marginal revenue is gained.
4. The gap AB is referred to as a disjoint/ a break. This implies that even if costs change so longer as the MC curve remains in this gap, it will not have any effect on price, profit and output maximization combinations because the firm will be still producing where MC=MR.
5. This disjoint is directly below the kink and it is meant for easy measurement of average revenue.
6. The MC curve must pass through the dotted vertical portion/ a disjoint of MR curve (AB) so that changes in marginal cost will not affect output and price.
7. AC curve also passes through the dotted vertical portion of the MR curve (AB).

UNEB 1998.

a) *Outline the-*

1. *Features of an oligopolistic market structure.(06 marks)*
2. *Advantages of an oligopolistic market to the consumers.(06 marks)*

b) *Explain how an oligopolistic firm maximizes profits in the short run (08 marks).*

EQUILIBRIUM OF AN OLIGOPOLISTIC FIRM IN THE SHORT RUN.

Short-run abnormal profits in oligopoly.

Abnormal profits are maximized in oligopoly at a point where marginal cost= marginal revenue MC=MR) as shown in the diagram below.

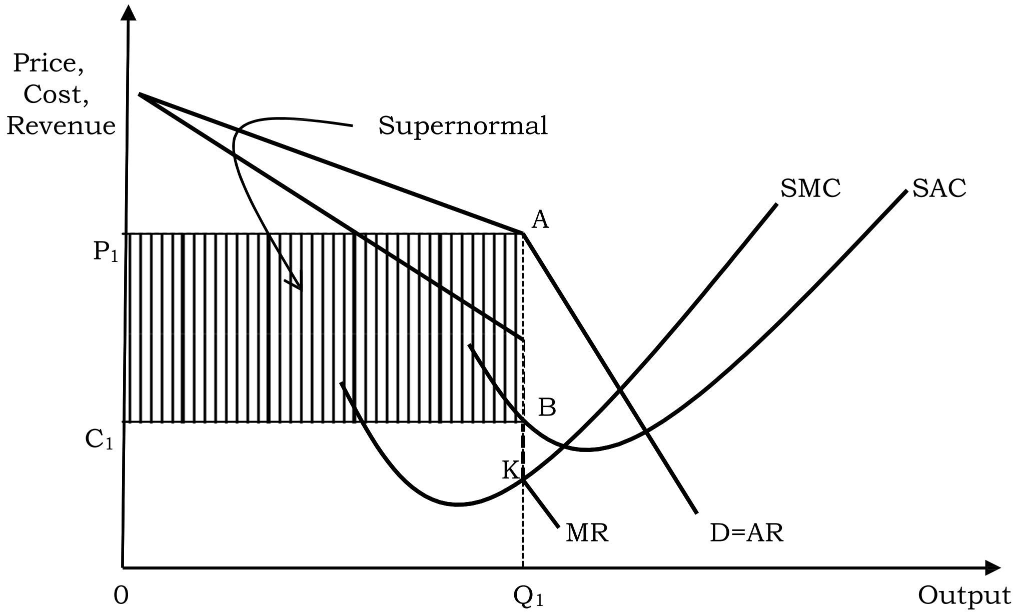


Figure 3.34: shortrun abnormal profits in oligopoly market.

1. Price OP_1 isa charged/determined at a point where output line meets AR./demand curve at the kink at (point A).
2. The firm"s average revenue is greater than average cost (AR>AC) at equilibrium level of output.
3. The firm earns abnormal profits shown by the shaded area P_1ABC_1.
4. MC and AC curves pass through the disjointed part of MR curve.

NB.

i) Equilibrium output is determine at point K where MC=MR.

ii) Cost OC_1 is determined at a point where output line meets the AC curve at B.

iii) The firm produces output OQ_1 and sells it at the administered price OP_1.

iv) MC and AC curves pass through the disjointed part of the MR curve.

EQUILIBRIUM OF AN OLIGOPOLY FIRM IN THE LONGRUN.

In the longrun, oligopolistic firms earn abnormal profits.

In the long run, average cost reduces due to relatively little expenditure on the production of each unit of output and therefore profits increase.

This is because in the longrun, oligopolistic firms form strong cartels and mature market sharing, reduced uncertainty leading to reduction in production costs.

The MR curve has a small break because of reduced uncertainty in the market.

UNEB 2008.

a) Describe the features of an oligopolistic market. (10 marks)
b) Explain the demerits of oligopolistic markets in an economy. (10 marks)

UNEB 2007

a) What are the features of oligopolistic markets in your country. (10 marks)
b) Discuss the merits and demerits of oligopolistic markets in your country. (10 marks)

ADVANTAGES/DEMERITS OF OLIGOPOLY MARKET

- **Promotes price stability.** This is a because of dominant firm which sets the price for other firms to follow which eases consumer budgeting.
- **Widens consumers' choice.** This is especially in imperfect oligopoly where differentiated products are traded.
- **Leads to production of high quality goods.** This is due to the desire among firms to attract large market share which creates stiff competition between firms.
- **Creation of more employment opportunities.** Firms are large enough and re-invest the abnormal profits enjoyed hence creating more job opportunities.
- **Contributes to high government tax revenue.** This is because of economic profits made which attract government taxation for public expenditure.
- **Consumers gain from non-price competition.** Consumers get free gifts, samples and guarantees which increases their welfare.
- **Abnormal profits are enjoyed both in the short run and in the longrun.** This enables firms to carryout further production and expand.
- **Leads to innovations and inventions.** Firms are able to carry out research due to abnormal profits enjoyed by firms.
- **Contributes to economic growth by increasing output.** This is due to large scale firms that exist in the market.
- **Low prices to consumers.** This is due to economies of scale enjoyed by large scale oligopoly firms.

DISADVANTAGES/DEMERITS OF OLIGOPOLY MARKET.

- ❖ **Leads to limited employment opportunities.** This is due to hi entry of new firms in production, existence of few firms in production and use of cut throat competition.
- ❖ **Distorts consumers' choice.** This is because of wide spread advertising where some consumers get confused on what products to buy and what products to leave out.
- ❖ **Promotes under utilization of resources.** This is due to high degree of uncertainty among firms and production at excess capacity both in the short run and in the longrun.
- ❖ **Leads to exploitation of consumers.** This is through overcharging them due to collusive pricing among firms.
- ❖ **High production costs.** This is due to intensive advertising among firms and other sales promotional activities which are costly.
- ❖ **Oligopolistic firms normally exert excessive pressure on government.** They are large enough and normally pressurize the government to provide them subsides, tax exemptions and tax holidays.
- ❖ **Worsens income inequality.** Abnormal profits are earned by oligopolistic firms both in the short run and the longrun, therefore they accumulate more resources than other producers in other industries.
- ❖ **Leads to collapse of small-scale firms.** This is due to stiff competition such as use of cut throat competition which pushes weak firms out of production.
- ❖ **Increased duplication of services which leads to resource wastage.** This is because firms produce similar goods under perfect oligopoly.
- ❖ **Limited variety of goods in perfect oligopoly.** This limits consumer"s choice.

UNEB 2013.

a) *Describe the features of an oligopolistic markets. (08 marks)*
b) *Examine the merits and demerits of oligopolistic markets. (12 marks)*

MERITS/ADVANTAGES OF OLIGOPOLISTIC MARKETS IN UGANDA .

- ❖ Contribute to high government tax revenue.
- ❖ Consumers gain from non- price competition.
- ❖ Enable firms to enjoy abnormal profits both in the short run and in the long run for expansion.
- ❖ Promote price stability.
- ❖ They widen consumer"s choice under imperfect oligopoly.
- ❖ Contribute to production of high quality output.
- ❖ Creation of more employment opportunities.

- ❖ Low prices to consumers due to competition.
- ❖ Leads to increased innovations due to competition.
- ❖ Contribute to economic growth by increasing output.

DEMERITS/DISADVANTAGES OF OLIGOPOLISTIC MARKETS IN UGANDA.

- ❖ They promote under utilization of resources due to operation at excess capacity.
- ❖ Lead to exploitation of consumers through over charging them due to collusion of firms.
- ❖ They lead to high production costs due to intensive sales promotional activities.
- ❖ They lead to limited employment opportunities.
- ❖ They distort consumers" choice.
- ❖ Lead to duplication of activities hence wastage of resources.
- ❖ Oligopolistic firms normally exert excessive pressure on government.
- ❖ Worsen a problem of income inequality.
- ❖ Lead to collapse of small-scale firms due to competition.,
- ❖ They lead to limited variety of goods in perfect oligopoly.

UNEB 2001.

a) What are the features of an oligopoly market? (06 marks)
b) Describe the forms of non- price competition used by oligopoly firms in your country. (14 marks)

NON-PRICE COMPETITION USED IN OLIGOPOLY MARKET

Non-price competition refers to the use of any economic methods mainly by rival firms to compete with each other to attain a wider market without using price as an instrument.

Or

It refers to the means or ways used mainly by rival firms to increase sales and profits without changing price of their products.

FORMS/METHODS OF NON-PRICE COMPETITION USED BY OLIGOPOLISTIC FIRMS IN UGANDA.

Oligopolistic firm in Uganda use a variety of methods to compete with each other to capture a wider market without changing price of their commodities. This is very pronounced and evident among telecommunication companies, soft drinks industries, brewing firms, cement manufacturing firms, petrol firms and mattress industry.

These firms use extensive non competition methods in Uganda through the following.

- ❖ Use of differentiated forms of packaging. Oligopoly firms try to use attractive packaging materials and brand names to convince the public to buy their commodities.
- ❖ Product quality improvement. Oligopoly firms normally improve on the quality of their output which helps to attract more customers even when the price is not changed.
- ❖ Undertaking promotional offers. Oligopoly firms come up with several promotions to increase demand for their product where customers are attracted to win given prizes which increases demand.

  These promotional offers are common among telecommunication companies, soft drinks industries and brewing firms.
- ❖ Provision of gifts to customers. Oligopoly firms such as telecommunication companies give out T- shirts, caps to various customers. This helps to attract more buyers of their products.
- ❖ Organizing trade fairs and exhibitions in various parts of the country. This is meant to attract various customers where customers are given extra attention on how the product works and this increases sales. This also helps to introduce new brands of differentiated commodities.
- ❖ Use of appealing slogans and attractive brand names. Oligopoly firms use attractive slogans to show consumers that the brand of agiven firm is more superior than that of other firms for instance MTN-very where you go, UTL- it is all about you.
- ❖ Opening branches or distribution points in different parts okf the country. This is accompanied by improved quality of shopping outlets which attracts more customers. For instance setting up new fuel stations.
- ❖ Free distribution of samples. These are given to potential customers to persuade them to start using more of the commodity and this increases sales.
- ❖ Provision of credit facilities or installment selling so as to attract customers and maintain the existing customers. This is normally offered to those who buy in bulk.
- ❖ Sponsoring events such as sports. They organize sports competitions and sponsor events to attract more demand from the public. For instancetelecommunication companies such as MTN sponsor sport activities such as World cup 2010 by MTN, sponsoring local games.
- ❖ Provision of after sales services. Extra services rendered to consumers help to maintain such customers for instance washing car windscreens after fueling and free transport to consumers who buy in large quantities.
- ❖ Persuasive advertising to attract more sales. Oligopoly firms excessively advertise their products over the radios, televisions, newspapers,

magazines, banners. There are excessive advertisements by telecommunication companies, brewing firms and soft drinks firms.

Format of presentation in an exam.

UNEB 1998.

Explain how an oligopolistic firm maximizes profits in the short run. (08 marks)

Abnormal profits are maximized in oligopoly at a point where marginal cost= marginal revenue (MC=MR) as shown in the diagram below.

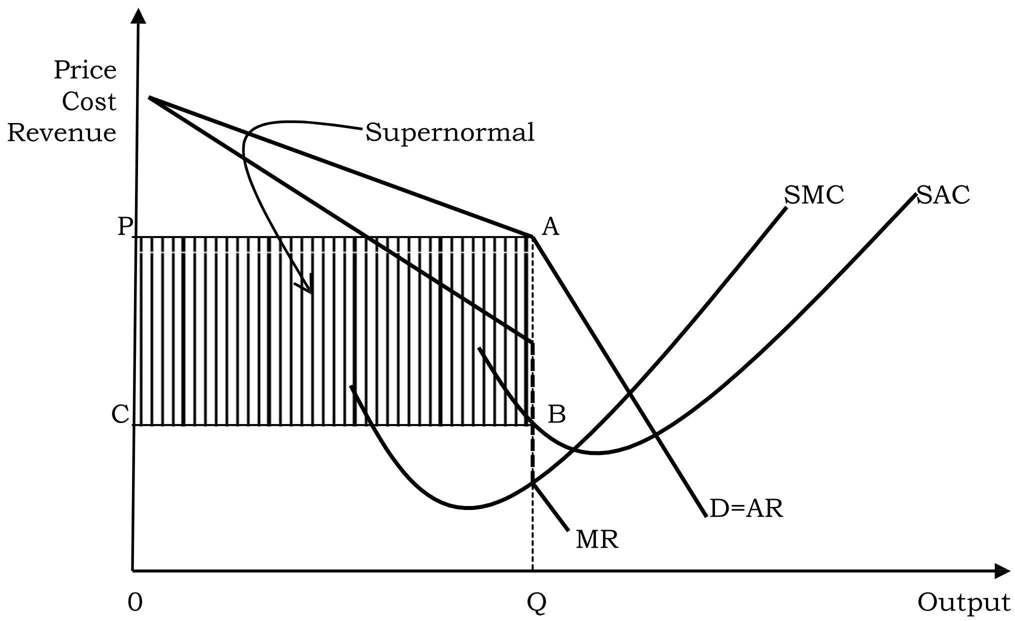


Figure 3.35: short run abnormal profits in oligopoly market.

- Price OP is determined at a point where output line meets AR/demand curve at the kink at (point A). 01mark.
- The firm‟s average revenue is greater than average cost (AR>AC) at equilibrium level of output.
- The firm earns abnormal profits shown by the shaded area CPAB (02 marks)
- MC and AC pass through the disjointed part of MR curve. (01 mark

CHAPTER 4: NATIONAL INCOME

National income is the total monetary value of all final goods and services from all productive sectors oractivities of the economy in a given period of time usually a year. National income is interested in the value of commodities produced in monetary terms but not the value of money itself.

National income should be derived from productive activities.

Major concepts used in national income

a) **Gross domestic product (GDP).** This is the total monetary value of all final goods and services produced within the territorial boundaries of a country by both nationals and non-nationals in a given year.
   It includes output by both foreigners and nationals in the country.
   GDP = C+I+G.
   Where C represents households, I represents firms and G stands for government.
b) **Gross national product (GNP).** This is the total monetary value of all final goods and services produced within and outside the country by only nationals in a given year. Nationals of a country who are abroad earn income and this income must be included in GNP.

Or

GNP is the total money value of all final goods and services produced by only nationals of a country within and abroad during a given period of time usually a year. Output by all nationals of a country is considered irrespective of where they live.

Gross implies that depreciation cost that was incurred in production process is not yet deducted.

GNP= C+I+G+(X-M) or GNP =GDP +(X-M).

Where (X-M) stands for exports minus imports. This gives net income from abroad.

Net income from abroad.

This refers to difference between incomes earned by nationals of a country abroad and property income earned by foreigners within the country.

c) **Net national product (NNP).** This is the total monetary value of all final goods and services produced by only nationals of a country within and abroad usually a year minus cost of depreciation.
   Net implies that the coast of depreciation that was incurred during the production process is already deducted.
   NNP = C+I+G+(X-M)- depreciation cost.
   Or NNP=GNP – depreciation cost.

NB:

DEPRECIATION

Depreciation refers to the tear an d wear of capital goods as a result of their use in production process. This therefore calls for depreciation allowance or capital consumption allowances.

Capital consumption allowance/depreciation allowance.

This refers to amount of money kept in reserve to cater for the tear and wear of capital goods during production process.

(i) **GDP at factor cost (GDPfc).** This is the total monetary value of all domestic goods and services valued according to what is paid to factors of production (costs of production) usually one year. This is inform of wages, salaries, rent and interest.

Or

This is the total money value of all goods and services produced within a country valued at payments received by factors of production in a year.

It is called GDP at factor cost because it shows cost of different factors of production to produce goods and services. The commodity is still at the factory.

GDP at factor cost= GDP at market price + subsidies – indirect taxes.

UNEB 2009.

i) *Distinguish between Gross Domestic product (GDP) and net domestic product (NDP) (02 marks)*
ii) *Given that GDP at factor cost is $300 billion for a given country, indirect taxes is $100 billion, subsides is $150 billion. Calculate the country"s GDP at market price . (02 marks).*

1. **GDP at market price (GDPmp).** This is the total monetary value of all domestic goods and services valued according at their final prices in the market usually a year.

   Alternatively, it refers to the total monetary value of all domestic goods and services valued according tomarket prices usually a year. It is national output valued at what is paid for final commodities in the market usually a year.

   GDP at market price= GDP at factor cost + indirect taxes – subsidies.

v) At market price, we deduct subsidies because they do not form part of the producers expenditure and it does not lead to increased costs of production and therefore it is not part of the price.

vi) At factor cost, we add there subsidies because it is actually used in paying factors of production in terms of rent, wage and interest.

2. **Percapita income.** This refers to average income of individuals of a country in a particular year.

   Or

refers to income perhead/person in a country usually a year.

$$\textbf{Percapita income} = \frac{\textbf{GNP or National Income for the year.}}{\textbf{Total Population for the same year.}}$$

3. **Real income percapita.** This refers to average income of the population in terms of quantity of goods and services that it can purchase in a year.
4. **Nominal income percapita.**This refers to average income of the population in monetary terms/ units in a year.
5. **Personal income.** This refers to the amount of money income received by the households from all sources in a given period of time.
6. **Disposable income.**It is income available to individuals and households for spending and saving after personal income taxes and other compulsory payments have been deducted. This is the income of the household available for spending and saving after direct taxes and other compulsory payments have been deducted.
7. **Nominal or money income.**This refers to income that is measured in monetary terms or units. For instance in shillings, dollars and pounds.
8. **Real income.** This is the purchasing power of nominal or money income expressed in terms of goods and services.

   Or

   It refers to the amount of goods and services which one"s nominal or money income can purchase.

   UNEB 2005, 2001

   i) *Distinguish between real income and nominal income. (02 marks)*
   ii) *Mention any two determinants of real income ion your country. (02 marks)*

DETERMINANTS OF REAL INCOME

a) Quantity of goods and services supplied.
b) Size of nominal income.
c) General price level.
d) Level of direct taxes
e) Size of subsistence/monetary sector.

9. **Nominal gross domestic product.** This is the total monetary value of all goods and services produced within a country during a given period of one year valued at current year prices.

   Or

   It refers to gross domestic product valued at current year prices.

10. **Real gross domestic product.** This is the total monetary value of all goods and services produced within a country during a given period of one year valued at base year prices (constant prices).

    Or

    It refers to gross domestic product valued at base year prices.

UNEB 2015

(i) *What is meant by the term Real Gross Domestic Product? (01 marks)*
(ii) *Given that nominal Gross Domestic Product is Shs 150,000,000,000 and the consumer price index is 105, calculate the real Gross Domestic Product. (03 marks)*

11. **Nominal gross national product.** This is the total monetary value of all goods and services produced by only nationals within and outside the country for a period of one year valued at current year prices.
12. **Real gross national product.** This is the total monetary value of all goods and services produced by only nationals within and outside the country for a period of one year valued at base year prices (constant prices.)
13. **Net domestic product (NDP).** This is the total monetary value of all final goods and services produced within the territorial boundaries of a country usually a year excluding the cost of depreciation.

UNEB 2006.

i) *Differentiate between Gross National product (GNP) and Gross Domestic Product (GDP). (02 marks)*
ii) *Given GDP at market price is £500 billion subsidies is £200 billion. Calculate GDP at factor cost. (02 marks)*

UNEB 2012

i) *Differentiate between nomal and real gross domestic product (GDP). (02 marks)*
ii) *Given that a country"s GDP is shillings 400 billion, net income from a broad is shillings 40billion and depreciation is shillings 20billion. Calculate Net National Product. (02 marks)*

UNEB 2004.

Given that the country"s stock of machinery is valued at shillings 100 billion at the beginning of the year, total output from the machinery during the year is shillings 500 billion, depreciation cost during the year was 20%.

Calculate the,

(i) *Value of depreciation.*
(ii) *Net output during the year.*

UNEB 2000.

i) *Distinguish between Gross Domestic Product and Gross National Product (02 marks)*

ii) *State any two uses of national income statistics iun your country.*
(02 marks)

1) Given GDP at factor cost is shillings 2,500million, net income from abroad is shillings 800million, and depreciation of capital equipment is shillings 50million, calculate Net National Product (NNP).

NNP=GNP- depreciation of capital.
NNP-GDP +Net income from abroad- depreciation cost.
NNP=2,500M+800M-50M.
3300m-50m
<u>NNP=Shillings 3,250 million.</u>

2) Given that GDP at factor cost is $300 billion for a given country, indirect taxes is $100 billion, subsidies is $150billion. Calculate the country's GDP at market price.

GDP at market price= GDP at factor cost+ indirect taxes – subsidies.
$400b+$100b-$150b
$400b-$150b
<u>GDP at market price = $250 billion.</u>

3) Given GDP at market price is €500 billion, indirect taxes amount to €155 billion, subsidies is €200 billion. Calculate GDP at factor cost.

GDP at factor cost= GDP at market price + subsidies – indirect taxes.
€500b+€200b-€155
€700b-€155b.
<u>GDP at factor cost= €545 billion.</u>

4) Given that the Gross National Income is shillings 275,000,000 million and net income from abroad is shillings 15,000,000 million. Calculate Gross Domestic Income.

GDY= GNY- net income from abroad.
275,000,000m- 15,000,000m.
<u>GDY=shillings. 260,000,000 million.</u>

5) Given that the country"s stock of machinery is valued at shillings 100 billion at the beginning of the year, total output from the machinery during the year is shillings 500 billion, depreciation cost during the year was 20%.

Calculate the,

a. Value of depreciation.

Value of depreciation = stock of machinery X rate of depreciation.

100billion x 20/100.

<u>Value of depreciation = shillings.20 billion.</u>

b. Net output during the year.

Net output = total output – depreciation value.
500 billion – 20 billion.

Net output during the year= shillings 480bilion.

UNEB 2011

a) *Differentiate between Gross Domestic Product and Net National Product . (04 marks)*

b) *Explain the factors that influence the level of national income in your country. (16 marks)*

DETERMINANTS OF NATIONAL INCOME FIGURES IN AN ECONOMY.

(Factors that influence/affect the size of national income figures in an economy)

NB. Neutral factors must be presented showing a positive side that favour expansion of production leading to high national income figures and a negative side that limit production levels leading to low national income figures in explanation.

1. **Availability of natural resources and their level of exploitation.** Large quantity of natural resources and of high quality such as minerals, water resources that are well exploited expand production hence high national income figures while limited natural resources and of low quality limits the amount of output leading to low national income figures.
2. **Political atmosphere.** Favourable political atmosphere encourages all forms of investment due to certainty for property which increases production and output thus high national income figures while unfavourable political atmosphere creates business uncertainty which discourages investment and therefore low national income figures.
3. **Government policy on investment/investment climate.** Favourable government policies in form of high subsidies, tax holidays, tax exemptions lead to high production and output hence high national income figures while unfavourable government policies such as high taxes on producers, limited subsidies discourages production hence low national income figures.
4. **Level of technology used in production.** Improved level of technology increases utilization of resources leading to high output hence high national income figures while low level of technology limits production hence low output and national income figures.
5. **Labour skills/availability of skilled labour.** High labour skills stimulate more labour productivity leading to high national income figures compared to limited skills and training which lead to low national income figures.
6. **Level of entrepreneurial ability or size of entrepreneurship class.** High level of entrepreneurial skills imply high level of organization of other factors of production which increases investment in risky but highly profitable ventures leading to high output and national income

figures but low level of entrepreneurial skills reduce production hence low output and national income figures.

7. **Size of existing capital stock.** A large size of capital stock implies that more natural resources areturned into final goods and services thus high output leading to high national income figures while limited and inefficient existing capital stock reduce the level of production hence low national income figures.
8. **Population growth rate.** High population growth rate increases dependence burden, limits savings and investment hence low national income figures but low population growth rate stimulates savings and later investment thus high national income figures.
9. **Market size for a country's output.** A large market size both at home and abroad for goods and services produced increases more investments thus high national income figures whole a small domestic and foreign market for a country"s output discourages more production thus low national income figures.
10. **Level of infrastructure development.** High level of infrastructure development in form of roads, railways help to coordinate production in all sectors hence high output and national income figures while underdeveloped infrastructure in form of limited power supply, poor roads limit production and national income figures.
11. **Level of monetization/size of subsistence sector in an economy.** Low level of monetization hampers growth since there is low output hence low national income figures but a highly commercialized economy increases economic activities which expands production hence high national income figures.
12. **Rate of inflation/economic climate.** High rate of inflation discourages production due to high costs and business uncertainty hence low national income while low rate of inflation leads to increased investment leading to high national income figures.
13. **Level of savings.** High level of savings increases production and investment leading to high national income figures while low level of savings limits investment levels leading national income figures.
14. **Level of accountability.** Proper accountability in resource allocation encourages more production leading to high national income while poor accountability limits investment leading to low national income figures.
15. **Degree/level of conservation.** High degree of conservatism limits introduction of modern technology which limits production leading to low national income while low level of conservatism stimulates more production leading to high national income figures.

UNEB 2014

a) *Explain the importance of computing national income in an economy. (10 marks)*

b) *Account for the low level of national income in developing countries. (10 marks)*

FACTORS WHICH LIMIT THE SIZE OF NATIONAL INCOME IN UGANDA.

NB. These are one sided points which are responsible for low production, low output and finally low national income figures.

1. **Unfavourable/poor investment climate.** At times government policy is not favourable to investment inform of high taxes, limited subsidies, high cost of trade licenses which discourages production and thus low output and national income.
2. **High rate of inflation/economic instability.** Persistent inflation discourage increased production due to high production costs thus low national income.
3. **Limited entrepreneurial ability.** There are few entrepreneurs which leads to poor organization of other factors of production thus low output and national income as well.
4. **Poor infrastructure.** The infrastructure network is not properly developed in form of poor roads, limited
5. **Low levels of technology.** Technology used in most production sector such as agriculture, industry, mining is still poor thus limited output levels and low national income.
6. **Small market size.** The domestic market is small due to low incomes among consumers while the foreign market is highly competitive which limits large scale production thus low national income.
7. **Poor/unfavourable political climate.** Political instability in some parts of the country has been discouraging increased investment and takes high government expenditure instead of investing it in productive investments thus low production levels and national income.
8. **High population growth rate.** Population grows at a high rate per annum which increases dependence burden and limits savings thus reduced investment, low output and national income as well.
9. **Low levels of monetization/existence of large subsistence production.** Production in some sectors is not highly geared for commercial purposes which leads to low output especially in rural agriculture thus low national income.
10. **Limited capital stock.** A small size of capital stock limits large scale production in most investments thus low output national income as well.
11. **Low levels of exploitation of natural resources.** The existing natural resources are underutilized in form of land, minerals leading to low output hence low national income.
12. **Poor land tenure system.** This discourages meaningful production leading to low national income.

UNEB 2002.

a) *Distinguish between national income valued at factor cost and national income valued at market price. (04 marks)*
b) *Suggest the steps that should be taken to increase the level of national income in your country. (16 marks)*

UNEB 2005.

i) *Distinguish between national income at market price and national income at factor cost. (02 marks)*
ii) *Given that Gross National Income is shs 275,000,000million and net income from abroad is shs 15,000,000muillion. Calculate Gross Domestic Income. (02 marks)*

Solution.

i) National income valued at factor cost. This refers to national income valued at what factors of production are paid in production process usually a year.

Or

It refers to the total money value of all goods and services produced in a country in a given year valued at factor prices.

National income valued at market price. This refers to national income valued according to prices of final goods in the market usually a year.

Or

It refers to the total money value of goods and services produced in a country in a given year valued at prices paid by final consumers of the products.

ii) Gross domestic income= gross national income- net income from abroad.
GDY=275,000,000m- 15,000,000m
<u>GDY= Shillings 260,000,000millio.</u>

MEASURES THAT CAN BE TAKEN TO INCREASE THE SIZE OF NATIONAL INCOME IN UGANDA.

These are intended to increase production, output and finally high national income.

❖ **Improve on existing level of technology.** This can be done through increased research and technological transfer to increase the rate of resource exploitation and increase output thus increase in national income.

- ❖ **Equip labour with appropriate skills/training labour in order to acquire necessary skills.** Labour needs to be equipped with relevant investment skills and this should be done through vocationalising growth so as to promote labour efficiency and productivity to increase investment and national income.
- ❖ **Expand market both local and foreign market.** Market for output should be expanded to stimulate more production through joining regional integration which encourages large scale investment leading to increased national income.
- ❖ **Improve and develop necessary infrastructure.** Existing infrastructure should be rehabilitated and new ones established in form of power supply, roads, railways, airfields and baking facilities to stimulate more production and increase national output.
- ❖ **Ensure and maintain political stability.** This is a key component of investment and can be done through holding peaces talks with rebels groups and ensure good governance so as to enable investors concentrate on productive activities and attract more investments for increased output leading to an increase in national income.
- ❖ **Provision of a conducive investment climate/offering investment incentives to investors.**

Attracting both local and foreign investors should be emphasized through provision of subsidies, tax holidays and tax exemptions which leads to increased output.

- ❖ **Ensure and maintain economic stability.** This can be done by use of effective, sound fiscal and monetary policies appropriate for a country to attract various investments and increase production and national income.
- ❖ **Control population growth rate.** There is a need to control population growth to keep pace with economic growth and this should be done by putting more emphasis on family planning to ensure that population growth matches with the existing resources and avail more savings for investment leading to increased national income.
- ❖ **Promote modernization and commercialization of agriculture.** Agriculture contributes greatly to GDP in Uganda, therefore, it should be improved through increased funding to facilitate mechanization, extension services, market research, providing modern inputs and training farmers on modern production techniques for increased agricultural output hence high national income.
- ❖ **Increase the level of exploitation of natural resources.** Resources such as minerals, forests, water resources should be utilized productively through changing the land tenure system, research while

ensuring sustainability in the use of water resources, minerals and forested areas. This leads to increased investment leading to high national income.

- ❖ **Further privatization of public enterprises.** More public enterprises should be privatized to attract various local and foreign investors in production to increase resource utilization and output leading to high national income.
- ❖ **Encourage further diversification of the economy.** This helps to reduce dependence on a few sectors which increases output and national income.
- ❖ **Improve entrepreneurial skills.** This helps to increase the level of investment and organization of other factors of production leading to high output and national income.
- ❖ **Ensure appropriate economic planning.** This helps to ensure proper plan implementation, ensures efficiency in production which increases resource utilization and national income.

WHY IS GNP/GDP OF U.S.A IS HIGHER THAN THAT OF UGANDA YEAR AFTER YEAR?

- ❖ U.S.A has more and better skilled labour than Uganda.
- ❖ U.S.A has better and advanced technology than Uganda.
- ❖ U.S.A has more capital stock than Uganda.
- ❖ U.S.A has well developed infrastructure than Uganda.
- ❖ U.S.A has a low population growth rate than Uganda.
- ❖ U.S.A has a large market size than Uganda.
- ❖ U.S.A is more politically stable than Uganda.
- ❖ U.S.A is much more industrialized than Uganda.
- ❖ U.S.A has favourable investment policies than Uganda.
- ❖ U.S.A has a high level of entrepreneurial ability than Uganda.
- ❖ U.S.A is highly monetized while Uganda has large subsistence sector.
- ❖ U.S.A is more economically stable than Uganda.
- ❖ U.S.A has more resources which are highly exploited than Uganda.

UNEB 2015

a) *How is national income measured in an economy? (06 marks)*
b) *Explain the problems faced when compiling national income in an economy (14 marks)*

UNEB 2004

a) *Describe the three approaches used in measuring national income. (06 marks)*
b) *What problems are encountered when compiling national income. (14 marks)*

APPROACHES/METHODS USED TO COMPUTE/COMPILE/MEASURE NATIONAL INCOME STATISTICS.

These are three approaches used in measuring national income figures.

A. INCOME APPROACH.

Using the approach, national income is obtained by adding up all the total money value of all incomes earned by individuals in an economy which contributed to the production of goods and services in a year. We add up the incomes earned in form of profits, rent, wages, salaries and interest less transfer payments.

Income approach= wages + salaries + rent + interest + profits-transfer payments.

National income = W+S+R+I+P – Transfer payments.

NB.

Using this approach, transfer payments such as gifts, pocket money, pension funds, grants, sick benefits,school fees, unemployment benefits and famine relief should not be included in national income. Also, incomes earned form illegal activities such as prostitution, murder, robbery, smuggling and theft should not be included in national income.

Therefore, there should be quid-proquo (income received for exchange of goods and services) for income to be included in national income.

The value of subsistence output should be estimated and included in national income because if forms part of the producer‟s real income.

Transfer payments.

These are payments made without corresponding the exchange of goods and services. They are referred to as non-quid proquo payments.

Subsistence output/non marketed output.

This refers to output for producer‟s own consumption.

UNEB 2014

(i) Differentiate between transfer earnings and transfer payments. (02 marks)

(ii) Give any two examples of transfer payments in your country. (02 marks)

UNEB 2003

i) Distinguish between transfer earnings and transfer payme(02 marks)

ii) Mention any two sources of transfer payments in your country. (02 marks)

Sources of transfer payments.

- Government (local and central government).
- Institutions in form of firms and nongovernmental organizations.
- Individuals.
- Foreign economies and donors.

B. EXPENDITURE APPROACH.

Using this approach, national income is obtained by adding up all the total amount of money spent on final goods and services by all sectors of the economy in a year. We therefore add up expenditure made by all sectors of the economy in form of-

- Consumption expenditure by households (C)
- Investment expenditure by business firms (I)
- Government/public expenditure on goods and services (G)
- Net foreign expenditure. It is equal to exports minus imports (X-M). this excludes expenditure on output from other countries by nationals.

National income= C+I+G+(X-M).

NB.

Expenditure must be on final goods and services in order to avoid the problem of double counting.

However, using this approach, expenditure made on transfer payments and illegal activities should be excluded.

The value of inventories should be estimated and included in national income.

Inventories.

Inventories refer to goods produced but not yet sold in the course of the year.

C. OUTPUT/VALUE ADDED/PRODUCT APPROACH.

Using this approach, national income is obtained by adding up the total value added on output of all sectors of the economy at each stage of production process in a given year. We add value added in order to avoid the problem of double counting.

NB.

Value added refers to the difference between the value of the final output and the value of intermediate input at each stage of production.

Or

It is the difference between the value of material input and output at each stage of production. It is the utility added to the commodity at different stages of production.

For example, if farmer produces and sells maize to firm B at shillings 1,000 per kg, firm B packs it and sells at shillings 1,800 per kg to firm D and firm D packs it and later sells to consumers at shillings 2,200 per kg.

Value added will be= 1,000 + 200+600+400.

National output=shillings 2,200.

NB total value added should be equivalent to the final price of the commodity.

SUMMARY OF THE THREE APPROACHES OF MEASURING NATIONAL INCOME.

a) Income approach presents difficulties to use in developing countries because of lack of enough information on all incomes earned since many people are self employed and it is hard to value their services interms of money, makes it hard to estimate value of subsistence output, there is difficulty in collecting data from incomes because of scattered business units.
b) Output approach is the most appropriate in developing countries since output is tangible unlike income and expenditure. With this method, the problem of valuing subsistence output and double counting are easily overcome. It is more direct and easy to sum up value added by the sectors of the economy.

THE CIRCULAR FLOW OF INCOME.

This refers to the flow of income and expenditure among different sectors of the economy. These sectors include.

(i) The household sector (C)
(ii) The business sector (I)
(iii) The government sector (G)
(iv) The foreign sector (x-m).

THE CIRCULAR FLOW OF INCOME IN A TWO- SECTOR MODEL.

This is a model that shows the flow of resources, commodities (real flows) and the flow of expenditure and incomes (monetary flows) between households and firms in an economy in a given time.

Assumptions of the circular flow of income in a two sector model.

- There is existence of only two sectors that is household sector and business sector.
- Assumes a closed economy.
- No government intervention.
- Household sector consists of owners of factors of production.
- The household sector consists of consuming class.
- There is full employment of all factors of production.
- All incomes earned by all sectors is spent i.e. no savings.
- All production takes place in business sector and no consumption in this sector.

The circular flow of income in a two-sector model.

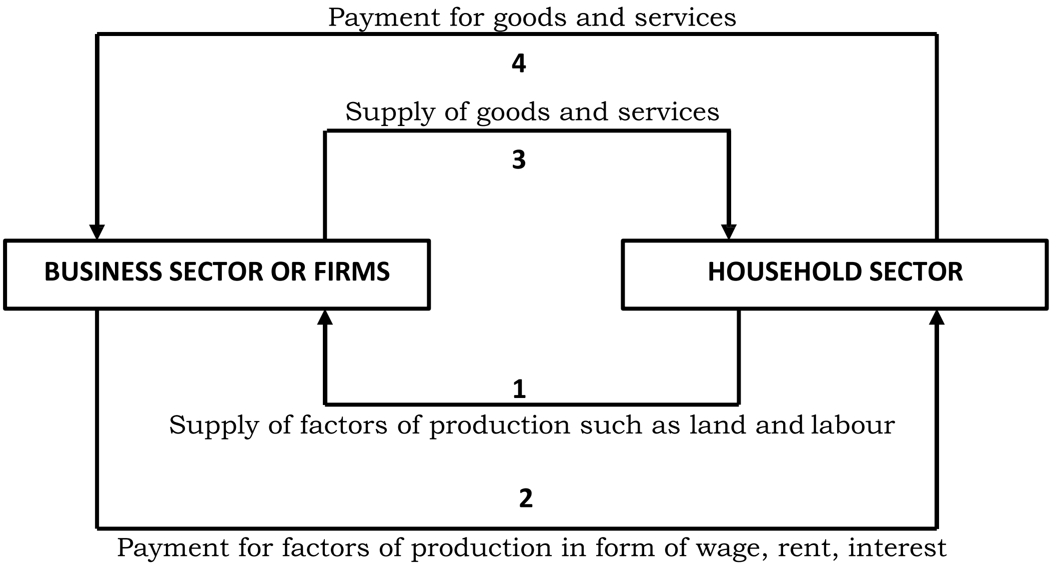


Figure 4.1: the circular flow of income in a two sector model.

- Arrow 1 indicates that in order to produce goods and services, firms must acquire factors of production from the household sector.
- Arrow 2 indicates that firms pay for factors of production acquired from the household sector.
- Arrow 3 indicates that after acquiring factors of production, firms produce goods and services that are supplied to the household sector.
- Arrow 4 indicates that the household sector pays for the goods and services supplied to them by firms.
- Arrows 1 and 3 indicate or show real flows. These show the flow of goods, services and factors of production and does not involve money.
- Arrows 2 and 4 indicate or show monetary flows/financial flows. These show payment for goods, services and factors of production.
- It is noted that the value added on goods and services by firms is equal to the household expenditure on such goods and services, therefore, 0=E.
- Output by firms from factors of production is equal to income obtained from the sale of such goods and services, therefore O=Y.
- All income earned by households is spent on goods and services, therefore expenditure is equal to income E=Y

Therefore, if O=E, O=Y, E=Y, then it follows that O=Y=E. this follows/means that the three approaches of measuring national income yield the same results if there are no statistical errors made in calculation.

NB. An open economy is one which carries out international trade transactions. In an open economy, national income=C+I+G+(X-M).

A closed economy is one which does not have international trade transactions. In a closed economy, national income=C+I+G.

UNEB 2008.

a) Explain the importance of computing national income in an economy. (10 marks)

b) What are the problems faced while computing national income. (10 marks)

IMPORTANCE OF MEASURING /COMPILING NATIONAL INCOME.

1) **It is a basis of economic planning and analysis.** National policy analysis on economic issues such as unemployment, inflation basing on the level of output, income, expenditure and investment through making necessary research is revealed by the size of national income.
2) **It is used to measure percapita income and show the trend of development.** This can only be obtained when national income is in place which helps to show the trend of development.
3) **It identifies leading sectors and weak sectors of the economy/it shows relative importance of various protective sectors of the rconomy.** This is interms of their productive capacity and their total contribution to the total national out put which helps to identify weakneses in the atructure of the economy.
4) **It show income/resource didtribution.** Income approaches is a basis of analyzing how income is spread Among different sections of thew population, thus a basis of essuring fair income distribution by taking appropriate actions.
5) **It indicates the rate of economic growth over time.** High national income implies high level of economic growth between given years abd low National income implies low rates of rconomic growth which helps to show annual growth rate.
6) **It is helpful in soliciting foreign aid.** Bi lateral and multi lateral donors require national income figures as a basis of determining the capacity of the country to repay or which sectors tp sponsor before channeling their resources in form of foreign aid.
7) **It shows patterns of national expenditure by both the public and private sectors.** Expenditure approach is a basis of determining of the modes of expenditures by different sectors of the economy.
8) **Its used for international comparisons between countries.** Copperative analysiss especially using pre capital income helps to determine the standard of living of a given country in relation to other countries.
9) **It is used for comparison purposes over time with in a country.** For instance standard of living with in a country.

UNEB 1999

a) *Distinguish between gross national product (GNP)and gross domestic product (GDP). (04 marks)*

b) *Why is it necessary to compute national income statistics (16 marks)*

UNEB 2007

a) Why is it necessary to messure national income. (08 marks)
b) Explain the problems encountered in measuring national income (12 marks)

WHY IS IT NECESSARRY TO COMPILE/COMPUTE NATIONAL INCOME OR REASONS FOR COMPILING/MEASURING NATIONAL INCOME.

- For economic planning and policy analysis.
- To measure per capita income
- To resource/income distribution.
- To solicit for foreign aid.
- To analyse paterns of national expenditure by both the public and private sectors.
- For international comparisons between countries.
- To identify relative importance of various productive sectors of the economy/identify leading and lagging sectors of the economy.
- To measure the rate of economic growth over time.
- For comparison purposes with in a country over time.

PROBLEMS/CHALLENGES/DIFICULTIES ENCOUNTERED WHEN MEASURING / COMPILING NATIONAL INCOME STATISTICS.

LDCs face both statistical and conseptial problems while compilling anational income.

Statistical problems are practical problems which orrigate from the difficulties/failure of collecting necessary information. These are problems related to handling statistics of national income.

Conceptual problems.

These are difficulties originating from the failure to define properly the concept of national income. They originate from the difficulty on what to include ane exclude in national income.

1. **Problem of double counting.** Thts is the act of estimating the value of the commodity more than once. This arises from the failure to distinguish between intermediate and finished goods for instance baking flour and sugar are both intermediate goods and finished goods and are likely to be counted twice.
2. **In adequate statistical data/information.** There is limited data on private incomes in self employment, private consumption and data that relate to various necessary variables.
3. **Problem of valuing subsistence output/non marketed output.** Output if such production is very difficult to measure in monetary terms and yet it has value which should be include in national income.

4. **Errors of omission and commission.** In the process of collection and processing and analyzing data, staticians are likely to make some errors. For instance, shillings 9,000 may be written as Sh 900 and this becomes the error of omission and shillings 900 may be written as shilling 9,000 and this becomes the error of commission. Such errors of very common due to lack of skills and this give wrong national income figures.
5. **Difficulty in calculating net income earned from abroad.** Nationals of a countrywho are abroad are difficult to determine how much they earn during data collection and it not easy to measure what foreigners earn in the country.
6. **Difficulty in valuing government output/services.**It is very difficult to determine the monetary value of public schools, roads, public hospitals, security services and yet they have value which must be included in national income.
7. **Problem of calculating depreciation cost.** The cost of depreciation during production process is not easy to estimate and yet it must be revealed to calculate net national product.
8. **Problem of changes in price level/inflation.** National income is measured in monetary terms, but money changes value whenever prices change and this gives exaggerated figure of national income.
9. **Problem of illegal activities.** Income from illegal activities such as prostitution, theft, smuggling, and black marketing is very difficult to know since it is not supposed to be included in national income.
10. **Difficulty in determining the boundary of production.** There is a problem of determining what to include or exclude when measuring national income which gives unrealistic results.
11. **Difficulty in valuing work in progress and inventories.** The stock goods not yet sold to customers during the course of the year and work in progress is difficult to value in monetary terms when compiling national income.
12. **Shortage of trained personnel/labour and inadequateequipment.** The process of computing national income requires experienced staticians, economists, accountants and researchers who are inadequate in most LDCs. There is lack of enough facilities such as vehicles and computers/ calculators to analyze and store information for future use.
13. **Problem of valuing unpaid for services.** This includes services of housewives which must be valued and included in national income but these are just estimated and this given unrealistic national income figures.

PATTERNS OF INCOME DISTRIBUTION.

Income distribution. This refers to the spreading out of consumer goods and services (resources) among various social groups of the population.

Income inequality. This refers to the economic gap/distance between the very rich and the very poor sections of the population.

Income inequality exists in form of individual inequality, regional inequality, sectoral inequality and intersectional inequality.

The pattern of income distribution in East Africa is unfair where income is concentrated in the hands of few individuals and therefore some people are worse off than others. This implied that there is a big gap between the rich and the poor.

UNEB 1998.

a) *Account for income inequalities in your country. (10 marks)*
b) *What policy measures have been adopted to reduce income inequalities in your country. (10 marks)*

CAUSES OF INCOME INEQUALITY/ DISPARITIES IN UGANDA.

NB. Two sided points beginning with the phrase differences should be presented and explained showing high income and low income.

1. **Differences in regional distribution of natural resources.** Some regions are endowed with abundant and high quality natural resources such as fertile lands, minerals, water resources are exploited which provide high income to people while areas with limited natural resources provide low income to the population.
2. **Differences in distribution of infrastructure.** Areas with well-developed infrastructure such as roads, schools, power supply and banking facilities facilitate more production hence high income to people while in areas with limited infrastructure, production and economic activities are limited hence low income to people.
3. **Differences in physical ability/strengthamong individuals.** Strong and energetic people are able to perform a variety of activities and get high income compared to weak individuals who are unable to perform several activities who get low income.
4. **Differences in employer's ability to pay.** Some employers have huge businesses and pay high wages to workers hence high income but some employers have small businesses and are unable to pay high wages to workers hence low income.
5. **Differences in individual's natural talents.** Talented individuals such as popular musicians footballers and athletes exploit their talents and get high income while less talented individuals get low income.
6. **Differences in political atmosphere between regions.** Politically stable regions attract infrastructural development and different forms of business which provide high income to people compared to politically

unstable regions which discourage investments because of uncertainty for life and business hence low income to people.

7. **Differences in level of education and skills**. Usually highly educated and skilled people are employed in highly paying jobs and earn more income while less educated and unskilled people have low income.
8. **Differences in family/social background.** People are born in different families in relation to wealth possession. Some people get high income because of inheriting property form rich parents while those from poor family background remain with loess income.
9. **Discrimination in the labour market.** Discrimination in favour of some workers basing on age, religion, sex, family background, political parties, colour leads to high income inequality since it leaves out majority of people unemployed. Therefore those who are favoured get high income while those who are not favoured get low income.
10. **Differences in nature of occupations/jobs.** Some occupations are highly paying and give high income to people such as risky jobs while other occupations are less paying hence low income to people such as less risky jobs.
11. **Differences in access to credit and vital contracts.** Individuals that are able to access credit and vital contracts are able to expand their investments and get morericher hence high income but individuals that are unable to access credit remain with low income.
12. **Differences in strength of trade unions.** Strong trade unions such as Uganda Law Society are able to bargain for high income and other better conditions of work for their members hence high income while weak trade unions are unable to bargain for high income for their members.
13. **Differences in working experience/seniority.** Highly experienced labour generally gets high income while less experienced and junior workers get low income.
14. **Differences in individual's ability to bargain for income.** Individuals with high ability to bargain for high income get high income while individuals with limited ability to bargain for high income get low income.
15. **Differences in elasticity of supply of labour.** Labour whose supply is inelastic gets high income while labour whose supply is elastic gets low income.
16. **Differences in number of hours worked.** Those who work for many hours get high income while those who work for less hours get low income basing on time rate method of wage payment.
17. **Political influence in allocation of resources in favour of certain regions/sectors.** Those are politically favoured get high income while those that are not politically favoured get low income.

ADVANTAGES OF INCOME INEQUALITY IN AN ECONOMY.

- **Creates harmony and respect between employees and employers.** This creates good employer-employee relationship. The poor workers respect their rich bosses.
- **Encourages labour mobility.** As the poor strive to get better paying jobs, they move from one place or job to another.
- **Encourages innovativeness and creativity among the poor.** This leads to development of a large entrepreneur class as poor people try to copy the rich.
- **Forces the government to undertake income redistributive measures** such as progressive taxation, poverty alleviation, empowerment of the poor.
- **Presenceof cheap labour form those occupations which are undertaken by the poor.** This increases labour supply to even unattractive jobs.
- **Results into an increase in investment among the rich.** This because rich people tend to have high marginal propensity to save and are able to invest more and take the advantage of the poor who are the majority.
- **Encourages hard work and effort among the poor.** This results into more out in the long run.
- **It is a source of government revenue through progressive taxation.** This helps to provides social services.

DISADVANTAGES OF INCOME INEQUALITY IN AN ECONOMY.

1. **Reduces government tax revenue.** This is especially where the majority are poor and unemployed which means that they have no capacity to pay taxes since they have no incomes to tax.
2. **Leads to misallocation of resources.** The rich tend to influence effective demand thus luxurious commodities demanded by the rich are produced leaving poor people with limited commodities.
3. **Reduces aggregate demand.** This is especially where the majority are poor and this discourages production since they have low purchasing power.
4. **Leads to brain drain.** This is brought about by unfair treatment of workers which limits development of manpower.
5. **Increases rural urban migration and its evils.** Poor people tend to move to urban areas expecting to get better paying jobs.
6. **Increases government expenditure** in providing social services and subsidizing the poor thus budgetary deficits.
7. **Leads to exploitation and domination of the poor by the rich.** Major political and economic decisions are made by rich people on behalf of poor people.

8. **Creates social tension and conflicts between the rich and the poor.** This leads to disharmony between individuals and this may result into political instability.
9. **Increases capital outflow.** This is especially when the majority of rich people are non-citizens of the country. Besides most rich people in developing countries prefer to invest their capital in foreign economies that are economically stable.
10. **Leads to overdependence of the poor ion the rich.** This increases dependence burden thus limiting savings.
11. **Leads to low standard of living among the poor.** The poor continue to live below the minimum economic welfare.
12. **Leads to regional imbalances in development.** Some regions develop at the expense of others depending on differences in income.

MEASURES THAT SHOULD BE ADOPTED TO REDUCE/CONTROL INCOME INEQUALITY IN LDCs.

1. **Improve and maintain political stability throughout the country.** The government should continuously campaign for political stability through holding peace talks with rebels and ensure good governance to increase investment in all parts of the country which increases employment and income.

2. **Provision of affordable loans or credit to the poor/establish rural credit schemes for the poor.**

Poor people should be helped to have access to affordable loans through establishment of rural financial institutions such as village banks, micro finance institutions and SACCOS. These will help the rural poor to establish small-scale businesses and generate incomes.

3. **Adopt population control measures.** This should be emphasized through family planning measures, especially in rural areas where birth rates are high so as to reduce dependency burden and increase savings. This reduces dependence burden which increases savings and investment among people and increase their income.

4. **Adopt land tenure reforms.** The way in which land is owned should be changed so a s to enable majority of poor people acquire land from few landlords and participate in production to increase their income.

5. **Emphasis on developing sound infrastructure.** The government should rehabilitate existing infrastructure and establish new ones in form of roads, railway, power supply facilities, banking institutions in order to increase investment and resource utilization to avail income to the majority.

6. **Use of progressive taxation.** High taxes should be imposed on rich individuals and high income earners. This income should be used to subsidize the poor and uplift their income.

7. **Encourage education reforms.** There should be introduction of practical subjects to increase labour skills, employment opportunities and income.

8. **Promote diversification of the economy.** Agricultural diversification should be emphasized by introducing several crops and animal varieties and establishment of both small and large scale industries to reduce over reliance on agriculture whose prices are ever fluctuating leading to more employment and increase income.

9. **Use of decentralized governance.** This should be ensured and maintained to encourage participation of all nationals in affairsof development from the grass root level and increase projects, employment and incomes at local levels.

10. **Promote modernization of agriculture.** Agriculture is carried out by the majority of the population, therefore policies should be put in place to increase and stabilize prices of agricultural products to avail the rural people with enough income through strong commodity agreements, emphasizing the role of cooperatives to increase employment and income among farmers.

11. **Increase government expenditure to develop disadvantaged group and regions.** The government should increase expenditure to poor regions to enable such regions get access to income generating projects and increase income.

12. **Improvement in investment climate.** This should be done through fair taxes on producers, establishing mi9nstitutions to encourage investment so as to increase employment opportunities and income.

13. **Liberalization of the economy.** This attracts many economic activities which increases participation in production thus high employment opportunities and income.

14. **Raise wages of low income groups.** The government should raise wages of low income groups so as to reduce wage differentials between occupations and close the income gap.

15. **Encourage development of small scale enterprises.** The development of small scale industries and other enterprises should be adopted especially in rural areas so as to increase income generating activities.

UNEB 2007.

a) Account for uneven distribution of income in your country. (10 marks)

b) What measures have been adopted to minimize uneven distribution of income in your country? (10 marks)

MEASURES THAT HAVE BEEN ADOPTED TO MINIMIZE UNEVEN DISTRIBUTION OF INCOME IN UGANDA.

1. **Used progressive taxation.** The rich have been taxed highly than the poor which has reduced income gap.
2. **Adopted land tenure reforms.** This has been done to allow many people especially the poor to access land and participate in production to increase ontheir income.
3. **Educational reforms.** This has been done through emphasizing science and practical subjects so as to increase labour skills necessary for increased employment and income generation.
4. **Improved political climate.** This has been done through encouraging political stability in all parts of the country so as to increase investment, employment and income.
5. **Provision of investment credit/affordable loans to poor people.** Credit facilities have been provided to the poor at low interest rates so as to set up income generating projects.
6. **Diversification of the economy.** This has been emphasized so as to reduce dependence on agriculture and this has created many economic activities leading to increased employment and income.
7. **Controlled population growth rates.** This has been done by employing family planning methods so as to reduce dependence burden, increase saving and investment to create more income.
8. **Agricultural modernization.** This has been done through increased mechanization, supply of subsidized inputs to farmers so as to increase production in rural areas and increase income.
9. **Decentralization of governance.** This has been done to encourage planning at local levels so as to absorb rural opportunities, increase investment and income.
10. **Liberalization of the economy.** Unnecessary government controls on economic activities have been removed which has increased establishment of projects to provide more income to the population.
11. **Improvement in infrastructure.**This has been done through constructing more roads, power supply systems so as to facilitate more income generating activities and spread employment opportunities.
12. **Improved investment climate.** This has been done through providing tax holidays, tax exemptions and subsidies to various investors so as to increase investment opportunities and income.
13. **Increased government expenditure to develop disadvantaged regions and groups.** This has been done through provision of free education to the poor for instance universal primary and secondary education, establishment of projects for disabled people.
14. **Encouraged development of small scale enterprises.** The development of small scale industries and other enterprises has been

emphasized especially in rural areas so as to increase income generating activities.

STANDARD OF LIVING AND PERCAPITA INCOME.

Standard Of Living.

Standard of living refers to conditions of life in which people live or hope to live.

Or

It refers to socio-economic wellbeing/welfare of an individual or society as represented by the basket of goods and services consumed.

Or

It refers to the measure of the level of social and economic welfare of an individual or society as represented by the basket of goods consumed.

It is all about the conditions of living among the people as measured in terms of welfare and normally indicated by the quality and quantity of goods and services consumed.

Percapita Income.

Percapita income is the average income per individual of a country ina given year. **Or**

It refers to income perhead in a country usually a year.

$$\textbf{Percapita income} = \frac{\textbf{GNP of the year}}{\textbf{Total population of the same year.}}$$

It is used as a good indicator of standard of living in a country at specific period, over time and comparing standard of living between countries.

Given that the GNP of country X is \$1200 million and total population is 20 million people for a given year. Calculate percapita income for such a country.

$$\text{Percapita income} = \frac{\textbf{GNP of the year.}}{\textbf{Total population.}}$$

\$1200m/20m people

<u>Percapita income= \$60.</u>

UNEB 2006.

a) *Distinguish between cost of living and standard of living. (04 marks)*
b) *Explain the factors that influence people''s standard of living in an economy. (16 marks)*

DETERMINANTS OF STANDARD OF LIVING IN AN ECONOMY (FACTORS THAT INFLUENCE/AFFECT PEOPLE'S STANDARD OF LIVING IN AN ECONOMY.

NB. Neutral points are presented and explained in two sides showing high standard of living and low standard of living.

1. **General price level/rate of inflation.** Low general price level reduces cost of living which leads to high standard of living.
2. **Nature of income distribution.** Uneven distribution of income where income is in the hands of few individuals implies low standard of living while fair income distribution among individuals leads to high standard of living.
3. **Level of education and skills.** High level of education and skills increases the standard of living while low level of education and skills leads to low standard of living.
4. **Degree of political freedom.** High degree of political freedom leadsn to high standard of living while limited political freedom leads to low standard of living.
5. **Degree of social costs/level of environmental pollution.** High degree of social costs inform of air, land and water pollution leads to low standard of living while limited social costs leads to high standard of living .
6. **Nature of goods produced.** Production of more capital goods does not improve welfare directly while production of more consumer goods improves standard of living directly.
7. **Level of income.** High level of income among the population implies low standard of living.
8. **Quality and quantity of goods and services produced.** High volume of goods and services produced and of high quality lead to high standard of living .
9. **Level of employment in the country.** High level of employment of labourforce implies high standard of living while low level of employment leads to low standard of living.
10. **Level of development of social and economic infrastructure.** High level of infrastructure development inform of health facilities, transport facilities, power supply increases production hence high standard of living while low level of infrastructure development implies low standard of living.
11. **Availability of time for leisure.** presence of enough time for leisure implies that people do not overwork hence high standard of living while

limited time for leisure implies that people overwork to increase production hence low standard of living.

12. **Political climate.** Favourable political climate increases production and security for life and property hence high standard of living while political instability discourages production, creates uncertainty for life and property which leads to low standard of living.

PERCAPITA INCOME AS A MEASURE OF STANDARD OF LIVING.

Percapita income is used as a good indicator of standard of living in a country at specific period, overtime and comparing standard of living between countries. However percapita income is not a reliable indicator of standard of living in an economy at a given period., over time and between countries.

UNEB 2002.

a) *Distinguish between standard of living and cost of living. (04 marks)*
b) *Why may percapita income not be a good indicator of standard of living? (16 marks)*

1. **Reasons why percapita income may not be a good measure of standard of living in an economy/a country.**

Holding other factors constant, high percapita income in a country should be an indicator of high standard of living while low percapita income should be an indicator of low standard of living.

However, high percapita income does not necessarily imply high standard of living and low percapita income does not necessarily imply low standard of living in a country because percapita income ignores a variety of aspects that influence standard of living.

Percapita income may not be a good measure of standard of living in an country at a given time because of the following.

1) **It ignores the nature of income distribution.** Percapita income may be high where income is unevenly distributed, concentrated in the pockets of the rich sections/in the hands of few rich people while majority are actually suffering hence high degree of income inequality and this does not imply high standard of living.
2) **It does not consider the nature/type ofgoods produced.** Percapita income may be high in a country which produces capital goods such as machinery which do not improve welfare directly and percapita income may be low where there is production of consumer goods which improve welfare.
3) **Percapita income does not take into account the amount of leisure enjoyed and foregone.** Percapita income may be high where people over work and forgo leisure to increase output which reduces welfare and low

percapita income where people have enough time for leisure does not mean low standard of living.

4) **It ignores the size of subsistence output.** Percapita income may be low where there is a large subsistence sector and this will not imply low standard of living because many of goods produced are not counted in GNP and they contribute to standard of living.
5) **It does not consider the level of social costs.** Percapita income may be high where there are high social costs such as pollution which reduce standard of living and low percapita income where there are low social costs does not imply low standard of living.
6) **It does not consider level of accuracy of statistical data.** Percapita income may be high or low because of inaccurate population figures made during population census and this is likely to reflect a lo9w or a high standard of living which may not be realistic.
7) **It does not consider the patterns of government expenditure/how income is spent.** Percapita income may be high when government is spending highly most of its income on non-productive activitiessuch as military hardware which do not contribute to welfare directly and this does not mean high standard of living.
8) **It ignores political climate of the country.** Percapita income may be high in a country where there are political instabilities and this will not mean high standard of living and low percapita income where there is political stability does not mean low standard of living.
9) **It ignores tastes and preferences of the population.** Percapita income may be high in a country where produced goods and services are not in line with tastes and preferences of people and this will not mean high standard of living.
10) **It ignores the level o9f employment in a country.** Percapita income may be high ina country where there is high rate of unemployment due to the use of capital intensive technology in production which affects the welfare of people and low percapita income where majority are employed doesnot mean low standard of living.
11) **It ignores price level/rate of inflation.** Percapita income may be high because of high national income figures as result of inflation and this will not mean high standard of living and low percapita income where there is no inflation does not imply low standard of living.
12) **Percapita income does not consider the nature and level of taxation on incomes.** High percapita income where people are subjected to unfair direct taxes reduce the standard of living.
13) **It ignores working conditions/occupational hazards.** Percapita income may be high and yet workers are subjected to high occupational hazards and this does not imply high standard of living.
14) **It does not consider the quality of goods produced.** Percapita income may be high when the quality of goods produced is poor and this

will not imply high standard of living and low percapita income but with high quality goods produced does not imply low standard of living.

UNEB 2011.

a) *Differentiate between disposable income and percapita income. (04 marks)*
b) *What are the limitations of using percapita income to compare standards of living between countries. (16 marks)*

2. Why may percapita income not be a good measure of standard of living between countries?

If country K has high percapita income than country M, does it mean that people in country K are enjoying a higher standard of living than those in country M?. percapita income ignores the fact that various factors that influence standard of living differ from country to country.

Percapita income may not be a good measure of comparing standard of living between countries because of the following g.

1. **Percapita income ignores differences in nature of income distribution between countries.**
   Percapita income may be high in a country where income is in the hands of few individuals which may not mean high standard of living and low percapita income in another country where income is evenly distributed does not mean low standard of living.
2. **It ignores differences in the nature/type of goods produced between countries.** A country with high percapita income may be producing capital goods which do not contribute directly to standard of living and another country with low percapita income may be producing consumer goods which enrich the standard of living.
3. **It ignores differences in price levels/structures (rate of inflation) between countries.** This is due to differences in currencies which have different purchasing power. One country may have high percapita income because of inflation and high price structure but this does not mean high standard of living than another country with a low price structure and free from inflation.
4. **It does not consider differences in level of subsistence sector/production between countries.** Percapita income may be low in one country than the other because of high subsistence production but this contributes to standard of living.
5. **It ignores differences in levels of accuracy of statistical data between countries.** Percapita incomemay be high or low in one country because of inaccurate population figures during population census and this doesnot mean that it enjoys low or high standard of living than another country.

6. **It does not consider differences in the amount of leisure enjoyed and foregone by people between countries.** High percapita income in a country where people forego leisure to increase output does not mean that such a country enjoys high standard of living than a country with low percapita income but where people have enough time for leisure.
7. **It ignores differences in level of employment between countries.** High percapita income in one country where machines have replaced labour to increase output is an indicator of low standard of living than a country where majority are employed but with low percapita income.
8. **It ignores differences in political climate between countries.** Percapita income may be high in one country where there are political instabilities and therefore uncertainty about life and property and this does not mean high standard of living but low percapita income in a politically stable country does not mean low standard of living.
9. **It does not consider differences in level and nature of taxation on incomes between countries.** High percapita income in one country where people are subjected to heavy and unfair taxes will not mean high standard of living compared to a country with fair direct taxes but with low percapita income.
10. **It does not consider differences in tastes and preferences of people between countries.** High percapita i9ncome in a country where produced goods and services are not in line with tastes and preferences of people doesn"t mean high standard of living and low percapita income in another country where produced goods and services are in line with tastes and preferences of people may not mean low standard of living.
11. **It does not take into account differences in requirements between countries due to climatic differences.** In European countries since it is not necessary to have such facilities.
12. **It does not consider differences in social costs between countries.** Percapita income may high in a country where there are high social costs which does not mean high standard of living than a country with low percapita income and low social costs.
13. **It does not consider differences in quality of goods produced between countries.** Percapita income may be high in one country where the produced goods and services are of a poor quality which does not mean high standard of living than a country with low percapita income but where the produced goods and services are of a high quality.
14. **It ignores differences in boundary of production and methods of compiling national income between countries.** These give different results which make percapita income differ which is not a true reflection on standard of living.
15. **It ignores differences in patterns and nature of government expenditure between countries.** Percapita income may high in one country when government is spending highly on non- productive

activities such as military hardware which do not contribute to welfare directly and this does not mean high standard.

16. **It ignores differences in transport costs/costs of production between countries.**

UNEB 2005.

a) *Distinguish between real income percapita and nominal income percapita (04 marks)*
b) *What are the limitations of using percapita income to compare welfare of people in a country overtime. (16 marks)*

3. Why may percapita income not be a good measure of standard of living/welfare in a country overtime?

Low percapita income in one period and high percapita income in another period may not form a strong foundation to conclude on standard of living between those two periods because such a situation ignores the fact that there are changes that take place overtime in major variables that influences standards of living not necessarily only percapita income.

Percapita income may not be a good measure of standard of living in a country overtime because of the following.

- ❖ Percapita income ignores changes in distribution of income overtime.
- ❖ It ignores changes in composition/type of goods produced overtime.
- ❖ It does not take into account changes in working conditions over time.
- ❖ It doesnot consider changes in price levels/rate of inflation overtime.
- ❖ It ignores changes in level of subsistence production overtime.
- ❖ It ignores changes in accuracy of statistical data over time such as population figures.
- ❖ It does not consider changes in the amount of leisure enjoyed by people overtime.
- ❖ It doesnot take into account changes in the nature andpatterns of government expenditure over time.
- ❖ It does not consider changes in quality of goods produced overtime.
- ❖ It does not consider changes in level of employment overtime.
- ❖ It ignores changes in political climate overtime.
- ❖ It ignores changes in the level and nature of taxation on income overtime.
- ❖ It ignores changes in tastes and preferences of people overtime.
- ❖ It does not consider changes in social costs overtime.

PRICE INDEX.

Price index is a measure of relative changes in prices from one period to another/overtime.

It measures relatives changes in prices overtime/between two periods. It helps to determine whether there has been an increase or a decrease in

general price level and hence determines an increase or a decrease in standard of living and cost of living between two periods.
Consumer price index. This is a measure of relative changes in prices of selected consumer goods overtime.
Costs of living index. This is a measure of relative changes in prices of basic needs of a group of people overtime.
Or
It is a measure of relative changes in prices of basic needs of people from one period to another/overtime.
All prices in the base year are given an index of 100 as a point of economic stability.
Producer price index. This is a measure of relative changes in prices of goods sold by manufacturers in a given period of time.
Retail price index. This is a measure of relative changes in consumer prices overtime.
Price index of GDP. This is a measure of relative changes in prices of both consumer and capital goods overtime.

COST OF LIVING.
Cost of living refers to the amount of money required by an individual to sustain the life style he is accustomed to.
Or
Cost of living refers to amount of money required by an individual to maintain a given level of welfare/standard of living in terms of goods and services.
UNEB 2008.
Describe how price indices are computed in an economy (06 marks)
PROCEDURE FOR COMPUTING PRICE INDICES.
1. **Selecting a suitable base year.** The base year is any previous year when the prices of commodities were relatively stable/reflecting normal economic conditions. It should be a year of no production shortages, price stability and no trade malpractices. The index of the base year is always given as a standard index of 100 as an indicator of price stability.
2. **Selecting a basket of commodities/goods.** A number of commodities are selected and these must be a representative of the whole society which arte popularly bought. This can be done by interviewing households, personal visits to retail shops for instance beans, meat,. Sugar, soap and rice.
3. **Collecting prices of commodities.** Prices of the selected commodities both in the base year and the current year are obtained.
4. **Calculating simple price index/price relatives for each commodity.** This relates the price okf the current year to the price of the base year. This is also called current year index.

Simple price index/price relatives = current year price
Base year price x 100

5. **Calculating average simple, price index for the year. This is for all commodities in the basket.**

   ASPI=Summation of price relatives/simple price index.

   Number of commodities.

   - When ASPI is above 100, it implies an increase in the general price level.
   - When ASPI is equal to 100, it implies that the general price level remained constant.
   - When ASPI is below 100, it implies a reduction in the general price level.

6. **Attaching weights to the selected commodities.** Weight of a commodity is the relative importance which a customer attaches to that particular commodity. Commodities are weighed according to their importance to the consumer. products which are very important to the consumer are assigned h9igher weights and those that are rarely bought have lower weights.

7. **Calculating weighted price index for each commodity.** This shows the relative importance the consumer attaches to each commodity considered.

   Weighed index= price relative/simple price index for a given commodity x weight for that commodity.

8. **Calculating average weighted price index for the year.**

   Average weighted index= **Total weighted index.**

   Total sum of weights.

Worked examples.

Study the table below showing the country's price indices for selected commodities and answer the questions that follow.

Commodity (kg)	2000 average prices	2000 simple price index	2002 average prices	Weight
Beans	800	100	1000	3
Sugar	450	100	600	5
Maize	220	100	400	6
Rice	700	100	1200	2
Meat	550	100	950	4

Calculate;

1. Simple price index for 2002.
2. Average simple price index for 2002.
3. Weighted price index for 2002.
4. Average weighted price index for 2002.

a) Simple price index = current year price

Base year price x 100.

Beans = 1000/800x 100 = 125

Sugar = 600/450 x 100 =133.3
Maize = 400/220x100 =181.8
Rice = 1200/700 x 100 = 171.4
Meat = 950/550 x 100 = 172.7

Average simple price index= $\frac{\textbf{summation of price relatives}}{\textbf{Number of commodities}}$

= $\frac{125+133.3+181.8+171.4+172.7}{5}$

Average simple price index= 784.2/5=<u>156.8</u>

c) Weighted index for 2002 = price relative x weight.
Beans = 125 x 3 = 375.
Sugar = 133.3 x 5 = 666.5
Maize = 181.8 x 6 = 1090.8
Rice = 171.4 x 2 = 342.8
Meat = 172.7 x 4 = 690.8

d) Average weighted index = $\frac{\text{Total weighted index}}{\text{Total/sum of weights.}}$

$\frac{375+666.5 + 1090.8 + 342.8+ 690.8}{3+5+6+2+4}$

Average weighted index. 3165.9/20 = <u>158.2</u>

i) It implies that the general price level increased by 58.2%
ii) Cost of living also increased by 58.2%
iii) Standard of living reduced by 58.2%
iv) The value of money reduced by 58.2%.

UNEB 2000

1. *Study the table and answer the questions that follow.*

Commodity	*Base year price (1990)*	*Base year index (1990)*	*Selected year price (1998)*	*Weight*
Beans	*200*	*100*	*700*	*5*
Sugar	*150*	*100*	*500*	*4*
Maize	*500*	*100*	*1000*	*3*
Rice	*100*	*100*	*300*	*2*
Meat	*700*	*100*	*1200*	*1*

a)

Calculate,

1. *Simple price index for each commodity in 1998*

Simple price index= $\frac{\text{current year price}}{\text{Base year price}} \times 100$

Commodity : A = 700/200 X 100 =350

B= 500/150 X 100 = 333.3

C= 1000/500 X 100 = 200

D= 300/100 X 100 = 300

E = 1200/700 X 100 = 171.4

2. Weighted index for each commodity in 1998.
3. Weighted index = simple price index x weight

Commodity : A = 350 x 5 = 1750

B = 333.3 X 4 = 1333.2

C = 200 X 3 = 600

D = 300 X 2 = 600

E = 171.4 X 1 = 171.4

iii) Average weighted price index.

Average weighted index = total weighted index.

Total sum of weights.

1750 + 1333.2 + 600 + 600 + 171.4

5+4+3+2+1.

Average weighted index = 4454.6/15.

Average weighted index = 296.97

b) Explain the problems encountered when compiling price indices 14marks.

UNEB 2005.

a) Study the table below showing commodity prices for selected items in 2000 and 2004 and answer the questions that follow.

Commodity	*Average prices index 2000 (Ug. Shillings).*	*Simple index2000.*	*Average prices index . 2004 (Ug. Shillings)*	*Weight index 2004.*
A	*1000*	*100*	*1200*	*2*
B	*800*	*100*	*1000*	*4*
C	*400*	*100*	*650*	*3*
D	*750*	*100*	*900*	*5*
E	*1500*	*100*	*1800*	*1*

Calculate

(i) Simple index for 2004. (06marks)

(ii) Weighted index for 2004. (06marks)

b) Explain the problems which are encountered in the computation of price indices in your country. (08 marks)

I) simple index for 2004= $\frac{\text{Average price index 2004.}}{\text{Average price index 20000}} \times 10$

Commodity A= 1200/1000 x 100 = 120

B = 1000/800 X 100 = 125

C = 650/400 X 100 = 162.5

D = 900/750 X 100 =120

E = 1800/1500 X 100 = 120

(iii)Weighted index for 2004 = simple index for 2004 x weight for the commodity.

Commodity: A = 120 X2 =240
B = 125 X 4 = 500
C = 162.5 X 3 = 487.5
D = 120 X 5 = 600
E = 120 X 1 = 120

UNEB 2006, 2000.

(i) Define the term retail price index. *(01 marks)*
(ii) Give any three uses of price indices. *(03 marks)*

USES OF PRICE INDICES.

- They measure changes in the value of money/rate of inflation overtime. This reveals the rate of inflation between the two time periods in the economy.
- Help in determining wages. Wages should go hand in hand with changes in general price level to avoid a decline in standard of living of workers. Wages should change according to changes in cost of living basing on sliding scale methods of wage payment.
- Help to determine tax levels/rates in different regions which should match with inflation. Direct and indirect taxes are adjusted basing on price indices for specific commodities to avoid causing an increase in cost of living.
- They are used to compare cost of living/standard of living in a country over time. Percentage changes in price help to tell changes in cost of living which has a direct impact on standard of living.
- They are used to deflate/adjust nominal national income to give real national income. This is to convert nominal GDP to real GDP.

$$\text{Real GDP} = \frac{\text{Nominal GDP}}{\text{GDP deflator/price index}} \times 100.$$

GDP deflator is calculated the same way as price index and it covers all the sectors of the economy which are included in national income.

Worked examples.

a) Given that a country has nominal GNP of 170 million dollars and price index of 112. Calculate real GNP for such a country.

Real GNP = $\frac{\text{Nominal GNP}}{\text{Price index}} \times 100.$

170,000,000/112 x 100

Real GNP = 151,785,714.3 dollars.

B 2014

Commodity	*Base year Prices 2010*	*Base year simple index*	*Current year prices 2013*	*Weight*
Sugar (kg)	*1500*	*100*	*2100*	*4*
Beans (kg)	*300*	*100*	*450*	*3*
Rice (kg)	*1200*	*100*	*15oo*	*2*
Bread (½ kg)	*12oo*	*100*	*1800*	*1*

a) Calculate the:

i Simple price index, *(02 marks)*

ii Average price index, *(02 marks)*

iii Weighted price index *(02 marks)*

For the year 2013.

b) Explain the uses of price indices in an economy. *(14 marks)*

UNEB 2011.

a) Why is it necessary to compute consumer price indices in your country? (08 marks)

b) Discuss the difficulties encountered when compiling consumer price indices in your country. *(12 marks)*

OBJECTIVES OF COMPILING CONSUMER PRICE INDEX IN A COUNTRY/WHY IS IT NECESSARY TO COMPUTE PRICE INDEX IN AN ECONOMY

- To measure changes in the value of money/rate of inflation overtime.
- To compare the cost of living/standard of living overtime.
- To determine wages.
- To measure terms of trade of a country.
- To determine tax levels.
- To determine real national income using nominal national income.

UNEB 2001

Why is computation of price indices difficult? *(12 marks)*

UNEB 1998

a) *Explain how price indices are computed. Illustrate your answer. (08 marks)*
b) *Why may price indices be unreliable indicators of cost of living. (12 marks)*

PROBLEMS/DIFFICULTIES ENCOUNTERED WHEN COMPILING PRICE INDICES/COST OF LIVING INDEX.

(Limitations of using price indices in measuring the cost of living and standard of living/why may price indices be unreliable indicators of cost of living).

- **Difficulty in choosing a suitable base year.** A year when prices are relatively stable is difficult to get due to constant price changes.
- **Difficulty in attaching weights to commodities in the basket.** Different consumers value commodities differently and this makes it hard to get common weights for all consumers which gives unreastic results on cost of living.
- **Changes in tastes and preferences of consumers overtime.** This takes place overtime and therefore a need to compile new price index numbers to accommodate the changes.
- **Limited skilled personnel/labour.** The process of computing price indices requires skilled staticians and economists who may be in short supply leading to inaccurate statistical data which may be misleading.
- **Quality improvement in products that usually affects prices of goods.** Changes in technology leads to quality improvement in the products produced which affects price level and this may be misinterpreted to be inflation when in actual sense it is due to improvement in quality of the products and ends up giving unrealistic results about standard of living.
- **Price changes within a year/existence of inflationary and deflationary tendencies.** Price changes within a year because of different factors, so there are no fixed prices for the whole year. These tend to alter expenditure patterns of consumers.
- **Inadequate data or information.** Most people do not keep records and some do not give the right information about actual prices for their commodities thus no standard records about prices and quantities in the market.
- **Appearance and disappearance of commodities from the market/ emergence of new goods and exit of old ones.** Some new products emerge into the market and old products disappear from the market when the exercise has been accomplished. This gives inconsistent results about the general price level.

- **Lack of standard measures and weighing systems for commodities.** Different commodities are sold in different units such as heaps, sacks, tins, baskets and kilograms making it difficult to determine prices.
- **Few areas are usually sampled.** Only a few areas are normally considered and the information obtained cannot be realistic to conclude for the whole country on cost of living.
- **Varying prices of goods in different regions/no uniform prices throughout the country.** Prices change from one region to another due to reasons of differences in demand, transport and bargaining power yet a uniform price is considered which makes price indices unreliable.
- **Problem of choosing representative commodities/basket of goods.** Very many products are produced and consumed and it becomes difficult to determine which commodities to consider and what commodities to leave out.

NATIONAL INCOME EQUILIBRIUM AND DETERMINATION.

This is where there is no tendency of national income values to either increase or reduce.

Equilibrium is a state of balance where two aspects in question have no tendency to change.

(i) In a closed economy and without government intervention.

For national income to be in equilibrium in a closed economy and without government intervention, leakages of which savings are part should be equal to injections of which investments are part.

Therefore, equilibrium under national income is attained at a point where savings are equal to investments. Therefore, S=I

Savings constitute a loss out of the circular flow of income and what compensates this leakage is investment expenditure which is an injection. Therefore savings constitute leakages and investment constitutes injections.

(ii) In a closed economy and with government intervention.

This implies that there taxation and government expenditure on goods and services. Therefore, taxes are leakages and government expenditure constitutes injections.

Therefore, S+T=I+G.

(iii) In an open economy and with government intervention.

National income equilibrium is determined by leakages and injections. At equilibrium, injections and leakages should be equal that is, I+G+X=S+T+M, where X stands for exports and M stands for imports. So exports constitute injections and imports constitute leakages.

INJECTIONS

Injections are elements that add to the circular flow of income.

Or

These are additions/inflows into the circular of income. In an open economy, injections include:-

- Investments (I),
- Government expenditure (G),
- And exports (X).

Injections increase aggregate demand curve and the size of the multiplier.

LEAKAGES

Leakages are elements that reduce the circular flow of income.

Or

These are withdrawals/outflows for the circular flow of income.

In an open economy, leakages include:-

- Savings (S),
- Taxation (T),
- And imports (M).

Leakages reduce aggregate demand curve and the size of multiplier.

UNEB 2007

i) Distinguish between injections and leakages. (02 marks)
ii) State any two examples of leakages in your country. (02 marks)

UNEB 2004.

With examples, distinguish between injections into and leakages form a circular flow of income. (04 marks)

NB. National income is in equilibrium when aggregate demand is equal to aggregate supply.

AGGREGATE DEMAND

Aggregate demand refers to total demand for goods and services by all sectors of an economy in a given period of time.

Or

It refers to the total amount of expenditure of goods and services by all sectors of an economy in a given period of time.

Aggregate demand is classified according to different sectors of the economy that spend.

Aggregate demand= C+I+G+(X-M), where C stands for household sector, I stands for business sector, G stands for government sector and (X-M) stands for foreign sector.

Each sector has a different demand curve, therefore summation of all these demand curves gives us aggregate demand curve.

DETERMINANTS OF AGGREGATE DEMNAD IN AN ECONOMY.

NB. These are presented as neutral points and each point is explained in two sides showing high aggregate demand curve and low aggregate demand.

1. **Level of income in an economy.** High level of income leads to high aggregate demand while low level of income leads to low aggregate demand.
2. **General price level.** High general price level for goods and services leads to low aggregate demand while low general price level leads to high aggregate demand.
3. **Population size and its growth rate.** Holding other factors constant, a large population size which grows at a high rate leads to high aggregate demand while a small population size which grows at a low rate leads to low aggregate demand.

4. **Nature of income distribution.** Even and fair distribution of income leads to high aggregate demand whereas uneven distribution of income in the hands of few individuals leads to low aggregate demand.
5. **Level of employment.** High level of employment leads to high aggregate demand while low level of employment leads to low aggregate demand.
6. **Political climate.** Favourable political climate leads to high aggregate demand whereas unfavourable political climate leads to low aggragate demand.
7. **Stock of available consumer goods and services.** A large stock of goods and services leads to high aggregate demand while a small stock of goods and services leads to low aggregate demand.
8. **Monetary policy existing in an economy.** Restrictive monetary policy reduces money supply leading to low aggregate demand while expansionary monetary policy reduces money supply and aggregate demand.
9. **Level of capital inflow and capital outflow.** High level of foreign resource inflow and low capital outflow leads to high aggregate demand while low level of inflow of foreign resources and high capital outflow leads to low aggregate demand.
10. **Nature of taxation and subsidization.** High direct taxes with limited subsidizing lead to low aggregate demand.
11. **Variety of tastes and preferences.** Tastes and preferences of the population have a special influence on aggregate demand in an economy.
12. **Existing capital stock.** Large capital stock implies increased demand while a small capital stock leads to low aggregate demand.

UNEB 2011

i) *What is meant by aggregate demand. (01marks)*
ii) *State any three components of aggregate demand in an open economy. (03 marks)*

COMPONENTS OF AGGREGATE DEMAND IN AN OPEN ECONOMY

a) Consumption expenditure by household ©.
b) Investment expenditure by firms (I).
c) Government expenditure (G) on goods and services.
d) Net foreign expenditure (X-M).

AGGREGATE SUPPLY

Aggregate supply. Refers to the total amount of output that is produced and offered for sale by all sectors of the economy at a given time.

Aggregate supply curve implies that all SECTORS of the economy increase their output as prices increase and reduce their output as price reduce thus it slopes upwards from left to right.

Therefore, the overall macro equilibrium is determined by interaction of aggregate supply and aggregate demand curves.

Aggregate demand and aggregate supply

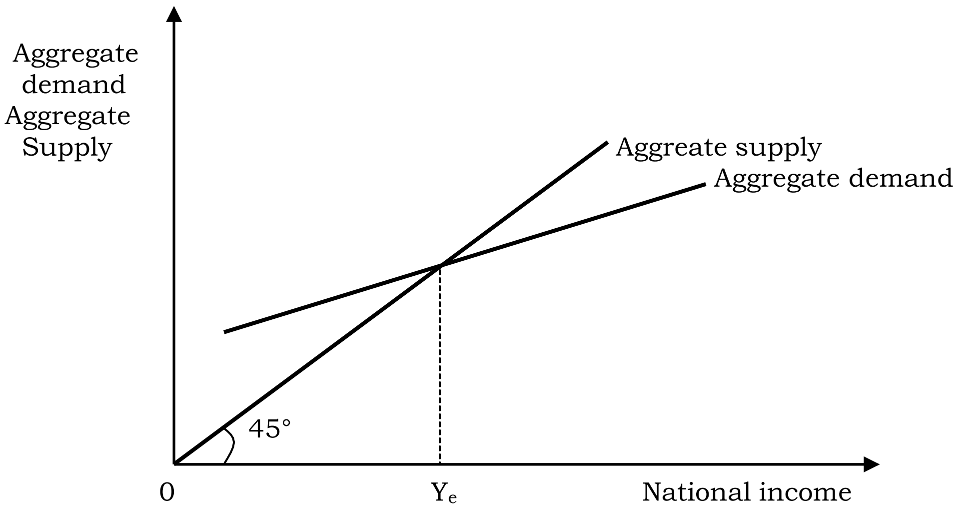


Figure 4.2: aggregate demand and aggregate supply.

Y_e is equilibrium income.

UNEB 1998.

a) *Distinguish between a deflationary gap and an inflationary gap. (04 marks)*
b) *Examine the policies that a country should adopt to close.*
   (i) *A deflationary gap. (08 marks)*
   (ii) *An inflationary gap (08marks)*

NATIONAL INCOME DISEQUILIBRIUM.

Equilibrium is attained when aggregate demand equals aggregate supply and at this point. There is full employment and no need for government intervention. The planned expenditure is equal to planned output.

However, Lord Keynes disagrees that at equilibrium Ye, the economy is always at full employment. To him full employment level (YF) may be greater or less than equilibrium income. This is explained by an inflationary gap and a deflationary gap.

1. A DEFLATION GAP

A deflationary gap is a situation where aggregate supply exceeds aggregate demand at full employment level of national income.

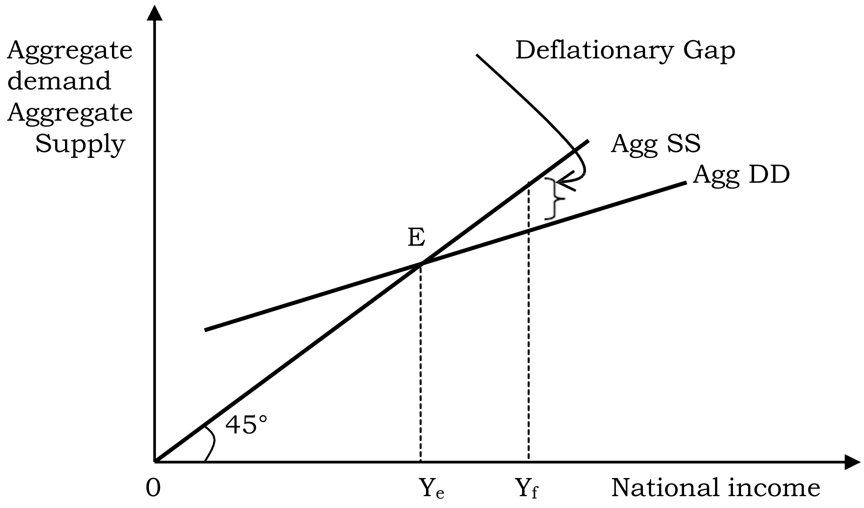


Figure 4.3: A deflationary gap.

- Y_e shows equilibrium level of national income.
- Y_f shows a deflationary gap at full employment level of national income.

2. AN INFLATIONARY GAP

An inflationary gap is a situation where aggregate demand exceeds aggregate supply at full employment level of national income.

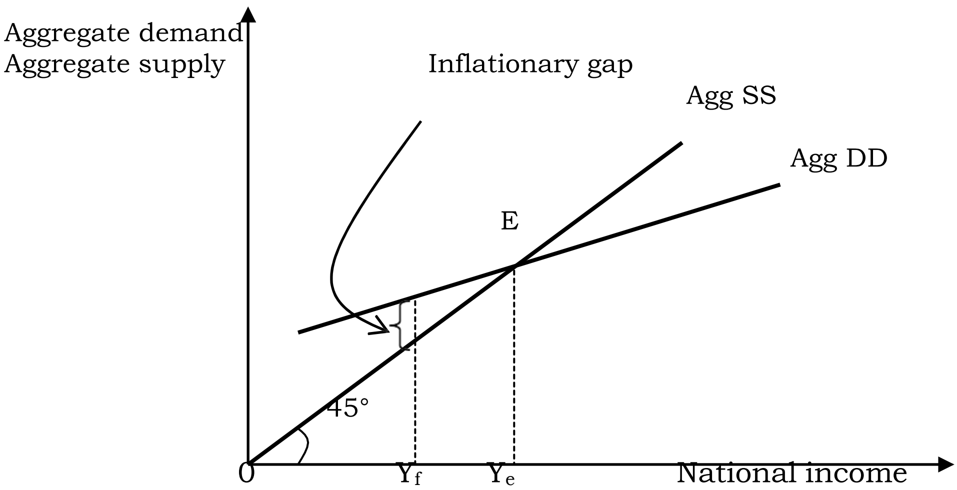


Figure 4.4: An inflationary gap.

- Y_e shows equilibrium level of national income.
- Y_f shows an inflationary gap at full employment level of national income.

POLICIES TO CLOSE A DEFLATIONARY GAP.

Closing a deflationary gap involves employing policies that help to increase aggregate demand.

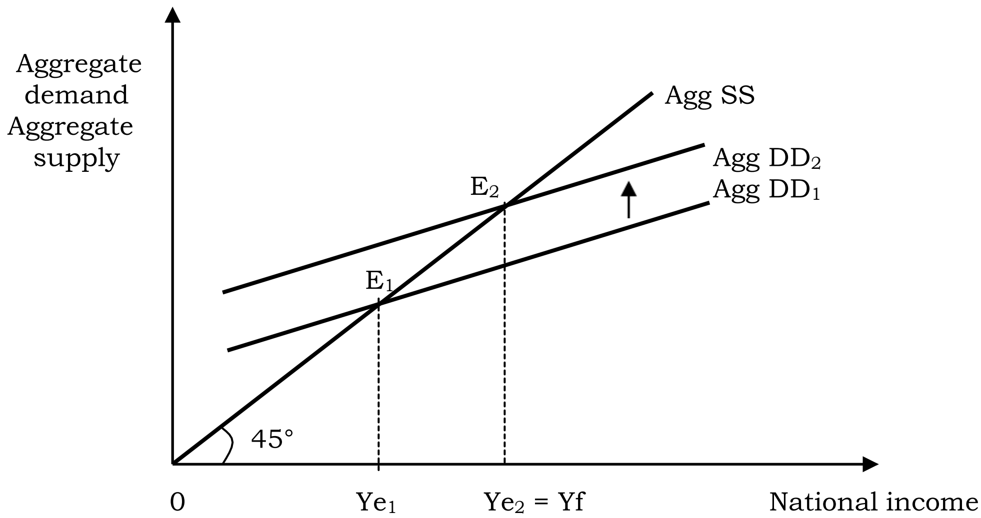


Figure 4.5: closing a deflationary gap.

Closing a deflationary gap involves increasing aggregate demand from Agg DD_1 to Agg DD_2.

Therefore at E_2 equilibrium is attained at full employment using the following policies.

- ❖ **Reducing direct taxes on people's income.** This helps to le them with enough disable income.
- ❖ **Increasing government expenditure on employment al development projects.** This helps to increase people"s income for spending and increase aggregate demand.
- ❖ **Use of expansionary monetary policy.** This is through reducing bank rate, reducing amargin requirement, buying securities from the public to increase money supply leading to increased aggregate demand.
- ❖ **Encouraging exports.** This is to increase net income from abroad fo spending thus increasing aggregate demand.
- ❖ **Reducing imports of similar goods** produced to increase gs demand for locally produced goods.
- ❖ **Improvement in investment climate.** This is aimed at ing employment opportunities and incomes. This is done by increasing investment expenditure and encouraging foreign investors in order to increase income and later increase aggregate demand.
- ❖ **Increasing wages of workers.** This helps to increase incomes ag workers which increases consumption thus increasing aggregate demand.

- **Provision of cheap loans (at low interest rates).** This increases demand for loans to undertake investments which increases consumer‟s purchasing power and increase aggregate demand.

UNEB 2007, 2003.

i) What is an inflationary gap. (01 marks)
ii) How can an inflationary gap be closed in an economy. (03 marks)

POLICIES TO CLOSE AN INFLATIONARY GAP.

Closing an inflationary gap involves employing policies that help to reduce aggregate demand.

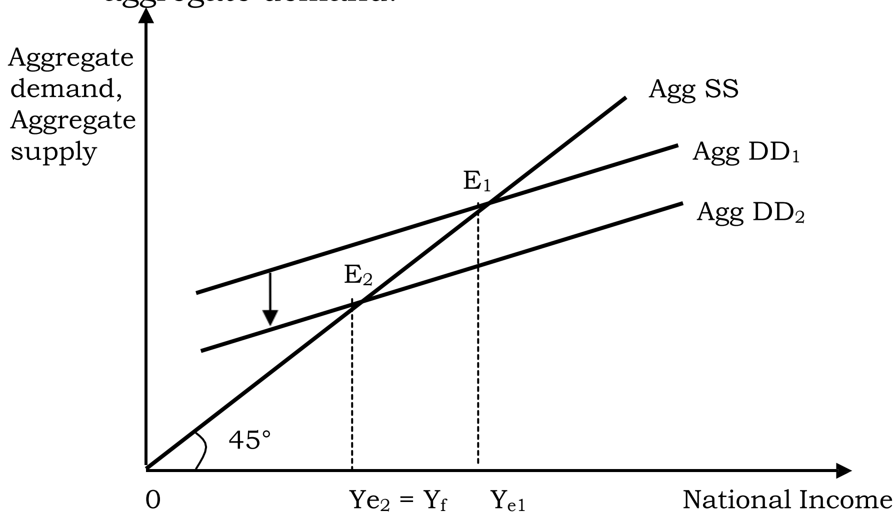


Figure 4.6: Closing an inflationary gap.

An inflationary gap is closed by reducing aggregate demand from AggDD1 to AggDD2 using the following policies.

- **Use of restrictive monetary policy.** This is through increasing bank rate, buying securities from the public, increasing margin requirements to reduce money supply and reduce aggregate demand.
- **Controlling wages/wage freeze.** This involves reducing wages of workers which reduces incomes available for spending thus reducing aggregate demand.
- **Reducing exports of scarce goods.** Reducing exportation of goods especially for essential commodities to increase aggregate supply.
- **Increasing imports of scarce goods.** This is through increasing imports especially essential/scarce commodities to increase aggregate supply.
- **Increasing direct taxes** so as to reduce disposable income which reduces income available for spending thus reducing aggregate demand.
- **Reducing government expenditure.** This helps to reduce income among people and reduces aggregate demand as well.
- **Providing a favourable investment climate.** This is done by providing investment incentives to producers to attract more foreign investors to increase aggregate supply.

- ❖ **Developing infrastructure** such as roads, power supply to increase production levels and match with the level of aggregate demand.

UNEB 2004.

i) *What is meant by an inflationary gap. (01 marks)*
ii) *State any three effects of an inflationary gap in an economy. (03 marks)*

EFFECTS OF AN INFLATIONARY GAP IN AN ECONOMY.

1. Increased resource utilization.
2. Increased importation of goods.
3. Increased profit margins for firms.
4. Increased demand for factors of production.
5. Persistent increase in prices of commodities.

THE MULTIPLIER PROCESS.

Increase in expenditure/increase in aggregate demand increases income more than the original increase in expenditure. If a firm spends on investment it creates more income and people who receive that income also spend it and create more income and the trend continues.

Multiplier is defines as the number of times initial change in expenditure multiplies itself to give a final change in income.

It shows that expenditure creates more income and this income can be re-invested to create more income and the trend continues.

Multiplier= change in income (ΔY).

Initial change in expenditure (ΔE).

Multiplier = 1/MPS or 1/1-MPC.

NB. Multipliers do not have units.

TYPES OF MULTIPLIER.

a. **Government multiplier.** This is the number of times initial change in government expenditure multiplies itself to give a final change in income. Government multiplier= change in income(ΔY)Change in government expenditure (ΔG).

b. **Tax multiplier.** This is the number of times initial change in taxation multiplies itself to give a final change in income.

Tax multiplier= change in income (ΔY) change in taxation (ΔT)

c. I**mport multiplier**. This is the number of times initial change in import expenditure multiplies itself to give/generate a final change in income.

d. **Export multiplier.** this is the number of times initial change in export earnings multipliers itself to give/generate a final change in income.

e. **Consumption multiplier.** this is the number of times initial change in consumption expenditure multiplies itself to give/generate a final change in income.

Consumption expenditure = Change in income (ΔY)/Change in consumption (ΔC).

UNEB 2009.

a) *Differentiate between investment multiplier and government multiplier. (02 marks)*

b) *Given that marginal propensity to consume (MPC) in economy is 0.7 and there is a change in investment as shillings 50,000,000. Calculate the,*

(i) *Investment multiplier (01 marks)*

(ii) *Final change in income in the economy. (01 marks)*

f. **Investment multiplier.** This is the number of times initial change in investment expenditure multiplies itself to give a final change in income.

Investment multiplier = change in income(ΔY) change in investment expenditure(ΔI).

Other related concepts.

1) **MARGINAL PROPENSITY TO CONSUME (MPC).** This is a fraction/proportion of additional income that is spent on consumption. It increases with increase in income and reduces with a reduction in income.

MPC= Change in consumption (ΔC)/Change in income(ΔY).

2) **Marginal prosperity to export.** This is a proportion/percentage of additional income that is earned from MPE=change in exports (ΔX)/Change in income (ΔY). increases government tax revenue on imports.

3) **Marginal propensity to import (MPI).** This is a fraction/proportion/percentage of additional income that is spent on imports.

MPI=Change in imports (ΔM)/change in income(ΔY).

Example.

Given that GDP of a country increased form shillings 100million to shs 300million and the value of imports increased from shillings 25million to shillings 75million. Calculate the marginal propensity to import.

Marginal propensity to import (MPI)= Change in imports/change in income.

$$\frac{75{,}000{,}000-25{,}000{,}000}{300{,}000{,}000-100{,}000{,}000.}$$

$$\frac{50{,}000{,}000}{200{,}000{,}000}$$

MPI=<u>0.25</u>

UNEB 2013

i) *What is meant by the term" marginal propensity to import" (01 marks)*

ii) *Give any three effects of a high marginal propensity to import in an economy. (03 marks)*

Effects of high marginal propensity to import.

- Leads to high outflow of foreign exchange.
- Leads to unfavourable balance of payment position.
- Limits growth of local industries/leads to decline in local industries.
- Causes unemployment problem.
- Increases dependence on other economies.
- Leads to limited inventions and innovations.
- Leads to imported inflation.
- Leads to underutilization of local resources.
- Leads to erosion of social-cultural values.
- Leads to provision of a variety of goods
- Increases government tax revenue though taxing imports.

4) **Marginal propensity to save (MPS).** This is a proportion/fraction/percentage of additional income that is saved/not consumed. As income increasesa, MPS also increases. Rich people have high MPS than poor people.

MPS = change in savings (S)/change in income(Y).

UNEB 2001.

i) *Distinguish between marginal propensity to save and marginal propensity to consume. (02 marks)*

ii) *Give any determinants of marginal propensity to save in your country. (02 marks)*

DETERMINANTS OF MARGINAL PROPENSITY TO SAVE (MPS).

- Current level of income.
- General price level.
- Consumption habits.
- Degree of uncertainty.
- Level of liquidity preference
- Interest rate on deposits.

5) **Average propensity to consume (APC).** This is a fraction/proportion/percentage of total income that is consumed or spent on consumption.

APC=total consumption (C)/Total in income (Y).

Example.

Given that the country‟s total income is shillings 60,000billion and its total consumption is shillings 48,000billion. Calculate it‟s APC.

$$APC = \frac{\text{TOTAL CONSUMPTION.}}{\text{TOTAL INCOME.}}$$

48,000 billion/60,000billion.

<u>APC=0.8 or 80%.</u>

6) **Average propensity to save (APS).** This is a proportion/percentage of total income that is saved. In most cases, it increases as income increases and reduces as income reduces.
APS =Savings(S)/income(Y).

7) **Marginal efficiency of capital (MEC).** This refers to anticipated/expected monetary returns on an additional unit of capital invested.

Or

It refers to expected monetary returns from employing an additional unit of capital.

UNEB 2010.

i) What is meant by marginal propensity to save(MPS). (01 marks)

ii) Given that the initial national income of a country is shillings 22billion, and MPS is 40%.

Calculate the final income in that country. (03 marks)

UNEB 2000.

i) Define then term marginal efficiency of capital. (01 mark)

ii) Mention any three determinants of marginal efficiency of capital. (03 marks)

DETERMINANTS OF MARGINAL EFFICIENCY OF CAPITAL IN UGANDA.

NB. Neutral points are required showing high marginal efficiency of capital and low marginal efficiency of capital in explanation.

1. **Level of expected output.** High level of expected output leads to high marginal efficiency of capital whereas low level of expected output leads to low marginal efficiency of capital.
2. **Level of taxation on investment.** High level of taxation on investment leads to low marginal efficiency of capital.
3. **Interest rate on capital invested.** High interest rate on capital invested leads to low marginal efficiency of capital while low interest rate on capital invested leads to high marginal efficiency of capital.
4. **Size of the market for output.** A large size of market for output leads to high marginal efficiency of capital while a small market size for output leads to low marginal efficiency of capital.
5. **General price level in an economy.** High general price level leads to high marginal efficiency of capital while low general price level leads to low marginal efficiency of capital.
6. **Rate of depreciation of capital.** High rate of capital depreciation leads to low marginal efficiency of capital n while low rate of depreciation of capital leads to high marginal efficiency of capital.
7. **Quality and quantity of other cooperant factors of production.** High quality and quantity of other cooperant factors of production leads to

high marginal efficiency of capital whereas low quality and quantity of cooperant factors production leads to low marginal efficiency of capital.

UNEB 2010.

i) Differentiate between average propensity to consume and marginal propensity to consume. (02 marks)

ii) Given that the country"s total income is shillings 60,000 billion and its total consumption is shillings 48,000billion. Calculate its APC. (02 marks)

Examinable questions.

1) Given that MPC in a two sector economy is 80%, initial investment is shillings 20,000,000. Initial equilibrium level of income is shillings 80,000,000 and if the investment increased by shillings 5,000,000,000. Calculate the,

i) Multiplier value.

ii) New equilibrium level of income.

Solution.

i) Multiplier = 1/1-MPC.

1/1-80%=5

Multiplier value=5times

ii) New equilibrium level of income=

(Change in investment X multiplier) + Original equilibrium level of income.

(5,000,000,000 X5) + 80,000,000.

New equilibrium level of income = shillings. 25,080,000,000

2) Given that the GDP of country"s X is shillings 200million, its change in national investment expenditure is shillings 50million and its MPS is 0.5.

Calculate the,

i) Multiplier

ii) Final level of national income.

Solution.

i) Multiplier = 1/MPS.= 1/0.5 Multiplier =2times

ii) Final level of income =multiplier x change in national investment expenditure + GDP.

2X50,000,000 +200,000,000.

100,000,000+200,000,000.

Final level of income = shillings 300,000,000 or shs. 300million.

3) Given the MPC in an economy is 0.7 and there is a change in investment as shillings 50,000,000.

Calculate,

i) Investment multiplier.

ii) Final change in income in the economy.

__Solution.__

i) **Investment multiplier=1/1-MPC**
1/1-0.7=3.3
<u>Multiplier = 3.3times.</u>

ii) **Final change in income = investment multiplier x change in investment**
a. x 50,000,000.

<u>Final change in income= shillings 165,000,000 or Shs. 165million.</u>

4) Given that, the initial national income of a country is shillings 22 billion and that MPS is 40%.

Calculate the final change in income.

Multiplier=1/MPS 1/40% = <u>2.5times</u>

Final change in income = multiplier x initial national income.

a. X 22 billion.

<u>Final change in income=shillings 55billion or shs. 55,000,000,000.</u>

5) Given that the current level of GDP is shillings 300million, the increase in national investment expenditure is shillings 50million and MPS is 0.2, calculate the final level of national income.

Multiplier=1/MPS.

1/0.2=<u>5times</u>

Change in income 5x50 million = shillings 250 million.

Final level of income = **change in income + current level of GDP**
250 million + 300million.

<u>Final level of income = shillings 550million.</u>

6) Given that an individual"s income increased from shillings 200,000 to shillings 350, 000 and this led to an increase in savings by shillings 50,000. Calculate the marginal propensity to save.

MPS=change in savings/change in income

50,000/350,000-200,000

50,000/150,000

MPS =0.3

7) Given that a country"s GDP is shillings 5,800 billion and investment expenditure increased from shillings 1,000 billion to shillings 1,400billion. Calculate the final level of income of the country is MPS is 20%.

Multiplier = 1/MPS = 1/0.2

Multiplier = 5times

Change in income=multiplier X Change in investment.

5X(1,400-1,000)

Shillings 2,000 billion.

Final level of income = initial income level (GDP) + change in income.

5,800 +2,000

Final level of income = shillings 7,800 billion.

INVESTMENT MULTIPLIER IN LDCs.

Change in investment expenditure leads to change in income by multiplier times, but in developing countries, there is limited income arising from investment expenditure because of unfavourable economic, social and political factors.

UNEB 2001.

a) *Distinguish between consumption multiplier and investment multiplier. (04 marks)*
b) *Explain the factors which limit operation of investment multiplier in your country. (16 marks)*

UNEB 1998.

a) *Distinguish between an investment multiplier and an export multiplier. (04 marks)*
b) *Examine the factors limiting the effective operation of investment multiplier in your country. (16 marks)*

LIMITATIONS OF INVESTMENT MULTIPLIER IN LDCS/FACTORS THAT LIMIT THE SIZE OF INVESTMENT MULTIPLIER IN LDCS(Uganda).

1. **High level of liquidity preference.** In LDCs, majority of people prefer to hold their accumulated wealth in cash or near cash form instead of re-investing it to accumulate more income which limits the size of multiplier.
2. **Low level of entrepreneurship ability.** Lack of organizational skills limit the level of local investments because entrepreneurs are in short supply in developing countries thus limited undertaking of risky but profitable ventures thus a small size of multiplier.
3. **Low income levels.** Income levels in LDCs are very low due to low savings and investment which limits the size of multiplier.
4. **High rate of capital outflow.** This is through high profit repatriation by owners of foreign capitalinvestments which limits re-investment and multiplier effect.
5. **High marginal propensity to import.** Majority of existing potential consumers prefer imported items, importing expensive capita goods takes a very big percentage of accumulated income instead of re-investing it to increase domestic production thus small size of multiplier.

6. **Small market size.** Domestic market is narrowed by limited purchasing power and foreign markets are highly competitive. This limits the level of expanding business and the size of multiplier.
7. **Poor infrastructure.** The existing social and economic infrastructure are in poor state and in some areas not existing such as poor roads, limited power supply, limited railways, underdeveloped banking systems which reduces profitability of business thus small size of multiplier.
8. **Poor political climate/atmosphere.** Persistent political upheavals in many LDCS discourage both local and foreign investments since it creates business and life uncertainty which limits expansion of business and size of the multiplier.
9. **Poor/unfavourable investment climate.** This is characterized by high and unfair taxes on producers, limited subsidies to producers and limited institutions to encourage investments which leads to high cost of production, low investment and size of the multiplier.
10. **Low levels of technology.** Production still depends on poor tools especially in primary sectors and there is constant structural break down in major industries. This reduces the rate of resource utilization and the size of multiplier.
11. **High population growth rate.** Population in most LDCs grows at a rate of more than 20% per annum. This limits savings and increases individual and government expenditure because of high dependence burden thus limiting the size of multiplier.
12. **High levels of corruption and embezzlement of funds in resource allocation.** Most resources which are provided by the public sector for project implementation and supporting the private sector are misused by appointed official of government instead of increasing productive projects. This leads to a decline in investment multiplier.
13. **Large subsistence sector.** This sector is managed by peasants which limits large scale production thus low investment and limited size of multiplier.

SAVING.

Saving is a proportion/part of income which is not spent on current consumption but kept a side for future use.

Or

It refers to the proportion of income that is not spent on current consumption in order to create funds for future use . Saving is necessary for increased future investment in an economy.

FACTORS INFLUENCING/AFFECTING THE LEVEL OF SAVING IN AN ECONOMY.

1. **Level of consumption/spending habits.** High level of consumption habits leads to low level of saving which low consumption habits lead to high level of saving.

2. **Level of income.** High level of income leads to high level of saving which low level of income leads to low level of saving.
3. **Interest rate on deposits.** High interest rate on deposited capital leads to high level of saving whereas low interest rate on deposited capital leads to low level of savings.
4. **Level of development of financial institutions.** High level of development of financial institutions leads to high level of saving whereas low level of development of financial institutions leads to low level of saving.
5. **Political climate.** Favourable political climate leads to high level of saving whereas unfavorable political climate leads to low level of saving.
6. **Population growth rate.** High population growth rate increases dependence burden which leads to low level of saving while low population growth rate leads to high level of saving.
7. **Rate of inflation/general price level.** High rate of inflation leads to low level of saving while low rate of inflation leads to high level of saving.
8. **Level of taxation and subsidization.** Low level of taxation and high subsidization leads to high level of saving while high level of taxation and low subsidization leads to low level of saving.
9. **Size of existing stock of wealth.** A large size of existing stock of wealth leads to high level of saving whereas a small size of existing stock of wealth leads to low level of saving.
10. **Government policy on saving.** Favourable government policy on saving through compulsory saving schemes such as NSSF leads to high level of saving while unfavourable government policy on saving leads to low level of saving.
11. **Degree of monetization/commercialization of an economy.** High degree of monetization of an economy leads to high level of saving whereas low degree of monetization of an economy leads to low level of savings.
12. **Degree of accountability in the financial sector.** Poor accountability in the financial sector limits savings whereas proper accountability in the banking sector promotes the level okf saving.

UNEB 2007.

Give any four factors which influence the rate of savings in your country. *(04 marks)*

UNEB 2007.

i) *Distinguish between multiplier and accelerator theories of investment.* *(02 marks)*

ii) *Given that marginal propensity to consume is 0.75, calculate the size of multiplier.* *(02 marks)*

THE ACCELERATOR PRINCIPLE

The accelerator shows the number of times initial change in consumption expenditure multiplies its self to give a final change in investment.

The accelerator principle states that initial change in consumption expenditure multiplies its self to give a rise in investment.

Accelerator principle= change in investment ($\Delta 1$)/change in consumption (ΔC).

It shows how changes in consumer expenditure may lead to changes in the level of capital accumulation if there is an increase in consumer‟s expenditure, demand will increase leading to an increasein the level of production and investment.

INVESTMENT

Investment refers to the process of devoting a person‟s or nation‟s income to create capital goods/stock.

Or

It is the process of creating capital stock in an economy. It is the expenditure meant to increase and maintain capital stock.

For instancepurchase of machinery, stocking raw materials and constructing infrastructure.

Economic growth and development can never take place when there is no increased level of investment in different production sectors of the economy.

TYPES OF INVETSMENT

A. Autonomous investment.

Autonomous investment is a form of investment that does not depend on the level of income,

Or

This is a form of investment that is independent of the level of income but depends on other factors.

It is independently motivated investment which does not depend on any economic variables such as income but is propelling and can take place at any time.

It is influenced by factors outside the income stream such as level of technology, weather changes, political climate, research and population size/growth rate.

For instance investment undertaken by public sector such as setting up roads, hospitals for various national objectives.

B. Induced investment.

Induced investment is a form of investment which depends on the level of income.

This is a type of investment that depends on economic variables such as changes in the level of income and it occurs in response to increase in consumer"s demand for commodities.

It is influenced by factors within the income stream such as price of goods, level of demand, wage rate and interest rate on capital.

NB.

Gross investment is the total amount of investment in a given period of time without considering depreciation cost.

Net investment is defined as gross investment less capital depreciation cost.

UNEB 1997, 2002.

a) Define the term investment. (04 marks)

b) Examine the factors influencing the level of investment in your country. (16 marks)

FACTORS DETERMINING/AFFECTING THE LEVEL OF INVETSMENT IN AN ECONOMY.

NB. These are presented as neutral points and explained in two sides showing high level of investment and low level of investment.

1. **Interest rate on borrowed capital.** Low interest rate on borrowed funds increases borrowing for investment which leads to high level of investment while high interest rate on borrowed capital discourages borrowing for investment which leads to low investment.
2. **Size of existing capital stock.** Large size of existing capital stock increases the utilization of other resources which increases production hence high investment levels whereas small size of capital stock limits utilization of resources which leads to low production leading to low level of investment.
3. **Level of income.** High income levels implies high savings for increased production hence high investment level while low income levels implies low savings hence low production leading to reduced level of investment.
4. **Political climate.** Favourable political climate attracts both local and foreign investments due to certainty for life and property hence increased production leading to high investment levels whereas unfavorable political climate scares away both local investors due to uncertainty for life and property hence low level of investment.
5. **Government policy on investment.** Favourable government policy towards investment through subsidies to producers, tax holidays, tax exemptions encourages production leading to high level of investment while unfavourable governmentpolicy towards investment through

unfair taxes on producers, limited subsidies leads to low level of production leading to low level of investment.

6. **Market size/level of aggregate demand.** Presence of a large market size both domestic and foreign implies profitability of businesses and encourages further production which leads to high investment levels whereas small domestic and foreign market for output discourage further production leading to low investment**.**
7. **Level of infrastructure development.** Presence of sound and modern infrastructure such as modern roads, railway6s, power supply systems and banking institutions increase mobility of factor of production hence high investment level while underdeveloped infrastructure limit movement of factor inputs and final products hence low investment levels.
8. **Level of entrepreneurial ability.** High level of entrepreneurial ability implies better organization of other factors of production and undertaking risky but highly profitable ventures leading to high investment levels whereas low entrepreneurial ability limits organization of other factors of production hence low investment levels.
9. **Population growth rate.** High population growth rate implies high dependence burden which limits the level of savings hence low level of investment whereas low population growth rate reduces dependence burden which increases savings hence high level of investment.
10. **Rate of inflation.** High rate of inflation increases cost of production which discourages investment while low rate of inflation leads to high level of investment.
11. **Level of technology in production.** High level of technology in production increases resource utilizationleading to further production hence high level of investment while low level of technology limits production leading to low level of investment.
12. **Level of savings.** High level of savings increases production leading to high level of investment while low level of savings leads to low of investment.
13. **Marginal efficiency of capital.** High marginal efficiency of capital encourages further production which increases the level of investmentwhile low marginal efficiency of capital discourages further production while leads to low level of investment.
14. **Profit level.** High profit level encourages further production hence high level of investment whereas low profit level limits further production leading to low level of investment.
15. **Level of inventions and innovations.** High level of inventions and innovations increases the level of investment while low levels of inventions and innovations reduces the level of investment.

UNEB 2005.

a) *Distinguish between saving and investment. (04 marks)*

b) *Explain the factors that have influenced the level of investment in private sector in your country. (16 marks)*

FACTORS THAT HAVE INFLUENCED/ AFFECTED THE LEVEL OF INVETSMENT IN PRIVATE SECTOR IN UGANDA.

NB. These must be presented as neutral factors and explained in two sides showing high level and low level of investment.

1. **Rate of inflation/economic climate.** High rate of inflation has increased cost of production which has discouraged investment while low rate of inflation has increased investment in private sector.
2. **Level of entrepreneur ability.** High level of entrepreneurial ability has increased proper organization of other factors of production which has promoted investment while low level of entrepreneurial ability has limited investment in private sector due to poor organizational skills.
3. **Political climate.** Favourable political climate in some areas has created certainty for property hence increased investment while unfavourable political climate has created business uncertainty which has discouraged investment in the private sector.
4. **Interest rate on borrowed capital.** Low interest rate on borrowed capital has attracted many borrowers for increased investment while high interest rate has discouraged borrowing for investment which has discouraged increased investment in the private sector.
5. **Level of infrastructure development.** High level of infrastructure development in form of roads has increased mobility of factor inputs which has increased investment while low level of infrastructure development has limited transportation of factor inputs and output hence reduced level of investment.
6. **Level of income.** High level of income has increased investment level among some investors while low level of income level has discouraged increased investment in private sector.
7. **Business expectations.** During a boom, there is increased economic activity which has increases investment levels while during a period of low economic activity investment levels have been always discouraged in the private sectors.
8. **Marginal efficiency of capital.** High marginal efficiency of capital has increased investment levels while low marginal efficiency of capital has discouraged investment in the private sector.
9. **Government policy on investment.** Favourable government policy on investment through tax holidays, subsidies has increased investment levels while unfavourable government policy on investment such as high taxes, limited subsidies has limited the level of investment inj the private sector.

10. **Level of savings.** High level of savings has increased the level of investment while low level of savings has limited the level of investment in the private sector.
11. **Size of the market.** A large market size for output has promoted increased production hence high level of investment while a small market size has discouraged more production hence reduced level of investment in the private sector.
12. **Population growth rate.** Low population growth rate has reduced dependence burden which has increased the level of investment while high population growth rate has increased dependence burden which has limited the level of investment in the private sector.
13. **Level of technology.** High level of technology has increased resource utilization which has increased the level of investment while low level of technology has limited resource utilization which has increased the level of investment while low level of technology has limited resource utilization which has reduced the level of investment in the private sector.
14. **Profit levels.** High profit levels have increased the level of investment since such profits are ploughed back while low profit levels have discouraged ploughing back capital into businesses which has limited the level of investment in the private sector.
15. **Size of existing capital stock.** A large size of existing capital stock has increased the level of investment while a small size of capital has discouraged the level of investment in the private sector.

FACTORS RESPONSIBLE FOR A LOW LEVEL OF INVETSMENT IN UGANDA.

1. **Low level of income.** Levels of income among Ugandans are low implying limited capacity to expand production hence low investment.
2. **Poor infrastructure.** Poor road network, limited railways, limited banking institutions limit perfect mobility of factors of production thus low production and investment.
3. **Small market size.** The domestic market is insufficient due to low purchasing power while the foreign market is too competitive which discourages large scale production leading to low investment.
4. **Low entrepreneurial ability.** The level of ability to organize other factors of production is low among the existing investors which limits production hence low investment levels.
5. **Small size of existing capital stock.** The size of capital stock is limited implying limited production and investment initiatives.
6. **High rate of inflation.** Persistent inflation in Uganda leads to increased cost of production, leads to loss of money value which discourages increased level of production thus low investment levels.

7. **High interest rate on borrowed capital.** Money lending institutions charge high interest rate on borrowed capital for investment which discourages borrowers for increased production and investment purposes.
8. **Poor political climate.** Unfavourable political climate creates uncertainty for life and property in some areas, increases government expenditure on military hardware instead of increasing expenditure in productive ventures thus low investment levels.
9. **Low level of technology.** Techniques of production in most production units are still poor which limits large scale production leading to low investment.
10. **Unfavorable government policy on investment.** The government policy at times is unfavourable towards investment inform of unfair taxes, limited subsidies to producers, high cost of trade licenses which discourages increased production hence low investment levels.
11. **Low level of savings.** The level of saving by the population is low due to high marginal propensity to consume implying limited resources for increased production hence low investment levels.
12. **High level of liquidity preference.** Many individuals prefer to keep their wealth in monetary form instead of investing it to create more wealth through increased investment. This limits production and investment levels.
13. **Low profit levels.** Profitability of business is still low which discourages further production leading to low level of investment.
14. **High population growth rate.** Population in Uganda grows at a high rate per annum which increases dependence burden, limits savings and in turn low investment levels.

MEASURES BEING TAKEN TO INCREASE THE LEVEL OF INVETSMENT IN UGANDA.

- **Controlling population growth rate.** The government is reducing population growth rate through family planning methods so as to reduce dependence burden and increase savings for investment.
- **Provision of investment incentives.** This is being done through providing tax holidays, tax exemptions and subsidies to producers to attract more investors.
- **Widening market for output.** Market for output is being expanded through joining economic integrations such as the EastAfrica community to encourage continuous production and attract more investors.
- **Improving and modernizing infrastructure.** The existing roads, power supply systems are being upgraded and new ones constructed so as to ease movement of factors of production and output leading to increased investment.

- **Conducting entrepreneurial training.** The government is supporting acquisition of entrepreneurial skills through workshops to stimulate entrepreneur development thus increased investment.
- **Maintaining economic stability.** The government is controlling inflation through relevant fiscal and monetary policies so as to scale down thecost of production andattract more investments.
- **Encouraging political stability throughout the country.** The government is campaigning for continued political stability in all parts of the country through good governance in order to reduce uncertainty for life and property and increase investment levels.
- **Further privatization of public enterprises.** More public enterprises are being transferred to private investors in order to attract more private investors and increase investment in the long run.
- **Providing information about investmentopportunities/putting in place specialized institutions to encourage investments.** Provision of information about investment opportunities is being done for instance through Uganda investment authority.
- **Encouraging savings through financial sector development.** Encouraging credit schemes such as SACCOs, micro finance institutions to mobilize enough savings and avail credit to rural investors is being supported thus stimulating more investment.
- **Further liberalization of the economy.** More liberty is being given to private individuals to carry out economic activities without undue government controls so as to attract more investors in economic activities.
- **Intensifying war against corruption and embezzlement of investment funds.** Intensive war against corruption and embezzlement of investment funds is being done so as to restore confidence among investors through putting in place anti-corruption organs to increase investment in both private and public sectors.
- **Providing cheap loans to investors.** Prospective investors especially the local investors are being availed with cheap loans at a low interest rate to undertake investment opportunities available in different areas.
- **Improving on technology.** The existing technology is being improved through increased innovations and inventions, technology transfer to produce high quality goods and increase the level of investment.

UNEB 2006.

a) *Define the term investment.* *(04 marks)*
b) *Suggest measures that should be taken to increase the level of investment in your country.* *(16 marks)*

Measures that should be taken to increase the level of investment in Uganda.

- Provision of information about investment opportunities i.e. through UIA.
- Further liberalization of the economy.
- Intensify war against corruption to reduce misuse of funds meant for investment.
- Control population growth rate.
- Further privatization of public enterprises.
- Build strong and sound infrastructure.
- Provision of investment incentives such as tax holidays and subsidies.
- Maintain economic stability.
- Encourage political stability in all parts of the country.
- Widen market for output.
- Undertake entrepreneurial training.
- Encouraging savings.
- Provide cheap loans to local investors.
- Improve on the level of technology.

UNEB 2003.

a) Define the term investment. (04 marks)

b) Assess the impact of private foreign investment in your country. (16 marks)

PRIVATE FOREIGN INVESTMENTS IN LDCs (FOREIGN CAPITAL INVESTMENT)

Private foreign investments are investments in a country carried out by foreign companies, individuals and multi-national corporations as they transfer their productive resources and capital into the country. Many developing countries have endeavored to encourage foreign direct investments in a move to facilitate rapid economic growth and development.

In the recent years, developing countries have witnessed rapid growth of direct foreign investments by transnational corporations or multi-national corporations and other various forms of investment owned by foreign investors in areas of banking, insurance industry, industrial activities, education, telecommunication, hotel industry and other various forms of investment are owned by foreigners in most LDCs.

In Uganda, the government has offered incentives and created a favourable investment climate for foreign investors which has attracted numerous investments from abroad especially in banking, industrialization, telecommunication, mineral exploitation among others.

Foreign direct investment.

This refers to the transfer of productive resources and capital by foreign individuals, companies and multinational corporations into the domestic economy in form of business operations.

POSITIVE ROLE OF PRIVATE FOREIGN INVESTMENTS IN LDCS.

1. **They fill savings-investment gap.** Foreign investors come with their capital hence supplementing the insufficient domestic savings thus improvement in investment levels.
2. **They close foreign exchange gap/they increase inflow of foreign exchange.** Foreign investors come with additional supplies of foreign currency hence supplementing the available forex from exports.
3. **Fill skilled man power gap.** They come with skilled labour to supplement locally available man power by use of expatriates.
4. **Provision of employment opportunities.** Both skilled and semi-skilled labour gets employed in various projects set up by foreign investors thus increasing employment.
5. **Source of government tax revenue.** This is through corporatetaxation of investments carried out by foreign investors and incomes ofpeople employed in such investments thus increased government revenue.
6. **They promote development of local skills.** They usually provide on job training and undertake labour training programmes in technical, scientific and managerial aspects. This promotes development of local entrepreneurial skills for local people to start their own investments.
7. **Accelerate growth of industrial sector.** They set up and manage medium and large scale industrial firms such as steel and chemical plants which stimulates industrialization.
8. **Facilitate technological transfer and development/ they close technology gap.** Foreign investors come with efficient, new and advanced techniques of production in form of capital intensive technology thus improvement in technology.
9. **They encourage infrastructural development.** For instance transport routes, banking facilities, power projects, telecommunications and this is a sign of economic development thus leading to more investment.
10. **They promote efficiency of local firms due to increased competition.** Local firms compete with foreign firms in production and this leads to production of high quality output thus increased efficiency.
11. **Facilitate production of a wide variety of goods.** This is because, they deal in diversified activities hence widening consumers‟ choice and improving standard of living.
12. **Promotion of international cooperation and understanding between countries.** This is important for increased foreign aid and increased international trade leading to increased production for export.
13. **They encourage innovations and inventions.** This is due to extensive research carried out by competing firms in production and use of better methods of production thus better quality output thus increasing market and profits.

14. **Promote use of idle resources/increase resource utilization.** The would be idle resources such as minerals, land are tapped which increases output and reduces resource underutilization.
15. **Promote economic growth due to increase in output.** They add to the productive capacity of the country due to the use of modern methods of production hence more goods and services are produced.

NEGATIVE ROLE OF PRIVATE FOREIGN INVESTMENTS IN LDCs.

- **They are accelerate capital outflow.** This is through profit repatriation by foreign investors which limits expanded investment in the domestic economy.
- **Worsen income inequality.** This is because, they employ few people who are highly paid and in most cases their own foreign manpower thus widened income gap.
- **They worsen unemployment problem.** This is due to preference of advanced capital intensive technology which replace human labour and use of foreign manpower thus limited employment creation.
- **Require excessive concessions/special fiscal incentives form the government** such as tax holidays, tax exemptions, subsidies which increases government expenditure and reduces benefits from such investments.
- **Lead to regional and sectoral imbalances in development.** They prefer to operate in urban areas with access to developed infrastructure and in few specific profitable sectors thus imbalances in development.
- **They out compete local firms** hence leading to closure of such firms and associated disadvantages. This is because they produce on a large scale and sell at low prices and out compete local firms which are still infant in nature.
- **Worsen economic dependence.** LDCs continue to rely on foreign investments from MDCs for resources, market, skilled labour and this discourages local initiatives.
- **Worsen rural urban migration and its disadvantages.** Most of the foreign businesses tend to locate in urban areas and attract people from rural areas leading to high crime rates in urban areas.
- **Worsen balance of payment problems.** This is because some resources are imported from other economies to facilitate production and they repatriate profits to their home countries thus high foreign exchange expenditure.
- **Lead to over/irrational exploitation of resources** leading to quick depletion of some key resources such as minerals, forests, water resources thus quick resource exhaustion.
- **They contribute to high social costs.** They establish large scale industries which pollute air, land and water thus environmental degradation.

UNEB 2000.

a) *Assess the contribution of foreign capital investment in the development of your country. (12 marks)*
b) *Examine the steps being taken to attract foreign investment in your country. (08 marks)*

UNEB 1998.

Assess the role of foreign capital investment in the development of your country. (20 marks)

ASSESSING THE IMPACT OF FOREIGN CAPITAL INVETSMENT IN UGANDA.

Positive impact of foreign capital investment (foreign capital) in Uganda.

- It closes savings-invetsment gap.
- Menas of technological transfer and development/closes technological gap.
- Creates employment opportunities.
- Fills skilled man power gap.
- Leads to increased output hence economic growth.
- Promotes development of local skills.
- Accelerates growth of industrial sector.
- Promotes development of infrastructure.
- Leads to efficiency of local firms through competition.
- Promotes international cooperation and mutual understanding between Uganda and other countries.
- Provides government tax revenue.
- Fills foreign exchange gap/increased inflow of foreign exchange.
- Increases production of a wide variety of goods and services which widens consumers choice.
- Increase utilization of domestic idle resources.
- Leads to production of better quality goods.

Negative impact of private foreign investment (foreign capital) in Uganda.

1. Leads to regional and sectoral imbalances in development.
2. Worsens unemployment problem.
3. Worsens income inequality.
4. Leads to over exploitation of resources hence quick depletion of resources.
5. Demands excessive concessions from government.
6. Worsens external dependence.
7. Increases capital outflow.
8. Local firms are out competed.

9. Worsens balance of payment problems.
10. Leads to high social costs.

UNNEB 2005.

i) What is meant by foreign direct investment. (01 marks)
ii) Mention any three merits of foreign direct investment in an economy. (03 marks)

UNEB 2012

Mention any two.

1. Factors that have influenced the level, (02 marks)
2. Benefits

Of foreign direct investment in your country. (02 marks)

FACTORS THAT INFLUENCE/AFFECT THE LEVEL OF FOREIGN DIRECT INVESTMENT IN AN ECONOMY (UGANDA).

- ❖ Level of external publicity of investment opportunities in the country.
- ❖ Economic climate/rate okf inflation.
- ❖ Degree of liberalization of the economy.
- ❖ Market size.
- ❖ Degree of bureaucracy.
- ❖ Level of bureaucracy.
- ❖ Level of accountability/corruption and embezzlement.
- ❖ Land tenure system.
- ❖ Techniques of production available.
- ❖ Size of existing capital stock.
- ❖ Availability of raw materials/natural resources base.
- ❖ Political atmosphere.
- ❖ Level of infrastructure development.
- ❖ Availability of investment incentives/government policy on investment.
- ❖ Availability of skilled manpower/labour skills.
- ❖ Level of entrepreneurial ability.

UNEB 1999.

i) What is meant by an investment multiplier. (01 marks)
ii) Give any three ways of attracting foreign investment in your country. (03 marks)

STEPS BEING TAKEN TO ATTRACT PRIVATE FOREIGN INVETSMENTS IN UGANDA.

The government of Uganda has endeavored to put in place a conducive and favourable investment plat form to attract numerous foreign investments in form of foreign commercial banks, foreign insurance companies, foreign investors in various industries/industrial expansion, multi-national corporations, hotel management and tourism, super markets, telecommunication services, foreign investors in education and mineral exploitation.

Currently some of the leading investments and large tax bases are owned by foreigners in Uganda.

The government is attracting and has attracted all these investments through employing the following policy measures.

- **Offering investment incentives to various foreign investors.** Tax holidays, tax exemptions, subsidies are being provided to foreign investors so as to attract them in large numbers.
- **Building improving infrastructure.** The government is rehabilitating and setting up roads, power supply projects so as to ease coordination of production and reduce transport costs and attract many foreign investors.
- **Ensuring political stability.** This is being done especially in rebel affected areas by holding peace talks with rebel leaders to ensure political stability throughout the country so as to ensure certainty for life and property among foreign investors.
- **Further liberalization of the economy.** More liberty is being given to private individuals to participate in economic activities and this is meant to attract more foreign investors.
- **Ensuring economic stability.** The government is trying as much as possible to stabilize prices by controlling inflation through relevant fiscal and monetary policies to stabilize the value of the currency and attract foreigners in investment.
- **Establishing and continuous funding of specialized institutions to encourage investments.** The government is setting up institutions such as the UIA to provide necessary guidance to foreign investors.
- **Carrying out international publicity/campaigns.** This is being done through advertising in foreign media to strengthen bi-lateral ties and make foreign investors get informed about existing investment opportunities in Uganda which attracts such investors.
- **Creation of a wider market.** The government is doing this through joining economic integration such as EAC, COMESA which expands market and attracts more foreign investors since they get assured of potential market.

- **Further privatization of public enterprises.** The government is encouraging privatization of public companies to attract foreign investments since most of these enterprises are bought by foreigners withenough capital.

CONSUMPTION

Consumption refers to use of part of income for the expenditure non final goods and services to satisfy human wants in a given time.

Consumption is therefore the use of available economic resources so as to satisfy an economic need.

Consumption function refers to the relationship between consumer's expenditure and the factors that influence these expenditures.

Consumption can either be autonomous consumption or induced consumption.

Autonomous consumption.

Autonomous consumption. Is consumption which does not depend on the level of income. Consumption is even at zero income where one consumes past savings or borrowed funds.

Induced consumption.

Induced consumption. Is consumption which depends on the level of income.

DETERMINANTS OF CONSUMPTION IN AN ECONOMY.

(Factors that influence/affect the level of consumption in an economy).

1. **Level of income among individuals.** High income level leads to high level of consumption while low income level leads to low level of consumption.
2. **Rate of interest on borrowed capital.** High interest rate on borrowed capital leads to low levels of consumption while low interest rate on borrowed capital increases the level of consumption.
3. **Level of taxation on income.** High direct taxes reduce consumption levels while low direct taxes lead to high level of consumption.
4. **Level of government expenditure.** High level of government expenditure leads to high level of consumption whereas low level of government expenditure leads to high level of consumption whereas low level of government expenditure leads to low level of consumption.
5. **Availability of credit facilitates such as hire purchase arrangement.** Presence of enough credit and hire purchase arrangements increase the

level of consumption while limited credit and hire purchase arrangements lead to low level of consumption.

6. **Nature of income distribution.** Fair distribution of income among individuals leads to high level of consumption while uneven distribution of income among individuals leads to low level of consumption.
7. **Attitude towards savings/level of savings.** Negative attitude of people towards savings leads to high level of consumption whereas positive attitude of people towards savings reduces the level of consumption.
8. **Expectation of future changes in price.** When price is expected to increase in near future, consumption increases in the present while in case price is expected to reduce in the near future, consumption reduces in the present.
9. **Size of the population and its structure.** Holding other factors constant,a large population size increases the level of consumption while a small population size leads to low level of consumption.
10. **Level of advertising in an economy.** High level of advertising through persuasive advertisements in an economy leads to high level of consumption while limited and informative advertisements lead to low level of consumption.
11. **Quantity of available consumer goods and services.** Large volume of goods and services in an economy leads to high level of consumption while limited quantity of goods and services in an economy leads to low level of consumption.
12. **General price level.** High general price level reduces the purchasing power of individuals hence low level of consumption while low general price level increases the purchasing power of individuals hence high level of consumption.
13. **Political climate.** Favourable political climate leads to high level of consumption whereas unfavourable political climate leads to low level of consumption.

CHAPTER 5: STRUCTURE OF UGANDA'S ECONOMY.

Structure of an economy refers to the basic features of a national economy in terms of pattern of production, output levels, ownership, control and organization of resources, the major sectors of the economy and their composition.

It seeks to describe the basic or outstanding characteristics of features of an economy.

UNEB 1998.

a) *Describe the structure of the economy of your country. (10 marks)*
b) *Examine the factors responsible for underdevelopment in your country. (10 marks)*

UNEB 2003.

Mention any four features of your country"s economy. (04 marks)

SALIENT FEATURES OF UGANDA'S ECONOMY.

NB. Qualifiers are necessary when giving your points and do not spzeculate.

- It is *predominantly* agricultural in nature in that the main economic activity carried out is agriculture which employs the largest percentage of labourforce either directly or indirectly and is a major foreign exchange earner.
- There is *a small but growing* industrial sector due to inadequate necessary industrial requirements. Most industries are smalls scale, medium and few large scale industries.
- It is a dual economy with examples of dualism such as rural and urban areas, subsistence production and monetary production, the rich and the poor, the elites and illiterates.
- It is *basically* a mixed economy with both public and private sector, although the current trend puts more emphasis on expansion of private sector because the government has adopted privatization and economic liberalization which has increased private participation in production.
- It is an open economy. Uganda participates in multi-lateral trade since it is involved in importation and exportation of different products involving various countries.
- It is *highly* a dependent economy. Uganda depends on other economies for trade, decisions and resources for her survival. This is reflected through direct economic dependence, trade dependence, sectoral dependence and external resource dependence.
- Labour force is *predominantly* unskilled and semi-skilled. This leads to limited entrepreneurial abilities which limits production levels.

- Most of the productive sectors mainly produce at excess capacity implying underutilization of resources. For instance the industrial sector and agricultural sector.
- It has high population growth rate relative to economic growth which reduces output and income percapita. This is attributed to various factors.
- There is a growing informal sector which brings together many traders on small scale basis such as shoe shiners, hair dressers, tailors, hawkers and carpenters, mechanics.
- There is generally low level of infrastructure development both economic and social due to inadequate resources. There are limited modern roads, banking institutions, recreational centres, power supply systems, health facilities and educational institutions are still poorly developed in most areas.
- There is generally wide spread unemployment and underemployment of labour. Many people are not employed and even those who are employed are not fully exploiting their potentials.

KEY SECTORS IN THE UNGANDA'S ECONOMY.

A. THE AGRICULTURAL SECTOR.

Agriculture is a science which deals with the production of crops, rearing of animals and marketing their products. In Uganda, agriculture development involve the transformation of agricultural production from subsistence production to a highly commercialized production so as to increase agricultural production. Many people in Uganda derive their live hood directly and indirectly from this sector.

UNEB 2014

State any four features of the agricultural sector in your country. (04 marks)

UNEB 2009.

Mention any four features of the agricultural sector in your country. (04 marks)

STRUCTURE OF UGANDA'S AGRICULTURE SECTOR/FEATURES OF AGRICULTURAL SECTOR IN UGANDA.

NB. Qualifiers are necessary when giving your points and do not speculate.

- It is *predominantly* subsistence in nature since majority of producers grow crops for home consumption though the trend is changing to commercialized production.
- The sector *mainly* depends on nature and subject to diminishing returns Output level is mainly determined by natural factors such as soil fertility, climate with limited control over such factors.

- It is *mainly* done on small scale and most farms exist on small scale peasant holdings though there are few large scale farms owned by foreigners.
- It is *dominated* by use of rudimentary tools such as pangas, hoes and this makes land and labour less productive. It uses basically labour intensive technology.
- It *mainly* produces low quality output due to limited technology and use of scientic methods on farm activities.
- It *mainly* employs semi skilled and unskilled labour which is considred to be relatively cheap.
- The sector is *basically* rural based because land and labour in rural areas are relatively cheaper.
- *Mainly* dependent on a few export crops since production is mainly for domestic market.
- Production is *mainly* composed of food stuffs and there is a narrow range of cash crops such as coffee, tea, cotton and tobacco.
- It *dominated* by use of family labour where women play a crucial role especially in food sub sector production and a few men in cash crop production and livestock. Most of the farm requirements are met by use of family labour.

ROLE/POSITIVE IMPLICATIONS OF SUCH AGRICULTURAL SECTOR.

- **Provision of food to the rapidly growing population.** This is because agriculture is dominated by food crops which ensures food security and this keeps the population healthy and productive.
- **Provides employment opportunities.** Agriculture employs the largest percentage of the population especially semi-skilled and unskilled labour either directly or indirectly which reduces unemployment especially in rural areas.
- **Generates foreign exchange to the country.** Agriculture is the major forex earner to the country since it dominates export trade through exportation of major cash crops such as coffee, cotton, and maize thus increased forex earnings. This is essential for importation of capital goods.
- **Supplies raw materials to agro based industries at relatively low prices/promotes industrial development.** Such as sugar production industries, teas processing, grain milling, textile mills, cotton ginning and coffee hulling thus industrial development.
- **Generates government tax revenue.** Majority of people are employed in agriculture directly and indirectly and are therefore taxed to finance government expenditure.
- **Ensures equitable income distribution/reduces income inequality.** Agriculture absorbs majority of people who are not taken up by other sectors and due to the fact that it is more labour intensive.

- **Reduces rural urban migration and it disadvantages**. This is due to the fact that, it is being carried out mainly in rural areas and therefore absorbs rural population.
- **Encourages rapid development of infrastructure.** Since it is mainly carried out in rural areas, it facilitates establishment of infrastructure such as roads, power supply, railways, banking institutions for rural development and transformation.
- **Contributes greatly to gross domestic product.** Agriculture contributes greatly to total GNP since it forms major exports and dominates production.
- **Provides market to industrial goods.** For instance hoes, fertilizers, machinery thus growth and expansion of the industrial sector.
- **Promotes balanced regional development.** His is because it is carried out almost in every region thus simultaneous development of all regions.

PROBLEMS FACED BY AGRICULTURAL SECTOR IN UGANDA.

1. **Natural hazards/unfavourable natural factors.** These include drought, floods, torrential rains, crop pests and diseases which reduce agricultural output and because of such risks and uncertainties, most insurance companies are not willing to insure agricultural risks.
2. **Price fluctuations for agricultural products.** Prices of agricultural output both on the international market and domestic market are not stable because of dependence on natural factors, high unplanned output and competition from artificial fibres which discourages farmers.
3. **Limited market for agricultural products.** The domestic market is not enough and the foreign market is flooded due to competition from artificial fibres which discourages farmers.
4. **Limited agricultural research facilities.** Research in agriculture is inadequate and this limits improvement in quality of output, expanding market and limits introduction of new crop and animal varieties.
5. **Inadequate capital.** Agriculture is carried mainly by peasants who do not have necessary capital to purchase required technology and improve production and a small percentage of the national budget is normally allocated to agriculture which limits large scale agricultural production.
6. **Under developed infrastructure.** The road network, railway net work especially in rural areas are limited and in poor state which makes it difficult to connect agricultural productive areas to market areas.
7. **Poor land tenure system.** Majority of agricultural producers are squatters on land and in other areas land is communally owned which reduces initiatives to increase agricultural production.

8. **High level of conservation among some farmers.** High attachment to social cultural factors makes farmers resist changes meant to improve agriculture is in most cases left for women which limits agricultural modernization.
9. **Low level of technology.** There is mainly use of rudimentary tools such as pangas, hoes which yield low quality output and of limited quantity.
10. **Limited skilled man power.** The sector mainly employs un-skilled and semi skilled labour who are less efficient and productive leading to low agricultural output.
11. **Political instability in some areas.** Political unrest in some areas limits farmers from settling down for serious agricultural production leading to low output.
12. **Rapid growing population.** Agricultural land is increasingly becoming scarce, land wrangles are rampant which has increased land fragmentation thus low agricultural output is realized.

UNEB 2011.

a) *Explain the role of agriculture in the development of an economy. (10 marks)*
b) *What measures can be done to improve agricultural sector in an economy. (10 marks)*

STEPS BEING TAKEN TO IMPROVE AGRICULTURAL SECTOR IN UGANDA.

The government is trying to improve the performance of agriculture through plan for modernization of agriculture aimed at eradicating poverty by transforming agriculture from subsistence production to commercial agriculture and is aiming at implementing several reforms in agriculture.

- **Establishing agro-based industries/industrialization within the agricultural sector.** This is being done in order to add value to agricultural products so as to fetch high prices especially on the international market.
- **Adopting land reform policies.** The government is putting m emphasis on redistributing land from absent landlords and rich owners of large expanses of land to people who need to use it for agriculture thus increasing agricultural output.
- **Diversifying markets for agricultural products/market expansion.** The government is increasing market for agricultural output through joining regional groupings such as the EAC, COMESA and discouraging importation of agricultural products similar to what is locally produced together with liberalization of agricultural export markets.

- **Developing and improving infrastructure.** Existing roads are being upgraded and feeder roads are being established in order to ease the transportation of agricultural products to market centres, transportation of agricultural inputs and rural electrification is being promoted.
- **Providing credit facilities to low income farmers.** The government is encouraging the establishment of financial institutions in rural areas for instance SACCOS and micro finance institutions so as to avail credit to farmers for agricultural production.
- **Promoting mechanization of agriculture.** The government is implementing the plan for modernization of agriculture through setting up irrigation schemes, agricultural mechanization to increase output by availing farmers with tractors, ox-ploughs to increase agricultural production.
- **Diversifying agricultural sector.** The government is encouraging the production of variety of crops and rearing of animals through NAADS programme to reduce dependence on a few agricultural crops and problem of price fluctuations.
- Stabilizing political climate. The government is holding peace talks with rebel groups in affected areas to ensure certainty for life and property and enable people effectively carryout agriculture.
- **Carrying out research within their agricultural sector.** Research is being carried out to improve on quality of products in agriculture, introduce new crop and animal varieties. For instance introducing of new crop and animal varieties by NARO and ensuring participation of all stake holders, Entebbe research centre for animal veterinary, Kawanda research centre.
- **Training of labour reforming education system.** The government is promoting the teaching of agriculture in schools and tertiary institutions to empower students with farming skills and create practical agricultural practioners so as to change the negative attitude of people towards agriculture.
- **Improving extension services to farmers.** This is being operated at various levels through NAADS programme where extension officers normally conduct demonstration farms, education to farmers on better crop varieties, proper farming methods and the use of fertilizers. There are extension workers at any sub country aimed at bringing agricultural extension services near to farmers.
- **Encouraging development/revival of co-operatives.** For instance Uganda national farmers association and joining cooperatives through Uganda cooperative alliance and this ensures joint marketing and storage of agricultural products. This helps to stabilize prices hence high agricultural returns.

- **Provision of inputs to farmers at subsidized rates**. This is being done in order to encourage production at a low cost and attract several agriculturalists.
- **Improving pricing policies.** This is done through strengthening international commodity agreements which encourages increased production among farmers.

MECHANIZATION OF AGRICULTURE.

Mechanization of agriculture refers to extensive introduction of machinery in agriculture (farm production activities) thus resulting into reduced labour input per given level of output. It involves mainly use of capital intensive techniques of production in agricultural activities such as tractors, combine harvesters and ox-ploughs.

It is mainly used in large scale farms.

Advantages of agricultural mechanization.

- Increases output since it makes farmers cultivate more land. It increases productivity of labour.
- Improves the quality of agricultural output through mechanized planting, harvesting and spraying.
- Simplifies farming activities by making it easier and less tiresome.
- Increases the size ofland under cultivation hence reducing excess capacity in agriculture.
- Increases acquisition of skills by farmers who are trained to use machines.
- Reduces costs in terms of supervision of labour.
- Appropriate to climate changes in agriculture. For example in dry areas, it can still be applicable.
- Encourages the development of rural infrastructure.
- Very helpful where labour is scarce.
- Promotes agricultural research hence inventions and innovations in agriculture.

UNEB 2008

Mention any four factors that limit agricultural mechanization in your country. (04 marks)

FACTORS THAT LIMIT AGRICULTURAL MECHANIZATION IN UGANDA.

- Inadequate capital among farmers.
- Limited technical man power to handle machines so as to maintain them in good state.
- Conservation among some farmers.
- Poor land tenure system.

- Limited market for agricultural output.
- Unfavourable natural factors such as rugged topography.
- Under developed infrastructure.
- Unstable and low agricultural price.
- Political instability in some areas.
- Corruption and embezzlement of funds meant for agricultural mechanization.
- Limited entrepreneurial skills.

Subsistence Agriculture.

Subsistence agriculture refers to agricultural production mainly for farmers own consumption. It involves production of mainly food crops to meet the requirements of the farmer.

It is characterized by.

- Family labour is mainly used.
- Production is mainly on a small scale.
- It uses mainly poor techniques of production.
- Quality of output is generally low.
- Limited specialization in production.
- Low productivity is generally realized.

Why is it necessary to reduce dominance of subsistence agriculture in an economy.

- To reduce income inequalities.
- To widen the tax base.
- To accelerate the process of rural transformation.
- To expand market for industrial output.
- To encourage more innovations and creativity in production.
- To increase productivity and reduce production at excess capacity.
- To encourage monetization of the economy.
- To improve the quality of agricultural output.
- To create more employment opportunities.
- To increase supply of raw materials to agro based industries.

Commercial Agriculture.

Commercial agriculture is agricultural production which is basically meant for market. It is carried out a large scale but in most developing countries, it is still generally on a small scale compared to developed countries.

It refers to promotion of agricultural production mainly for the market. It involves use of modern tools, use of modern tools, use of wage labour, improvement of land, use of improved crop and animal varieties. In Uganda it is limited by-

- Limited capital among farmers.
- Land fragmentation.
- Poor land tenure system.
- Poor political climate.
- High level of conservation among farmers.
- Underdeveloped infrastructure.
- Inappropriate education system in relation to agriculture.
- Limited use of mechanization practices.

AGRICULTURAL DIVERSIFICATION

Agricultural diversification is the creation of a wide range of economic activities in agricultural sector to avoid relying on few activities in order to produce variety of agricultural output.

Or

It refers to attendance of widening the scope of production activities within the agricultural sector. For instance producing a variety of crops and rearing many animals.

AGRICULTURAL MODERNIZATION

Agricultural modernization. Is the process of changing the agricultural sector from subsistence production to a commercialized high yielding sector.

Or

This refers to the process of changing agriculture from traditional subsistence production to modern commercial production aimed at increasing both quality and quantity of output.

It has been embarked on in Uganda as a macroeconomic agricultural plan known as plan for modernization of agriculture (PMA).

PMA is meant to eradicate poverty and improve people"s livelihood through raising farm productivity on a sustainable level. It aims at introducing technological changes throughout the agricultural sector.

UNEB 2008.

i) Define the term agricultural modernization. (01 marks)
ii) Mention any three methods of agricultural modernization. (03 marks)

METHODS OF AGRICULTURAL MODERNIZATION.

- Rehabilitation and extension of necessary infrastructure in different places.
- Undertaking land reforms to increase productivity.
- Diversification of agriculture.

- ❖ Provision of favourable credit facilities to farmers.
- ❖ Carrying out agricultural research.
- ❖ Provision of inputs to farmers at a subsidized price.
- ❖ Providing extension services and setting up demonstration farms.
- ❖ Mechanization of agriculture.
- ❖ Industrialization in order to increase on quality of output.
- ❖ Ensuring better marketing systems.

UNEB 2010

a) *What is meant by the term "agricultural modernization. (04 marks)*
b) *Explain the factors limiting agricultural modernization in your country. (16 marks)*

LIMITATIONS OF AGRICULTURAL MODERNIZATION IN UGANDA.

1. **Limited market size for agricultural products.** The market for agricultural output is limited both internally and externally which discourages large scale agricultural production through the use of machinery.
2. **Limited supply of capital/low incomes.** Many farmers have low incomes and are unable to raise enough capital and purchase agricultural inputs to increase agricultural production.
3. **Inadequate skilled labour.** Agricultural engineers and extension workers are not enough and most farmers are unskilled thus low quality and quantity of agricultural output.
4. **Price fluctuations of agricultural products/low prices of the products.** prices of agricultural products are never stable both in the domestic market and foreign market which reduces monetary returns for reinvestment in the sector and discourages farmers.
5. **Conservatism of some farmers.** Certain tribes still maintain tieswith their traditional crops and animals and are reluctant to adopt new and high yielding animal and crop varieties which keeps production on a subsistence level.
6. **Unfavourable natural factors/ natural hazards.** These are in form of crop pests and diseases, unpredictable climatic conditions which reduce agricultural output.
7. **Poor land tenure system.** Large expenses of land belong to few individuals who are not willing to use it for agriculture which limits free use of land for increased agricultural output.
8. **Poor infrastructure.** Road network, railway network is not modernized especially in rural areas which limits transportation of agricultural output to market centres and agricultural inputs to areas of production which limits large scale agricultural production.

9. **Political instability in some areas.** Poor political climate in some areas discourages large scale agricultural production because of increased uncertainty for life and property among farmers.
10. **Poor techniques of production/low level of technology.** Agriculture is dominated by use of rudimentary tools such as hand hoes, axes, pangas, such low level of technology leads to small scale agricultural production.
11. **Low levels of accountability.** Rampant corruption and embezzlement of funds meant for agricultural modernization by policy makers and implementers limits the necessary changes in the sector for agricultural modernization.
12. **Unfavourable topography.** This is in form of rugged relief which limits use of machinery in production thus low output.
13. **Limited entrepreneurship skills.** This limits proper organization of other factors of production leading to limited output.

UNEB 2007.

Mention any four features of industrial sector in your country. (04 marks)

B. THE INDUSTRIAL SECTOR.

Industrialization is the process of transforming raw materials with the aid of human resources and capital goods into consumer goods and new capital goods. The industrial sector in Uganda is generally small but growing at a steady rate.

UNEB 2008.

a) *Describe the structure of industrial sector in your country. (06 marks)*
b) *Examine the factors that have influenced the development of the industrial sector in your country. (14 marks)*

UNEB 2011.

a) *Describe the features of the industrial sector in your country. (10 marks)*
b) *Explain the measures being taken to improve the industrial sector in your country. (10 marks)*

STRUCTURE OF INDUSTRIAL SECTOR IN UGANDA/MAJOR FEATURES INDUSTRIAL SECTOR IN UGANDA.

NB. Qualifiers are very important but do not speculate and do not use ambiguous and generalized responses.

1. It is *dominated* by small scale industries and a few medium scale industries thus employing very few people.
2. It *mainly* comprises of processing industries such as coffee processing and tea processing, sugar and cement processing industries.
3. *Most* small scale industries are privately owned by local entrepreneurs and large scale industries are mainly owned by foreigners such as steel industries, brewing industries and soft drinks industries.
4. *Many* industries are agro based such as dairy industries, grain milling, sugar processing, tea processing and coffee processing.
5. The sector is *basically* urban based in towns such as Kampala, Mukono, Jinja, Mbale, Tororo, Hoima and Mbarara.
6. Production is *mainly* of low quality manufactured goods because of employing poor technology.
7. Industries *mainly* produce consumer goods such as sugar, edible oil, dairy products, bread, soft drinks and beverages.
8. It is *dominated* by import substitution industries and therefore production is largely for local market such as beverages industries and sugar processing industries, soft drinks industries.
9. It *basically* depends on imported raw materials and intermediate inputs which are used in processing and manufacturing industries.
10. *Mainly* uses labour intensive techniques of production except few large scale industries where capital intensive technology is employed.
11. The sector has limited linkages with other sectors of the economy.
12. Industries *mainly* produce at excess capacity and therefore the sectors contribution to GDP is low due to limited power supply, limited entrepreneur skills and inadequate market.
13. Many industries *mainly* use unskilled and semi skilled labour.
14. Durable consumer goods industries are mostly assembling plants. For instance different parts of vehicles are imported and assembled from Uganda.

FACTORS THAT HAVE INFLUENCED THE DEVELOPMENT OF THE INDUSTRIAL SECTOR IN YOUR COUNTRY.

NB. Have/has/is can be used in explanation for such a question but do not speculate.

Neutral points must be presented and explained in two sides showing a positive part which favours industrial development and a negative part which limits industrial development.

1. **Government policy on industrial development.** Favourable government policies on industries such as subsidization, fair taxes have encouraged development of industries while unfavourable government policies on some industries such as heavy taxes have limited industrial development.
2. **Availability of land for expansion.** Presence of enough land is in some areas has encouraged ion has limited the development of industries.
3. **Level of technology.** High level of technology through the use of capital intensive technology especially in urban foreign owned industries has increased industrial development whereas low level of technology through the use of poor and labour intensive technology has limited the growth of some industries.
4. **Level of accountability.** Proper accountability in some industrial firms has encouraged development of such industries whereas corruption and embezzlement in some industries has limited industrial development.
5. **Size and quality of labour force.** Presence of enough labourforce and of high quality skills for some industries has encouraged industrial development while limited labourforce for some industries has limited industrial development.
6. **Amount of capital.** Presence of enough capital has encouraged the growth of some industries while limited capital has limited the development of some industries.
7. **Level of economic stability.** High level of economic instability in form of persistent inflation has limited the development of industries whereas low level of economic instability has encouraged the development of industries.
8. **Political climate.** Politically stable areas have encouraged industrial development while industrial development has been discouraged in politically unstable areas.
9. **Level of infrastructure development.** High level of infrastructure in terms of roads, railways, power supply have increased the level of industrial development whereas underdeveloped infrastructure has discouraged industrial development.
10. **Size of market for output.** A big market size for industrial output ha encouraged the growth of some industries while a small market size ,for industrial output has discouraged the development of some industries.
11. **Supply level of raw materials.** High supply of raw materials for industries has encouraged zthe development of some industries while limited in some has discouraged their development.

UNEB 2005.

a) *Describe the features of the industrial sector in your country. (10 marks)*
b) *What are problems faced by the industrial sector in your country. (10 marks)*

CONSTRAINTS TO INDUSTRIAL DEVELOPMENT\PROBLEMS FACED BY INDUSTRIAL SECTOR IN YOUR .

1. **Weak entrepreneur skills.** Most investors in the sector have limited initiative and leadership skillsand are not able to organize other factors of production for increased production and this leads to collapse of already established industries
2. **High taxes imposed on industries.** These increase production costs and reduce profitability hence a distinctive to industrialists since it reduces profits.
3. **Poor land tenure system.** This leaves ownership of land to a few a few people who cannot effectively exploit it for industrial expansion for instances there is shortage of industrial land in Kampala and Mukono which limits industrial expansion
4. **Limited skilled man power.** There are few accountants and industrial managers available for employment and therefore dependence on expatriates who are very costly.
5. **Inadequate market size.** The domestic market faces stiff competition from high quality imported commodities and foreign marketsis highly competitive because L D Cs produce similar commodities.
6. **Poor infrastructure.** This is in form of limited telecommunications facilities, banking facilities and poor roads and railway net work which makes transportation of factor inputs and industrial products difficult.
7. **Limited capital stock.** There is inadequate supply of real and monetary capital and therefore firms are forced to produce at excess capacity because industries require heavy capital investment thus low capital accumulation.
8. **Low levels of technology.** There is heavy dependence on imported expensive technology which limits industrial expansion and this is worsened by constant industrial breakdown which limits industrial growth.
9. **Political instability in some areas.** Political unrest in some areas discourages producers from setting more industries and destroys the existing industries thus discouraging investors in the sector.
10. **Poor performance of agricultural sector.** Agriculture is the main source of raw materials for industries but because of uncontrollable natural factors, it continues to perform poorly thus unreliable supply of raw materials to industrial sector especially agro based industries.
11. **Stiff competition from foreign goods.** There is increased importation of high quality commodities because of high marginal propensity to import which discourages large scale industrial production.

MEASURES BEING TAKEN TO IMPROVE ON THE PERFORMANCE OF INDUSTRIAL SECTOR IN UGANDA.

The government is campaigning for an internationally competitive, variable and strong industrial sector through the following ways;

- **Ensuring economic stability to stabilize prices.** This is being done through the use of relevant monetary policies so as to give confidence to industrialists about future prices. This is through fighting inflation and stabilizing interest rates to encourage production at a low cost.
- **Adopting land reform policies.** The government is redistributing the land to potential industrialists to create more room for industrial activities hence leading to setting up of various industries.
- **Developing necessary infrastructure.** New roads are being constructed and the existing ones rehabilitated to ease the transportation of industrial inputs and final products, power supply projects thus increased industrial production.
- **Widening market for output.** The government is joining economic groupings to increase market for manufactured products through EAC, COMESA so as to reduce on trade barriers and expand market for industrial output to attract more industrialists.
- **Provision of investment incentives to industrialists.** The government is giving subsidies to both local and foreign industrialists, tax exemptions and holidays thus attracting more investors in the sector. For instance removal of sales tax to avoid double taxation.
- **Further liberalization of the economy.** The government is removing all unnecessary controls and barriers on trade to free trade so as to encourage people to set up industries. For instance liberalization of foreign exchange markets to enable industrialists acquire foreign currencies easily.
- **Further privatization of public enterprises.** This is being done so as to enhance effective performance of the industrial sector by attracting more private investors into the industrial sector.
- **Vocationalising education to equip labour with skills.** Educational policy aimed at equipping labour with industrial skills is being promoted through skills oriented educational programmes through, practical subjects and providing on job training to local labour to enhance effective performance of industrial sector.
- **Setting up specialized institutions to encourage investment.** Institutions such as UIA are being established so as to give direction and information to both local and foreign industrialists thus promoting industrial growth.
- **Stabilizing political climate.** The government is continuously putting more emphasis on political stability by equipping security agencies, holding peace talks with rebel groups to ensure security throughout the country and this is a pre-requisites for industrial development.

- **Modernization of agriculture (developing cheaper sources fo supply of raw materials).** The government is putting more emphasis on agricultural development through plan for modernization of agriculture in order to ensure constant supply of raw materials to agro based industries and production at low costs thus expansion of the industrial sector.
- **Improving technology/techniques of production.** This is being d through technology transfer, development andindustrial research to stimulate industrial growth by improving the quality and quantity of output.
- **Improving entrepreneurial skills.** Investors are being equipped wi organizational skills through training in various workshops on enterprise growth. Promoting entrepreneurship education thus attracting more investors in the sector.
- **Fighting corruption and embezzlement in allocation.**Misuse of resources by policy makers and plan implementers is being fought using relevant organs such as police and anti-corruption units so as to attract more industrialists.
- **International publicity campaigns to attract industrial in** The government is extensively advertising in foreign mass media by showing the various industrial investment opportunities available in the country to attract more foreigners in the sector.
- **Provision of affordable credit/capital for industrialization.** This is being done so as to attract many investors in the sector due to increased accessibility to credit.

ECONOMIC DUALISM IN UGANDA'S ECONOMY.

Economic dualism is where there is co-existence of two contrasting socio-economic situations/conditions with one being superior and desirable and another being inferior and undesirable.

A dual economy is the one where there is co-existence of two contrasting sectors one being desirable and another one undesirable.

It means that one sector is advanced, modern, desirable, superior while the other is traditional, backward, inferior, or undesirable.

UNEB 2014

(i) *What is adual economy?* *(01 mark)*
(ii) *State any three advantages of a dual economy.* *(03 marks)*

UNEB 2007.

i) *What is meant by the term dual economy.* *(01 mark)*
ii) *Mention any three features of a dual economy.* *(03 marks)*

UNEB 2005, 2003, 2001.

State any four features of dualism in your country. *(04 marks)*

UNEB 2012.

Mention any four features of dualism in your country. (04 marks)

EXAMPLES OF ECONOMIC DUALISM.

- Mordern technology versus rudimentary technology.
- Extremly rich versus very poor people.
- Commercial production versus subsistence production.
- Rural areas versus urban areas Developed regions versus undeveloped regions.
- Formal sector versus informal sector.
- Bater trade versus monetary trade Ellites versus illiterates.
- More developed countries versus less developed countries.
- Small scale production versus large scale production.

CAUSES OF DUALISM IN UGANDA.

- Concentration foreign investments in specific areas and sectors of interest especially in major urbarn centers.
- Un even distribution of social economic infrastructure.
- Importation of social economic infrastructure.
- Uneven natural resource endowement.
- Demonstration effect on consumption in developing countries.
- Comperative advantage theory which ties L D Cs to primary products.
- Unfavourable policies of taxation.
- Rapid population growth rate.
- Emergency of monopoly and oligopolistic firms in production.

PROBLEMS/DEMERITS OF ECONOMIC DUALISM IN DEVELOPING COUNTRIES.

- Leads to rural urbarn migration.
- Creates imbalance in development.
- Results in to un even distribution of income.
- Leads to under utelisation of resouses in the traditional sectors.
- Results in unemproyment such as technological unemployement.
- Reduces government tax revenue due to reduced taxable capacity.
- Reduces aggregate demand for goods and services.
- Creates social conflicts\un rest between the poor and the rich.
- Makes government economic planning difficult because of divergent sectors.
- Leads to mis allocation of resources to cater for then inferior sectos.
- Leads to domination and exploitation LDCs by MDCs.
- Retards the rate of economic growth especially by the inferior sectors.

THE INFORMAL SECTOR.

An informal sector refers to an immediate sector that exists between the modern sector and the traditional sector or back ward sector.

This is a sector which is midway between the traditional subsistances sector and modern monetary sector.

Its is a sub urban sector made up of small scale individually operated business with l;imited formal book keeping and out side direct government control. For insitance shoe shiners petty retail trade,tax drivers,tailors,local distillers, capenters and hawkers.

UNEB 2009, 2006.

i) *Define the term informal sector.* *(01 marks)*
ii) *State any three features of informal sector.* *(03 marks)*

UNEB 2011.

Mention any three features of an informal sector. *(04 marks)*

UNEB 2015

State four characteristics of the formal sector in your country. (04 marks)

CHARACTERISTICS OR FEATURES OF AN INFORMAL SECTOR.

NB. Qualifies are necessary when giving your points

- Its *dorminated* by small scale firms which are individually owned.
- Production is *mainly* for domestic market.
- It uses *mainly* simple production technicques which are labour intensive.
- It produces *mainly* consumer goods.
- It *mainly* uses locally available inputs or raw materials.
- Limmited accounting procedures such as formal book keeping and record management.
- Its *mainly* sub urbarn and urbarn based.
- Limmited government control over the activities carried out in the sector.
- *Mainly* low quantiy of out put is produced by firms ie .there is genellary low productivity.
- *Dominated* by sole prpprietorships.
- Its *mainly* dominated by unskilled and semi skilled labour.
- *Mainly* produces low quality goods.

UNEB 2000.

a) *What are the features of an informal sector. (04 marks)*
b) *Assess the contribution of the informal sector to your country (16 marks)*

UNEB 2000.

a) *What are the features of an informal sector. (04 marks)*
b) *Asses the contribution of the informal sector to your country. (16 marks)*

UNEB 2003, 2001.

What is the role of the informal sector to your country (04 marks)

ROLE OF INFORMAL SECTOR IN AN ECONOMY.

Positive role of the informal sector in an economy.

1. **Creation of employment opportunities.** This is because it mainly uses labour intensive technology where both semi skilled an un skilled labour is absorbed thus reducing unemployment.
2. **Widens consumers choice.** There is awide range of activities carried out in the sector hence increased diversification. It reduces awide variety of commodities from where the consumers chooses.
3. **Promotes technological development or increases innovation and invention.** The sector is dormited by small scale firms and thi creates comperative production which are innorvative.
4. **Promotes fair distribution of income.** Since it mainily uses semi skilled and un skilled labour and majority participate in production, it fairy distributes income
5. **Promotes commercialization of the economy.** It produces mainily for market which helps to reduce the subisistance sector.
6. **Contributes tax revenue to the government to some extent.** The diverse economic activities carried out in the sector are taxed by the government thus increasing government tax revenue.
7. **Promotes acquisition of entrepreneur skills.** Individual sole proprietors are able to organize factors of production to ensure that their business performs successfully thus acts as training ground for managers in acquisition of entre prenuer skills.
8. **Facilitates exploitation of local resources.** It largely depends on locally inputs and this increases output and exploitation of domestic resources such as minerals, forests, water.
9. **Provides cheap training ground for local labour.** Since the sector employs mainly semi skilled and un skilled labour there is on job training which enhances skill acquisition.

10. **Reduces capital out flow.** The sector uses local inputs and spends less on imported low materials and it is operated mainly by nationals thus reduced profit repatriation.
11. **Facilitates production of locally affordable goods.** The sector mainly uses local inputs and production costs are therefore low leading to low priced output leading to increased consumer welfare.
12. **Increases the level of GDP.** The sector contributes to increase in the level of output thus increase in the Gross Domestic Product

Negative role of the informal sector in an economy.

1) **Leads to congestion in sub urban areas.** It attracts many people in the sub urban areas since its activities are normally concentrated in towns.
2) **Causes high social costs in sub urban areas.** This leads to pollution and its negative effects on the environment thus high government expenditure. The small scale industries pollute air, land, and water through their activities.
3) **Creates wasteful competition and duplication of resources.** This is through excessive advertisement by individual firms leading to resource wastage.
4) **Promotes production of poor quality output.** The use of semi skilled and un skilled labour and low technology are associated with output of low quality.
5) **Leads to high administrative costs.** The government incurs high costs to maintain effective performance of the sector in regulating and monitoring its activities. For instance setting up the required infrastructure and providing security.
6) **Less government revenue or fluctuation in the government revenue.** This is due to the limited record keeping, un registered business the high rate of tax evasion and avoidance in the sector..
7) **Produces at excess capacity leading to under utilization of the available resources.** This implies low level of output.
8) **Leads to under employment and disguised unemployment.** This is because most activities are on asmall scale with the sector.

PROBLEMS FACED BY THE INFORMAL SECTOR IN UGANDA.

1. **Inadequate capital.** Owners of businesses in the sector have limited access to finance due to lack of collateral security and this limits business expansion.
2. **Interruption from the government.** Town inspectors interfere with their activities. For instance chasing town vendors from streets.
3. **Limited market size.** This is due to the stiff competition between producers of similar products which limits expansion of the business.

4. **Poor management of the business.** Majority of the operators in the sector are not well versed with modern business management skills thus frequent closure of the business.
5. **Low level of technology.** Industries mainly use simple technology leading to low quality output which can compete favourably with imported similar products in the domestic market.
6. **Limited entrepreneurial skills.** Most owners of the business in the sector do not have skills to organize other factors of production beyond their first year of operation thus limited business expiation.
7. **Under developed infrastructure.** The productive infrastructure required to support the growth and expansion is limited for instance under developed roads and power supply.
8. **Shortage of basic raw materials.** Since they are competed for by several firms. This limits the ability of business to expand.
9. **Un stable prices or inflation.** Persistent increase in the general price leads to loss of money value and this reduces profitability of the business and business expansion as well.
10. **High costs of doing the business.** This is inform high rent,cost of trade license in sub urban areas thus discouraging business operators.

UNEB 2009.

i) *Distinguish between economic dependence and interdependence. (02 marks)*
ii) *State two forms of economic dependence in your country. (02 marks)*

ECONOMIC DEPENDENCE

Economic dependence is the reliance of an economy on another or specific economic sectors for resources and economic decisions for her development or survival.

There is no any economy in the world that is self sufficient but the degree of dependence differs from country to country depending on the level of economic development.

UNEB 2007.

a) *In what ways is your country economically independent (10 marks)*
b) *What are the implicationsn of economic dependence in your country (10 marks)*

UNEB 2011.

i. *Differiatiate between economic dependence and economic interdependence. (02 marks)*
ii. *Give any two of economic dependence in your country. (02 marks)*

UNEB 2015

(i) What is meant by the term economic dependence? (01 marks)
(ii) Mention any three forms of economic dependence in your country. (03 marks)

WAYS IN WHICH UGANDA IS ECONOMICALLY DEPENDENT.

- **External resource dependence.** This is where an economy depends on external resources such as foreign capital foreign skills foreign entrepreneurs and foreign technology for her survival.
- **Direct economic dependence.** This is where decision making power on the direction of economic management are are undertaken by foreign governments and multinational corporations and international organizations ie dependence on foreign decisions such as world bank IMF play avery big role here.For instance policies such as privatization trade liberalization, rentrenhmentn are initiated here byIMF and the wold bank.
- **Sectoral dependence.** This where the country relies on a particular sector for most of its developmentactivities. For instance on agriculture as amajor source of foreign exchange.
- **Trade dependence.** This is where acountry relies on importation and exportation of apaticular commodities from or to other countries. It is involves awide range of imports and exports for both comsumer and capital goods to meet the market demand.

Trade dependence may be in form of export dependence on afew exports and in this case, Uganda depends on a few primary export crops such as coffee cotton tea tobacco as amajor source of foreign exchange. It is also in inform of import dependence where acountry relies on imports of both consumer and capital goods. Uganda imports awide range of veriety of commodities such as marchinary ,drugs, veichles clothes auto mobile and computers.

UNEB 2009.

i) Define the term economic dependence. (01 marks)
ii) Give three effects of economic dependence in an economy 03 marks

NEGATIVE EFFECTS OR PROBLEMS OF ECONOMIC DEPENDENCE IN YOUR COUNTRY.

- **Worsens the balance of payement problem.** Since LDCs export primary products and import mainly expensive capital goods, theren is ahigh foreign expenditure.
- **Leads to under utilization of domestic resources.** A country relies on other countries for particular resources instead of utelising her domestic resources.
- **Discourages local initiatives and efforts or encourages laziness.** High foreign given to LDCs discourage or makes people in the reciepient coutry. This suppreses the development of localk skills and entrepreneurs.
- **Leads to heavy debt burden.** External debt crisis facing LDCs results directly from high external resource dependence.
- **Leads to erosion of social culture values.** The nativies adopt un desirable fporiegn values and beliefs leadin to culture erosion.
- **Subjects an economy to dumping for manufactured goods from donors.** This suffocates the domestic maket leading to collapse of infant industries.
- **Encourages capital out flow.** It leads to continuous loss of acontrys capital through debt servicing, Importationn of foreign goods and profit repatriation by foreign investors .
- **Leads to economic dormination by foreigners.** Since the economy depends on economic decisions made by donor agencies, it is unstable to carry uout independent decisions with out seeking approval from foreign donors.
- **Leads to political dormination by foreigners/loss of political independence.** Over reliance on other contries for decisions and resources erodes acountry of her politicalsoveriengnity and foreigners take politics of the country.
- **Leads to imported inflation.** Heavy importation increases chances of importing from infration hit economies because of un restricted inflow of imports.
- **Leads to unemployement of local man power.** This results from heavy importation of marchinary thus replacing human labour and excessive use of expertriats.
- **Leads to stagnant development of the local technology.** This limits technological development.
- **Discourages domestic savings and investment.** This is due to increased reliance on external resources.

UNEB 2004.

(i) *What is meant by the term economic dependence.* *(01 marks)*

(ii) *Suggest any three measures to reduce economic dependence in your country. (03 marks)*

MEASURES T0 REDUCE ECONOMIC DEPENDENCE IN YOUR COUNTRY OR IN LDCs.

1. **Diversification of the economy.** Various economic activities should be encouraged so as t0o increace the the volume of out put and reduce exports.
2. **Trainig of local labour force.** Local labour should be trained through on job trining so as reduce dependence opn expatriates from MDCs.
3. **Diversification of markets.** Local labour should be diversified through joining economic integration to reduce dangers of geographical concentration of trade.
4. **Encourage local savings and investments.** Domestic savings should be increased through financial istititions development to increace the financial base of the country and reduce on foreign capital.
5. **Promote development of local technology.** There should be use of appropriate technology so as to minimize dependence on foreign technology which is expensive.
6. **Ensure suitable patial and macro economic planning.** Relevant planning should be done so as to increase resource uitelisation and ensure consistent use of available resources so as to increase out put and minimize over reliance on imports.
7. **Improvement in political climate.** There is a need to ensure political stability to minimize capital out flow on impotation of fire arms and military hard ware and encourage large scale production at home.
8. **Promotion of local entreprenure skills.** Thisn should be done through relevant educational training to increase investment and reduce on over reliance on foreign investors.
9. **Promote import industrial substitution strategy.** Industries should be established in the domestic economiesn to reduce formerly imported commodities which reduce on the rate of importation.

UNEB 2006.

Give four demerits of economic dependence in your country (04 marks)

Demerits of economic dependence in Uganda.

- ✓ Increased capital flow.
- ✓ Stagnants development of local technology.
- ✓ Discourages domestic savings and investment.
- ✓ Increased persisitet balance of payement problems.
- ✓ Heavy external debt burden.
- ✓ Kills local initiative or encourages laziness.
- ✓ Increaseed economic dormination by foreigners.

- ✓ Increased political domination by foreigners or loss of political independence.

ECONOMIC INTERDEPENDENCE.

Economic interdependence is the situation in which two or more economies rely on each other for mutual benefits of all.

Or

It"s the mutual co existence between two or more economies where economies

Benefit equally from trade and other activities. This is only possible where trading countries are at the same level of development.

UNEB 2009.

a) *Describe the structure of exports in your country. (06 marks)*
b) *Suggest measures that should be taken to increase export earnings in your country. (14 marks)*

STRUCTURE OF UGANDA'S TRADE.

A. EXPORT SECTOR IN UGANDA.

The export sector is dominated by agricultural products and other semi finished products which make export volume and foreign exchange earning unpredictable.

Uganda"s exports are destined to COMESA region, European Union, Asia and east African countries.

Major exports of Uganda include- coffee, cotton, tea, cattle hides, flowers, fish and fish products, fruits, vanilla, textile fibres, live animals, timber dairy products, maize and electricity.

UNEB 2004.

Give any four features of Uganda"s export trade. (04 marks)

FEATURES OF EXPORT TRADE IN UGANDA/STRUCTURE OF UGANDA'S EXPORT TRADE.

NB. Qualifiers are necessary when giving your points.

- ✓ Exports are *mainly* agricultural products dominated by traditional crops such as coffee, cotton, tea and tobacco.
- ✓ Limited variety of exports/commodity concentration of trade.

- ✓ Exports are *basically* semi processed/low value added implying low value added on exports.
- ✓ Limited range of markets for export/geographical concentration of trade.
- ✓ *Mainly* poor quality goods are exported.
- ✓ *Mainly* fetch low prices which are ever fluctuating on the international markets.
- ✓ Few manufactured consumer goods are exported.
- ✓ Few services are exported.
- ✓ *Mainly l*ow volume of exports.

MEASURES THAT SHOULD BE UNDERTAKEN TO INCREASE EXPORT EARNINGS IN UGANDA.

1. **Diversification of export products.** Measures need to be put in place to have a variety of commodities for export and reduce commodity concentration of trade.
2. **Extensive advertising of commodities For export in the foreign markets.** This can be done by increased advertising in foreign media to increase demand for exports.
3. **Processing primary products to add value.** Value addition especially on agricultural products should be done through agro-based industries so as to increase prices for exports on the world market.
4. **Campaign for removal of trade barriers in exports market.** This increases the volume of exports thus increasing export earnings.
5. **Lowering costs of production.** This helps to increase competitiveness of exports on the world market thus increasing export earnings.
6. **Strengthening commodity agreements.** This stabilizes price on the world market thus increasing earnings from exports.
7. **Allowing the local currency to depreciate.** This increases demand for exports thus increasing foreign exchange earnings.
8. **Increasing the volume of exports by setting up export promotion industries.** Producing more for export market helps to increase export earnings.
9. **Diversification of export markets/joining economic integration.** This can be done through economic integration so as to increase export volume and reduce geographical concentration of trade.
10. **Establishment of export promotion institutions** such as Uganda export promotion board which is intended to encourage exports.
    Uganda export promotion board was created in 1996 by the act of parliament to promote and manage export industries.

B. IMPORT TRADE/SECTOR IN UGANDA.

Uganda is a net importerof commodities such as machinery, petroleum andits products, chemical materials,iron and steel. Office machines and automatic data processing machines, telecommunication and sound producing equipment, road vehicles , electronically machinery and appliances, paper and pulp, military hardware, human drugs, iron and steel, rubber manufacturers, essential oils, clothes and shoes.

FEATURES OF IMPORT TRADE IN UGANDA/STRUCTURE OF UGANDA'S IMPORT TRADE.

NB. Qualifiers are necessary when giving your points.

- ✓ Uganda *mainly* imports finished products such as petroleum products, pharmaceutical products and military hardware, machinery.
- ✓ Goods imported are *mainly* consumer goods and capital goods such as machinery.
- ✓ Importation of *basically* few services such as tourism, banking, insurance and telecommunication services.
- ✓ *Majority* of imports are highly priced.
- ✓ Imports are *mainly* of high quality.
- ✓ Importation of petroleum products *mainly* take the highest import share.
- ✓ Uganda *mainly* imports second hand commodities such as used vehicles, second hand clothes and bags.

MULTI-NATIONAL CORPORATIONS.

Multi-national corporations are international/transnational companies which have their headquarters in one country but with a variety of branches and areas of operation in a number of countries across the world *both developing and developed countries).

Examples are Philips, Shell, Coca-cola, Pepsi Cola, Barclays bank.

These multi- national corporations are playing a great role in spearheading economic growth and development in developing countries Uganda inclusive.

UNEB 2007.

Assess the impact of Multi-national Corporation in your country. (20 marks)

UNEB 2001.

a) What are multi-national corporations? (04 marks)
b) Assess the contributions of multi-national corporations to the development of your country. (16 marks)

POSITIVE CONTRIBUTIONS/IMPACT/ROLE OF MULTI-NATIONAL CORPORATIONS.

1. **Filling savings investment gap.** Multi-national corporations come with their capital hence supplementing the insufficient domestic savings.

2. **Closing the skilled man power gap**. They come with skilled labour to supplement what is locally available.
3. **Filling the skilled man power gap.** They come with skilled labour to supplement what is locally available.
4. **Create employment opportunities.** Labour gets employed in various projects set up by such corporations thus reducing unemployment.
5. **Source of government tax revenue.** This is through corporate taxation of investments carried out by such corporations and incomes of people employed in such investments thus increasing government revenue.
6. **They promote development of local skills.** They usually provide on job training and undertake labour training programmes in technical, scientific and managerial aspects. This promotes entrepreneurial skills for local people to start their own investments.
7. **Accelerate industrial growth.** They set up industrial firms such as steel and chemical plants, processing plants which stimulate industrialization and capital accumulation.
8. **Promote technological transfer and development.** Multi-national corporations come with advanced techniques of production especially capital intensive technology thus technological development.
9. **Encourage infrastructural development.** They facilitate the development of transport routes, bankingfacilities, power projects, telecommunication services and this is a sign of economic development.
10. **Increase competition in production between local firms and foreign firms.** This leads to efficiency of local firms and production of high quality output. They encourage innovations and inventions. This is due to extensive research carried out by competing multi-national corporations and local enterprises in production.
11. **Facilitate production of a wide variety of goods.** They deal in diversified activities hence a variety is produced which widens consumer‟s choice.
12. **Promotion of international cooperation and understanding between countries.** This is important for foreign aid and increased international trade.
13. **Increase local resource utilization.** The would be idle resources are tapped which increases output since such corporations have the capacity to exploit the resources which reduces resource underutilization.
14. **Facilitate economic growth due to increased output.** This leads to an increase in GDP. They add to the productive capacity of the country hence more goods and services are produced since they operate on a large scale.

NEGATIVE CONTRIBUTIONS/IMPACT/ROLE OF MULTINATIONAL CORPORATIONS IN DEVELOPING COUNTRIES.

1. **Accelerate capital outflow.** This is through profit repatriation thus limiting further investment. This worsens balance of payment problems due to increased foreign exchange expenditure.
2. **Worsen income inequality.** This is because multi-national corporations employ few people who are highly paid and get high income at the expense of others thus widened income inequality.
3. **They worsen unemployment problem.** This is due to preference of advanced capital intensive technology and limited local labour is employed.
4. **Require excessive concessions/special fiscal incentives from the government.** These are inform of tax holidays, tax exemptions which are very costly for the government.
5. **Lead to regional and sectoral imbalances in development.** They prefer to operate in urban areas and in few specific sectors thus imbalances in development.
6. **They out compete local firms.** This leads to their closure and associated disadvantages because the produce on a large scale.
7. **Worsen external dependence which discourages local initiatives.** Most developing countries rely heavily on such corporations and limited initiatives for development are undertaken at home.
8. **Contribute to political and economic domination by foreigners.** Large scale multi-national corporations interfere with the political decisions and economic decisions of the country thus limited national sovereignty.
9. **Contribute to over exploitation/irrational exploitation of resources.** This leads to quick depletion some key resources.
10. **Contribute to high social costs.** Negative externalities such as pollution increase due to large scale operations carried out by such corporations.
11. **Worsen rural urban migration and its disadvantages.** Most of these corporations tend to locate urban areas and attract people from rural areas thus high crime rates, congestion in urban areas.
12. **Contribute to erosion of cultural and moral values.** Developing countries copy undesirable culture beliefs such as modes of dressing which are socially undesirable.

PUBLIC SECTOR.

Public sector is that section of the economy where resources are publically owned and major economic activities are undertaken by the state.

UNEB 2004.

a) *What is a parastatal organization?* *(01 marks)*

b) *Give any three reasons for the poor performance of parastatal organizations in developing countries. (03 marks)*

PARASTATAL ORGANIZATIONS.

Parastatal organizations are statutory bodies set up by the act of parliament to carry out certain functions that may not necessarily be profit motivated.

Or

These are business organizations established by the act of government to carry out specific activities on behalf of the state. They qualify to do so if at least 51% of the shares are owned by the state.

They are managed by people appointed by the government unlike public corporations. For example Uganda Coffee Development Authority, National Social Security Fund,National Insurance Corporation, Uganda Revenue Authority, National Agricultural Research Organization, Uganda National Bureau of Standards, National Drug Authority, Uganda Wildlife Authority.

A Public Corporation.

A public corporation refers to a business enterprise/organization in which the government holds either all the shares or majority of its share capital.

It is established by an act of parliament which clearly defines its aims and objectives to run specific activities within the state.

For instance Uganda national waters and Sewerage Corporation, National Housing and Construction Corporation.

A Public Enterprise.

A public enterprise is a business organization/enterprise which is set up, controlled and owned by the government or the state.

UNEB 2014

a) *What is a parastatal organisation? (02 marks)*
b) *Describe the role of parastatal organisation in an economy. (18 marks)*

UNEB 2008.

i) *Distinguish between a private and a public enterprise. (02 marks)*
ii) *Give any two reasons for the establishement of public enterprises in your country. (02 marks)*

NEED FOR PARASTATAL ORGANIZATIONS /REASONS FOR ESTABLISHMENT OF PARASTATAL ORGANIZATIONS/PUBLIC ENTERPRISES IN UGANDA.

- To promote economic development.
- To avoid duplication in production and resource wastage.
- To provide essentials of life at fair prices such as water ,electricity and medical facilities.
- To ensure regional balance in development and reduce income inequality.
- To complement the private sector and reduce monopoly powers from the private sector.
- To protect consumers from exploitation and consumption of dangerous commodities by providing the services.
- To create sustainable employment opportunities.
- To promote investiment.
- To raise public revenue for national expenditure and development.
- To produce goods of strategic importance i.e undertake very sensitive and risky strategic ventures such as national security and mining.
- To ensure social security.
- To undertake large scale enterprises which cannot be managed by private investors.
- To provide goods and services which have low commercial profitability but having high socio/economic benefit.
- To mobilize savings.

UNEB 2010.

a) *What is a public corporation* *(04 marks)*
b) *Assess the role of public corporations in an economy* *(16 marks)*

UNEB 2013.

a) *Explain the contribution of public enterprises to the development of your country.* *(10 marks)*
b) *What are the problems faced by public enterprises in your country.(10 marks)*

POSITIVE ROLE OF PUBLIC ENTERPRISES/CORPORATIONS IN AN ECONOMY.

- **Provide essential services to the population at affordable prices** such as education, health, water, supply. This improves standard of living since such enterprises normally charge low prices for output.
- **Help in avoiding foreign domination of the economy/promote economic independence.** Presence of large public enterprises reduces

the strength of private sector thus reducing participation of foreigners in domestic economy thus reduced balance of payment problems.

- **They undertake strategic and risky projects/provide goods of strategic importance/investments of national importance.** Investment in strategic projects is effectively managed by public corporations.
- **Provide non profitable but essential goods and services such as garbage collection.** The private sector is not normally willing to provide such goods to benefit the entire population.
- **Source of revenue to the government.** This is through charging of fair prices for services rendered by public corporations.
- **Create substainable employement opportunities to the people.** They reduce un employement and ensure job security.
- **`They complement private sector hence controlling private monopoly and its evils.** Their activities helpn to supplement output produced by private thus reducing the dangers of private monopoly.
- **They ensure social security.** This reduces on uncertainity for life and property especially insurance companies.
- **Raise large capital and undertake large scale business operations** which private firms cannot easily manage.
- **Promote the level of investiment thus economic growth.** This is because are development oriented.
- **Ensure consumer protection against exploitation and undesirable goods.** For instance Uganda National Bureau of standards.
- **Promote fair distribution of income and wealth.**
- **Avoid duplication in production and resource wastage.**
- **They promote infrastructure development.**
- **They promote balanced regional development.**
- **They help to mobilize savings.**

NEGATIVE ROLE OF PUBLIC CORPORATIONS/ENTERPRISES IN AN ECONOMY.

- **They are normally interfered with by politicians.** Appointment of top officials in these enterprises is normally influenced by politicians.
- **Result into poor accountability by public officials.** Corruption is rampant in public corporations which limits production.
- **Limited flexibility in their activities.** There is slow response to necessary changes.
- **They discourage private investments/discourage growth of large private sector.**
- **They lead to high bureaucracy in decision making and implementation of plans.** This negatively affects their efficiency.
- **They strain the government budget through subsidies.** This leads to high government expenditure.
- **They produce poor quality products and services due to limited competition.**

- **The public is taxed highly to cover the losses made by these public corporations.**
- **They limit consumer sovereignty.** This is because what is produced by such corporations does not correspond to consumers desires.
- **Shortages occur in times of breakdown.**

UNEB 2002.

State any four causes of poor performance of public enterprises in your country. (04 marks)

UNEB 1999.

Mention any four problems faced by public enterprises in your country. (04 marks)

PROBLEMS FACED BY PARASTATAL ORGANISATIONS/PUBLIC SECTOR/PUBLIC ENTERPRISES IN UGANDA OR CAUSES OF POOR PERFORMANCE/INEFFICIENCY OF PUBLIC ENTERPRISES IN UGANDA.

- Low levels of accountability/rampat corruption and embezzlement of funds.
- High bureaucracy andred tape.
- Foreign interference and influence. This discourages expansion of such enterprise.
- Poor management in most governbment departments/lack of enough skilled manpower.
- Poor infrastructure especially in rural areas.
- Political interference and sabotage in running of the enterprises.
- Limited commitment and interest on part of employees and management.
- Political instability and change of government. This limits expansion of such enterprise in such areas.
- Limited capital to run the enterprises due to low tax base.
- High level of competition from the private sector.
- Limited market size.
- Poor techniques of production.
- Price instabilities.
- Limited supply of raw materials.

PRIVATE SECTOR.

Private sector refers to that section of the economy consisting of productive activities directed and controlled by private individuals and companies.

In uganda it consists of a number of invetsments carried out by both foreign and local invetsors or individuals. With government privatization and economic liberalization, the private sector has greatly expanded in uganda in the last 20years.

Several private investors both local and foreign have been attracted on board to participate in a diversity of economic activities.

Uganda has affected some reforms in providing a conducive invetsment platform for the growth of private sector which has led to the emergence of various private enterprises owned by both local and foreign invetsors.

A private enterprise is a business unit owned and controlled by private individual(s).

Characteristics/structure of private sector in uganda.

- The main aim in production is basically profijt maximization.
- It is dominated by small scale enterprises.
- Firms are mainly sole proprietorship.
- There is mainly production of low quality goods .
- Firms mainly employ local resources.
- Most firms mainly produce for local markets.
- Firms mainly employ unskilled and semi skilled labour.
- Most firms are characterised by poor or no record keeping.
- It tends to be dominant in urban areas.
- Large firms in the private sector are basically foreign owned.
- The private setcor mainly produces consumer goods.

UNEB 2004.

a) *Explain the role of the private sector in development of your country. (10 marks)*
b) *What are the problems faced by the private setcor in youhr counntry. (10 marks)*

POSITIVE ROLE OF PRIVATE SECTOR IN DEVELOPMENT OF UGANDA.

1. **Provides employment opportunities.** Both semi skilled and unskilled labor is employed in various investments set up by individuals thus reducing unemployment.
2. **Accelerates economic growth.** This is because various industries and investments set up to increase output hence economic growth.
3. **Provision of government tax revenue.** The government taxesvarious activities in this sector and incomes of workers in such investments hence increasing government revenue.
4. **Promotes inventions, innovations and technological development.**This is as a result of stiff competition between various private firms especially where substitutes are produced.

5. **Provision of a variety of goods and services.** Various products are produced and supplied to the market hence widening consumer"s choice. Private individuals engage in a variety of businesses so as to cater for different tastes and preferences.
6. **Facilitates the increased use of local resources.** Local resources Such as land, water and forest resources are greatly utilized by various businesses established by various private individuals thus reducing resource under utilization.
7. **Promotes efficiency in production thus high quality products areproduced.** This is due to the stiff competition between producers and supervisors which increases consumer"s welfare.
8. **Brings about infrastructural development**. It forces the government to establish supporting infrastructure in form of roads, power supply systems and infrastructure set by private individuals such as buildings hence smooth running of the economic activities.
9. **Helps in training local labor / development of skills of labor**. Thisleads to development of local skills through job training especially those employed in private industrial sector.
10. **Promotes commercialization in production/reduces subsistence production.** Private individuals produce basically for market hence increased use of money as a medium of exchange.
11. **Increases foreign earnings which improves balance of payment position.** Some private enterprises produce for foreign markets and foreign entrepreneurs bring in foreign exchange for increased investment**.**
12. **Promotes industrial growth.** Private sector encourages the establishment of private industries hence industrial growth leading to increased production level.
13. **Promotes development of entrepreneurial skills.** Itenables people to engage in business activity leading to development of entrepreneur skills.
14. **Promotes economic diversification.** this reduces economic dependence because of increased involvement in various economic activities.

NEGATIVE ROLE OF PRIVATE SECTOR IN DEVELOPMENT OF UGANDA.

1) **Results into inequality.** Income tends to concentrate in the hands of few individuals with access to factors of production thus increased income gap**.**
2) **Creates unnecessary competition and duplication of goods and services.** This leads to resource wastage in production especially where substitutes are produced.
3) **Results into production of undesirable goods.** private individuals are driven by profit maximization goal and they

engage in production of harmful commodities thus reducing consumer welfare.

4) **Leads to irrational exploitation of resources.** Non renewable resources are over utilized to maximize profits leading to quick resource depletion.

5) **Leads to foreign dependence and domination.** Most of the large scale private enterprises in private sector are dominated by foreigners especially in the industrial sector.

6) **Increases regional imbalances in development and rural urban migration.** Most private individuals especially foreigners prefer to invest in urban areas with necessary infrastructure thus neglecting rural areas. This implies that many private enterprises are urban based.

7) **Worsens capital outflow.** Several private foreign investors trend to repatriate profits to their home countries thus limiting re-investment in the domestic economy.

8) **Neglects production and provision of public goods** such as roads, water supply, security since private investors are mainly profit oriented thus reducing the strength of the public sector.

9) **Makes it very difficult for government planning.** The activities of the private sector are not directly controlled by government and it becomes difficult to be incorporated in the national plans thus limiting effective economic planning.

10) **Causes constant price fluctuations/inflation.** Private individuals aim at profit maximization through the activities of hoarding and speculation thus causing scarcity of commodities leading to high prices for commodities.

11) **Leads to emergence of private monopoly.** Stiff competition between private firms pushes weak firms out of production leading to monopoly powers thus unemployment and exploitation of consumers by few existing firms.

12) **Increases social costs.** This is in form of pollution since production is controlled by profit motives thus less consideration of the environment.

UNEB 2009.

a) *Explain the challenges being faced by the private sector in developing countries. (10 marks)*

b) *What measures should be taken to promote the private sector in developing countries. (10 marks)*

PROBLEMS FACED BY PRIVATE SECTOR IN UGANDA/DEVELOPING COUNTRIES.

- **Inadequate capital.** Most private investors have low incomes to pay workers, buy and maintain machinery hence limited scale of production in the sector.
- **Limited skilled manpower.** There is use of unskilled and semi skilled labour due to poor educational facilities and high illiteracy leading to low productivity and poor quality output.
- **Small domestic and foreign markets.** Domestic consumers have low purchasing power due to low incomes and foreign markets are highly competitive and this limits expansion of businesses.
- **Low level of technology.** Labour intensive technology dorminates production hence leading to low output and production of poor quality and low quantity of output.
- **Limited entrepreneural skills.** This leads to limited willingness to take on risks and inability to organize other factors of production which affects management and organization of firms leading to low production levels.
- **Poor infrastructure.** This is in form of poor road network, limited banking institutions and power shortage which limits easy movement of output and inputs and this limits the level of production.
- **Poor political climate in some areas.** Unstable political climate in some areas disrupts production and creates uncertainty among investors which discourages more investment in the private sector.
- **Poor investment climate.** This is inform of unfair and high taxes, limited subsidies, high cost of trade licenses which reduce profit margins of firms thus discouraging further production.
- **Poor land tenure system.** Land belongs to few individuals, in some areas it is communally owned and fragmented. This limits large scale production in private sector.
- **Unfavourable natural factors/poor performance of the agricultural sector.** These include drought, floods, landslides which mainly affect agricultural sector such as changes in climate, which leads to poor performance of agricultural sector which reduces the quantity of raw materials available for agro-based industries.
- **Shortage of basic sources of raw materials to use in industries and other projects.** Raw materials are competed for by many private firms especially in industries thus high cost of inputs.
- **Unstable prices/inflation.** This makes money to lose value which scares away most investors and reduces profitability of business since it increases the cost of operating businesses.
- **High corruption and embezzlement of funds.** Funds meant to promote and develop the private sector are misused by government officials on board, investors are denied investment opportunities in the process thus limiting investment opportunities and reduces the level of profits.

- **Ineffective enforcement of patent/copy rights.** There is a lot of forgery and duplication of activities because patent rights are not properly emphasized thus creating duplication.
- **Bureaucratic delays.** This is in most cases experienced in the process of acquiring contracts, exportation of output and importation of inputs.

POLICIES BEING TAKEN TO PROMOTE THE PERFORMANCE/DEVELOPMENT OF THE PRIVATE SECTOR IN UGANDA/DEVELOPING COUNTRIES.

- ✓ **Offering investment incentives/provision of a conducive investment climate.** These include tax holidays, tax exemptions, subsidies to attract many private investors.
- ✓ **Further privatization of public enterprises.** This is mainly intended to enable more private individuals own enterprises.
- ✓ **Further liberalization of the economy.** More liberty given to private individuals to carry out economic activities encourages more private individuals to set up investments.
- ✓ **Improvement in political climate.** This helps to enable investors develop confidence in the economy and this reduces uncertainty for life and property which attracts more private investors.
- ✓ **Stabilizing economic climate/controlling inflation.** This is through relevant monetary policies and this stimulates production among private investors due to reduced cost of production.
- ✓ **Carrying out international publicity/campaigns.** This is through extensive advertisements made in international media showing foreign investors various investment opportunities available in Uganda thus attracting more investments.
- ✓ **Improving infrastructure.** With modernized roads, railways and power supply, investment activities in private sector are encouraged through increased factor mobility.
- ✓ **Expansion of market through economic integration.** For instance EAC, COMESA to attract more local and foreign investors in production.
- ✓ **Establishment of more specialized institutions** to encourage investments such as Uganda investment authority to handle needs of investors and provide information on investment opportunities available thus attracting more investors.
  - ✓ **Providing affordable credit or loans to private sector.** This is through encouraging the development ofmicro finance institutions, SACCOs and commercial banks which increases access to credit for investment.
  - ✓ **Fighting corruption and embezzlement of funds meant for private sector/ encouraging proper accountability.** This is done through anti corruption legislations so as to strengthen private sector initiatives.

- ✓ **Promoting development of entrepreneurial skills.** This is done through increased training on enterprise growth which helps to equip people with investment skills thus increasing private investors.
- ✓ **Undertaking land reforms/changing land tenure system.** This enables private investors to access land and participate in various economic activities.
- ✓ **Training labour to acquire necessary skills.** This increases efficiency in production thus increased investment in private sector.
- ✓ **Encouraging technological development.** This is being done by encouraging increased technological transfer thus increased technological development and increasing investment in the private sector.

UNEB 2013.

a) *Explain the role of the private sector in the development of your country. (10 marks)*

b) *What measures have been taken to promote the development of the private sector in your country? (10 marks)*

MEASURES THAT HAVE BEEN TAKEN TO PROMOTE THE DEVELOPMENT OF THE PRIVATE SECTOR IN UGANDA.

1. Developed infrastructure.
2. Provided affordable loans/credit to investors.
3. Improved political climate/ensured political stability.
4. Widened markets both local and foreign.
5. Ensured price stability/fought inflation.
6. Undertaken privatization policy
7. There has been liberalization of the economy.
8. Trained labour to acquire relevant skills.
9. Offered investment incentives.
10. Encouraged technological development.
11. Changed land tenure system.
12. Improved entrepreneurial skills.
13. Encouraged proper accountability/fought corruption and embezzlement.
14. Enacted copy rights and patent right laws.
15. Undertaken international publicity and campaigns.
16. Establishment of specialized institutions to promote investment.

FOREIGN AID.

Foreign aid refers to the transfer/inflow of subsidized resources from one country to another either directly or through international agencies. It can be multi-lateral aid or bi-lateral aid.

Or

It refers to the international transfer of resources in form of grants, loans, technical assistance among others either directly from one government to another (bi-lateral aid) or indirectly through multi-lateral agencies (multi-lateral aid).

Developing countries depend heavily on various forms of foreign aid to finance their budgets and other development endeavors.

Multi-Lateral Aid.

Multi-lateral aid refers to assistance given to a country through international aid agencies or multi-national agencies such as WORLD BANK, IMF, UNESCO, WHO and UNICEF.

Bi-Lateral Aid.

Bi-lateral aid refers to direct assistance given by one country to another. For instance Germany giving aid to Uganda.

UNEB 2010.

i) *What is meant by the term „tied trade" (01 marks)*
ii) *Give any three problems of relying on foreign trade in your country. (03 marks)*

Foreign trade can be tied or untied trade.

Tied Aid.

Tied aid is the aid which requires the recipient country to abide by the conditions set up by the donor. For instance the recipient country is required to purchase goods from the donor country using the grants /funds, the recipient country is required to implement socio-economic and political conditions dictated by the donor before the aid can be given to finance a specific project named by the donor.
For instance project tied aid. It is therefore tied to projects o sectors as dictated by the donor.

Project tied aid. This aid is where the donor countries dictate the projects that should be done with the provided aid.

Untied Aid.

Untied aid is aform of foreign aid where donor countries do not dictate on how the aid given should be used by the recipient country. Its use is tied to the total needs and development plans of the recipient country.

Forms of foreign aid.

- ✓ Loans in form of foreign currency which has to be paid back which is used to finance development expenditures such as roads, railways.
- ✓ Projects in form of specific projects initiated by the donor country to the recipient countries.
- ✓ Technological aid in form of the machines, equipment and new scientific methods of production .
- ✓ Educational aid in form of facilities such as scholastic materials such as laboratory equipment, text books and computers an buildings, scholarships to bright students.
- ✓ Humanitarian assistance/relief aid from the friendly countries, WHO, UNICEF, FAO.
- ✓ Military assistance in form of fire arms and ammunitions, uniforms, military assistance and training and hard ware.
- ✓ Technical assistance in form of expatriates, to run the key sectors as engineers, managing directors.
- ✓ Grants and donations from friendly countries.

UNEB 2002.

a) What is the role of foreign aid in the economic development of your country? (10 marks)
b) Explain the problems associated with over reliance on foreign aid. (10 marks)

UNEB 2011.

a) Differentiate between bi-lateral and multilateral aid. (04 marks)
b) Assess the impact of foreign aid on the development of an economy. (16 marks.

UNEB 2013)

a) What is meant by foreign aid? (04 marks)
b) Assess the impact of foreign aid to the development of an economy. (16 marks)

POSITIVE ROLE OF FOREIGN AID IN DEVELOPMENT OF LDCs.

1. **Closes savings-investment gap.**The level of savings in developing countries is still low compared to planned expenditure and this is covered through foreign aid leading to high investment levels.
2. **Fills/foreign exchange gap.** In LDCs foreign exchange earned from exports is less than what is required to buy the necessary imports because of the small forex pocket which is closed by the foreign aid. **Closes skilled man power gap.** There is limited skilled man power in l.d.cs is lower than their development requirements and this is solved through transfer of such technology from donor countries to the l.d.cs.

3. **Closes technology gap/increases technological transfer.** Level of technological transfer. Level of technology in l.d.cs is lower than their development requirements and this is solved throughthe transfer of such technology from don0or countries to l.d.cs.
4. **Closes government revenue-expenditure gap/budgetary deficits.** Planned revenue is normally less than planned expenditure of fiscal year and foreign aid from grants, loans is used for covering this gap and supplement the available revenue for the government expenditure .
5. **Alleviates/reduces effects or catastrophes/natural calamities i.e.**alleviating the effects of natural disasters such as floods, earth quakes and land machinery loan cooperates foreign expatriates is systems thus large scale.Slide by giving the relief aid in form of drugs, food stuffs, clothes, medicine to cope up with humanitarian crisis.
6. **Facilitates the infrastructure development.**Foreignaid in form of machinery,loans,foreign experts,is used to facilitate the of roads,railways,power supply projects thus encouraging large scale production.
7. **Expands employment opportunities.** Many jobs are created by projects production and investment in mining, industry and agriculture funded by donor funds and employs more labor thusreducingencouraging unemployment.
8. **Strengethens international corporations among countries.**This enhancesinternational trade and ensures political and economic ties betweendonor and recipient countries.
9. **Increases utilization of resources which increases productivity**. Necessaryforeign aid in form of technology, funds, and expatriates is used to increase exploitation of recourses minerals forests,land and water resources.
10. **Facilitates industrial development**. Foreign aid in form of capital investments, expert rites and loans accelerate industrial development in the recipient country.
11. **Promotes development of local skills.** Foreign aid in form of manpower training through scholarshipsincreases skills of local people in the recipient country.

PROBLEMS/ NEGATIVE ROLE OF FOREIGN AID IN LDCs.

1. **Worsens balance of payment problems**. This is through high capital outflow in paying foreign expatriates and repaying external loans thus high foreign exchange expenditure.
2. **Leads to unemployment of local man power.** Sometimes the foreign aid is inappropriate through expatriates and transfer of capital intensive technology which replaces the human labor.
3. **Discouragesthe local initiatives and effort/promotes laziness.** Creativityat home reduces becauserecipient countries are ever expecting aid from the donors incase o any problem.

4. **Erodes cultural/social values of the recipient country.** People from the recipient country keep adopting the values of the donor countries for instance dressing"s styles,eating habits which are undesirable for a country to demonstration effect created by the foreign aid.
5. **May be withdrawn before the completion of some projects/its not sustainable.** Foreign aid can be withdrawn before the completion of some projects being undertaken duet o to some reasons like political misunderstandings which leads to failure of such projects.
6. **Politicalstrings attached to the aid undermines a country's political sovereignty.**It leads to political domination by the donor countries. It is because of the tired aid to political conditions.
7. **It is at times tied to UN productive projects/non priority sectors/areas of the economy which hindersdevelopment.** In most case said is tied to even part of the economy which many not be a priority to development.
8. **Creates external debt servicing problems which denies the nationals essential goods and services**. A large percentage of the nationalbudget is required in the long run to clear huge external debts especially when the aid is tied hence denying their nationals various essential goods.
9. **Distorts economic planning .**This is because in most case s the foreign aid is inconsistence which limits implementation of plans, leading to plan failure.
10. **Worsens economic domination of donors over the recipient countries.** Donors dominate the economic policies of the recipient countries which erodes away economic independence of the recipient country.
11. **Leads to brain drain.** Foreign aid in form of training through the scholarships to bright students to study from abroad leads to brain drain because after acquisition of the skills, suchlabor doesn"t come back.
12. **Promotes under utilization of the localresources.** There is reduced domestic production due to heavy reliance on foreign aid leading to under development.
13. **Sometimes the pre-conditions set by the donors are disastrous.** For instance SAPS.

FACTORS WHICH INFLUENCE/DETERMINE THE EFFECTIVE UTILISATION OF FOREIGN AID IN THE DEVELOPED COUNTRIES.

1. Availability of skilled labor.
2. Population growth rate.
3. Political climate.
4. Level of infrastructure development.
5. Rate of inflation.
6. Size of domestic market.
7. Level of corruption and embezzlement.
8. Level of technology.

9. Foreign aid conditionality.

NB. Absorptive capacity is the ability of an economy /country to utilize efficiently the foreign aid given.

REASONS FOR THE LOW ABSORPTIVE CAPACITY IN L.D.CS/UGANDA.

1. Limited skills among labor.
2. Political instabilities.
3. Poor infrastructure.
4. Persistent economic instabilities.
5. Corruption and embezzlement of funds.
6. Limited market.
7. High levels of conservatism.
8. Poor technique of production.

PRIVATISATION OF PUBLICENTERPRISES.

Privatization of public enterprises refers to the transfer of ownership of public/state enterprises to private sector/individuals.

Or

It refers to the transfer of ownership of enterprises from the public sector of the private sector.

Privatization runs a very broad range of activities with government efforts to develop the private sector and reduce the disadvantages related with large public sector. It‟s one of the policy packages by IMF and World Bank developing countries.

In 1970s,the government participated greatly in the trading because it owned large public enterprises and many enterprises were nationalized with expulsion of Asian

In 1970s the government participated greatly in trading because it owned large enterprises and many enterprises were nationalized with the expulsion of Asia

In 1986 the N R M government found at least 146 public enterprises in place excluding banks and he government had the majority share holding but by 2002, many of these enterprises had been privatized This has attracted a large number of foreign investors to buy these enterprises.

Examples of divestures that have been made in Uganda.

Kakira sugar works,Ugandan telecoms limited, Uganda cranes estate. Uganda commercial bank Uganda grain milling company, Uganda pharmaceuticals limited ,Nytil Public Motors,Mweya safari lodge,Tororo cement works lake Victoria hotel Uganda air lines lake Victoria bottling company Mt Elgon hotel White Rhino hotel Uganda tea corporation White horse in Nile hotel International conference centre Uganda hard ware limited Uganda electricity board among others.

UNEB 2011.

State any four ways in which public enterprises are privatized (04 marks)

FORMS OR WAYS OF PRIVATIZATION OF PUBLIC ENTERPRISES.

1) **Partial privatization**. It is where the government and private individuals own shares in the enterprises. Agiven number of shares in the company is retained by the government and some are sold to the private sector.for instance New Vision.
2) **Leasing out/mortageging.** The government rent out public enterprises to private enterprises for agiven period of time For instance public taxi and bus parks and markets.
3) **Privatization of management.** The government retains ownership of the enterprises but privatizes the management. For instance Sheraton hotel managed by Sheraton hotel international in USA air ports, water plants.
4) **Divestiture/complete sell off.** This is where the government transfers all its shares and assets of the public to the private sector . for instance Nile breweries shell Uganda Kakira sugar works Lake Victoria bottling company, NYTIL, Hima cement works.
5) **Denationalization/repossession.** This refers to the return of the nationalized to their formal or original private owners for instance return of those enterprises formally owned byAsians who were expelled in1972. For instance Aghakan School
6) **Contracting**. The government retains ownership of the enterprise but provision of the goods and services is transferred to the private sector for instance maintaining by private individuals.
7) **Joint ventures/recapitalization.** The government runs businesses jointly with private entrepreneurs.

UNEB 2008.

"Developing counties should privatize public enterprises if they are to attain economic growth and development" discuss. (20 marks)

UNEB 2007.

- *Distinguish between privatization and nationalization of public enterprises. (04 marks)*
- *Assess the impact of privatization of public enterprises in your country. (16 marks)*

ADVANTAGES/POSITIVE IMPACT OF PRIVATIZATION OF PUBLIC ENTERPRISES IN UGANDA AND OTHER DEVELOPING COUNTRIES.

- ✓ **Reduced dependence on imports.** This is because of increased local production thus saving scarce foreign exchange leading to improvement in balance of payment position.
- ✓ **Reduced corruption and embezzlement in enterprises.** This results from high rate of supervision and accountability by private owners.

Private individuals do not tolerate corruption to undermine their objectives thus leading to proper accountability.

- ✓ **Reduced unnecessary bureaucracy in business management.** There are limited delays in decision making under private owned enterprises compared to state owned businesses thus quick decision making.
- ✓ **Increased investment by foreigners/increased direct foreign investments.** More foreign investors are attracted to buy the enterprises available for sale thus advantages thus increased inflow of foreign capital.
- ✓ **Reduced government expenditure in form of subsidies on inefficient public enterprises.**
  Government spends heavily on such enterprise but privatization reduces such expenditure hence limited budgetary deficits.
- ✓ **Improved quality of output produced.** This is because of stiff competition created among private enterprises leads to high quality output on the market.
- ✓ **Increased innovations and inventions/technological development and transfer.** This is because it encourages private initiatives so as to maximize profits. Private investors are able to carry out research so as to be very creative thus technological development and transfer.
- ✓ **Improved international relationships between Uganda and other countries.** This is because most of the public enterprises are bought by foreign investor"s thus increased international trade.
- ✓ **Increased employment opportunities in the long run.** Privatized enterprises expand and employ more people in the long run thus reducing unemployment.
- ✓ **Controlled structural inflation due to increased domestic output.** This is because of increased domestic output on the market in the long run due to increased efficiency which keeps prices at a low level.
- ✓ **Improved efficiency in resource allocation/enables firms to operate more efficiently.** This is because of the e close super vision and profit motive and better management of firms by private sector and because of the competition hence better resource utilization.
- ✓ **Increased tax revenue for the government.** Privatized enterprises are expanded in the long run and this increases the tax base hence high government revenue for spending.
- ✓ **Widening the consumer's choice due to production of a wide range of variety of goods and services.** This is because privatized enterprises diversify their activities.
- ✓ **Increases output hence economic growth.** This is due to expanded production where more output is realized by privatized enterprises hence benefits of economic growth.
- ✓ **Improved skills of workers.** This is due to increase on job training of the labor employed in the privatized enterprises hence increasing the skilled labor.

UNEB 2015

a) *Why have public enterprises been privatised in your country? (10 marks)*
b) *Explain the contribution of the private sector to the economic development of your country. (10 marks)*

UNEB 2009, 2001, 2000.

a) *Account for the privatization of the public enterprise in your country. (10 marks)*
b) *What problems have been encountered in the privatization of public enterprises in your country? (10 marks)*

UNEB 2003.

a) *Account for divestiture of the public enterprises In your country. (10 marks)*
b) *What are the problems encountered in the divestiture of the public enterprises in your country. (10 marks)*

UNEB 2011.

a) *Distinguish between the privatization and nationalization of the public enterprises. (04 marks)*
b) *Account for the privatization of the public enterprises in your country. (16 marks)*

REASONS/NEED FOR THE PRIVATIZATION OF THE PUBLIC ENTERPRISES. OR WHY IS IT NECESSARY TO PRIVATIZE PUBLIC ENTERPRISES AN ECONOMY.

NB. These are given as reasons not as effects or advantages.

- ✓ To fulfill the conditionality of I.M.F of creating a private sector led economy.
- ✓ To control structural inflation.
- ✓ To create more employment opportunities in the long rub.
- ✓ To increase tax revenue of the government /expand the tax base.
- ✓ To reduce over dependence on the on imports because of increased local production.
- ✓ To reduce corruption and embezzlement of the funds in the state enterprise s.
- ✓ To reduce UN necessary beauracracy in the /red tape in then business management.
- ✓ To attract direct foreign investments and hence increased capital inflow.
- ✓ To reduce the government expenditure in form of subsidies on inefficient public enterprises.
- ✓ To enable firms operatemore efficiently hence better delivery of services.

- ✓ To encourage competition in production and increase and improve the quality of goods and services.
- ✓ To encourage private initiatives and creativity through innovations an inventions.
- ✓ To increase the level of resource utilization.
- ✓ To allow government concentrate on the provision of social services.
- ✓ To increase the domestic output/economic growth.

DISADVANTAGES/NEGATIVE IMPACT OF PRIVATIZATION IN UGANDA AND OTHER DEVELOPING COUNTRIES.

- ✓ **Increased consumer exploitation.** private investors normally increase commodity prices In orderto earn more profits thus exploitin consumers.
- ✓ **Increased foreign control of the economy.** Many public enterprises are bought the foreigners who to some extent con troll the country economically and politically.
- ✓ **Increased unemployment in the short run.** This is as result of restructuring and retrenchment of workers in order to reduce the costs labour and preferences to use capital intensive technology.
- ✓ **Increased irrational exploitation of the resources.** Resources are over utilized leading to quick resource depletion and environmental degradation.
- ✓ **Increased profit repatriation/capital outflow.** Most public enterprises are bought by the foreign investorswho repatriate profits to their home countries hence limiting more investment.
- ✓ **Increased income inequality.** High profits are made by the private investors at the expense of other individuals hence widened income gap.
- ✓ **Losses are incurred by the government in the process.** This is because of the under development of the enterprises for sale and high costs of the whole process of privatization. E.g. advertising in both local and foreign media, asset evaluation which is very costly.
- ✓ **Reduced provision of certain/vital services and goods to the population.** Private individuals do not normally provide essential services such as security and water to the public.
- ✓ **Increased resentment of the government by the population.** The public in most cases opposes the process of privatization which sabotages development hence loss of political support.
- ✓ **Increased exploitation of labor.** It increases the private enterprises which tend to offer low wages to labor and characterized by the poor condition so work.
- ✓ **Makes planning by the government difficult.** This is due to the increased non responsive growing private sector leading to plan failure.
- ✓ **Increased wasteful competition and duplication of production.** This leads to resource wastage in production.
- ✓ **Increases the price fluctuations.** This is due to the desire for high profits leading to inflation and its negative effects.

PROBLEMS ENCOUNTERED IN THE PRIVATIZATION PROCESS IN UGANDA.

1. **Corruption within the privatized enterprises /limited transparency and accountability in the privatization unit.** There is corruption in the privatized unit where some officials on board take bribes from the intending buyers which scares away some investors and at time s such enterprises are sold cheaply.
2. **High opposition from the public.** The public normally decampaignthe process mainly due to general ignorance of the people about the benefits of privatization thus delaying the sale of some enterprises.
3. **Poor valuation of public enterprises that are on sale.** There is overvaluation or undervaluation which scares away buyers of enterprises and makes government lose respectively.
4. **Poor state ofsome public enterprises.** Many enterprises are old andin bad shape which discourages buyers of enterprises.
5. **Under developed capital markets.** There are limited stock exchange markets where shares can be bought. This limits smooth sale ofshares in the public ventures in case ofjoint venture privatization.
6. **Political sabotage.** Parliamentarians especially on opposition side normally block bills concerning the sale of public ventures to foreigners which delays the sale of enterprises.
7. **Poverty among nationals.** Most Ugandans have low incomes n and this forces the government to sell such enterprises to foreign investors since local investors lack enough capital to purchase these enterprises.
8. **High cost of the privatization process.** Privatization involves renovating enterprises meant for sale, advertising in local and foreign media, scrutinizing bidders and such a process is very costly which reducesthe benefits of privatization.
9. **Unscrupulous buyers/dishonest buyers.** Some people pretend to be buyers when they do not have adequate capital for purchasing the public enterprises meant for sale thus delaying the sale of some enterprises.
10. **Small market for output from the enterprises.** Local and foreign markets are still inadequate; this discourages buyers of such enterprises who aim majorly at profit maximization in fear of incurring losses.
11. **Political instability in some areas where the enterprises are located.** The prospective investors fear to risk their capital and life in such areas thus making such enterprises not attractive to buyers.

UNEB 2012.

a) *Define the term nationalization of enterprises. (04 marks)*
b) *Examine the merits and demerits of nationalization of enterprises in an economy. (16 marks)*

NATIONALIZATION OF ENTERPRISES.

Nationalization of enterprises is the taking over by the state the ownership, control and management of enterprises formerly owned by private individuals to be run in public interest. This can be done with or without compensation.

Or

This is where the government/state takes over the ownership and control of enterprises formerly privately owned to be run in public interest. This can be done with or without compensation.

The government can take over the ownership and control of privately owned enterprises in case itintends to achieve given objectives and goals o development such as;

- Reducing foreign domination of the economy.
- Providing sustainable employment.
- Discouraging emergence ofprivate monopolies.
- Controlling structural inflation and
- Achieving sustainable use of resources.

In Uganda, nationalization ofenterprises was so pronounced in 1970"s under Nkivubo pronouncements by president Milton Obote where the government was to take over 60% of over 80 corporations in the country including banks, oil companies, manufacturing industries, plantations, insurance companies but this was not fully realized.

It was also at high gears under President Idi Amin in 1972 when he presided over the expulsion of Asians from Uganda.

UNEB 2006

i) *Distinguish between privatization and nationalization of enterprises. (02 marks)*
ii) *Give any two merits nationalization of enterprises in an economy. (02 marks)*

MERITS OF NATIONALIZATION OF ENTERPRISES.

- **Reduces consumer exploitation by charging affordable prices /helps to provide essential goods and services to the population.** This is because the nationalized enterprises normally charge goods at fair prices for their services provided.

- **Reduces foreign domination of the economy with its evils /promotes indigenization of the economy.** This is especially where foreign owned firms are nationalized which reduces the participation of foreigners in the economy.
- **Reduces social costs such as pollution.** Nationalized enterprises are run in theirinterest of the publichence social costs are controlled by the government.
- **Ensures government control of strategic sectors/enterprises/vital investtiments in an economy.** Strategic areas of the economy such as security are easily controlled where enterprises are controlled by the government.
- **Provides sustainable employment.** This increases the employment opportunities due to the large production.
- **Makes it easy to respond to the rapid structural changes when need arises or quickens adjustments to the changing marketing conditions.** Thisis because such structural changes e.g.occurrence of the natural disasters require quick attention from the government which is difficult with the private investors.
- **It helps to reduce the on production of the un desirable goods and services.** This is because what is normally produced by the enterprises is run by the government is of desired standards.
- **It helps to reduce on the actions of the private monopolies and its negative effects.** The actions of monopoly are reduced through government control of the productionprocesses through nationalization.
- **Reduces wasteful competition/avoids the duplication of goods and services and resource wastage in production.** This is due to limited competition in enterprises run by the government since they are not normally profit minded.
- **Helps to generate public revenue.** Natrionaliosed enterprises generate revenue for public expenditure.
- **Encourages large scale production.** It makes it easy to mobilize large amounts of capital for the large scale investment hence increased output.
- **Leads to equitable distribution of resources/wealth and income.** The government is able to reduce income inequality since nationalization reduces the possibility of accumulating excessive resources by the private investors whose businesses are taken over by the government.
- **Minimizes the profit and income repatriation by foreign investors.** This is because nationalization helps to limit the number of foreigners in domestic production.
- Promotes economic stability. Controls structural inflation because of controlle supply of commodities and use of price control.

DEMERITS OF NATIONALIZATION OF ENTERPRISES.

- **Leads to political interference and direction in running nationalized enterprises.** This is concerned with appointment of workers especially at managerial levels.
- **Limits the growth of a strong private sector/ private investment.** This limits enjoyment of advantages of high level of private investment.
- **Makes it difficult to check on corruption and misuse of funds in resource allocation.** This leads to misuse of public funds which limits expansion of enterprises.
- **Increases government expenditure on subsidizing nationalized firms.** This is especially if they do not make profits which leads to high taxation on nationals.
- **Leads to bureaucracy hence delays in decision making.** There are unnecessary procedures followed and this sows down the level of production.
- **Leads to inefficiency in firms.** This is due to poor supervision within public enterprises.
- **Low quality products are produced due to limited competition.** Limits innovations and research since firms are sheltered from completion.
- Limits consumer choices. This is due to limited variety of goods and services produced.
- **Leads to low tax revenue.** This is because most of these nationalized enterprises are exempted from taxation which limits government tax revenue.
- **Leads to resource misallocation.** This is because it interferes with the functioning of price mechanism and what is produced may not be in line with consumers demands.

ECONOMIC LIBERALIZATION.

Economic liberalization is the removal of unnecessary controls on economic activities hence giving people liberty to carry out economic activities without undue government controls. Many economies have embarked on economic liberalization because it opens the economy to trade and investment opportunities.

In Uganda, the economic recovery programme of May 1987 put more emphasis on economic liberalization and this has been affected on the following.

a) Trade liberalization. –foreign exchange liberalization. –financial sector liberalization.
b) Capital account liberalization policies in Uganda were implemented in late 1980s.

UNEB 2002.

a) *Distinguish between trade creation and trade liberalization. (04 marks)*
b) *Examine the implications of trade liberalization on economies of developing countries. (16 marks)*

UNEB 2013

a) *What is meant by the term "trade liberalization" (04 marks)*
b) *Examine the merits and demerits of trade liberalization in your country. (18 marks)*

UNEB 2015

a) *What is meat by the term trade liberalisation? (04 marks)*
b) *Examine the implications of trade liberalisation on an economy. (16 marks)*

TRADE LIBERALIZATION.

Trade liberalization refers to the removal of unnecessary controls on trade hence giving people liberty to trade without undue government controls.

Or

It refers to the removal of unnecessary restrictions on trade (by relaxing the use of instruments such as quotas, total ban, tariffs and administrative control) in order to give people opportunity for increased participation in trade (to increase value, volume and benefits of trade).

In Uganda, the government liberalized trade as one of the package policies of IMF and this has attracted many entrepreneurs, investors both local and foreigners to engage in diversified business activity.

UNEB 2009.

i) *Define the term trade liberalization. (01 marks)*
ii) *Give any three advantages of trade liberalization in your country. (03 marks)*

ADVANTAGES OF TRADE LIBERALIZATION IN AN ECONOMY.

1. **Increases employment opportunities.** This is due to increased investment because many private investors are free to join business thus employing more labor.
2. **Increases output levels hence economic growth.** More output is realized because of many firms attracted in production and expanded trade activities.

3. **Increases utilization of resources.** Free participation in trade leads to increased emergence of many private firms to utilize the available resources thus reducing underdevelopment.
4. **Encourages innovations and inventions/technological development.** Investors are forced to become more creative and this is through research which helps to compete and make more profits which brings about technological development.
5. **Increases efficiency among the different firms in he production processes.** Stiff competition is created which forces firms to be efficient which leads to better quality products.
6. **Leads to production of variety of commodities.** Various commodities are produced and this widens the consumers choice due diverse production of goods an d services.
7. **Leads to improvement of the balance of payment position.** This is because of the reduction in the volume of imports and the increased production of the exports which reduces the expenditure abroad and increases the foreign exchange earnings.
8. **Upholds the consumer sovereignty.** This is because the market forces of demand and supply are left to determine what should be produced. Production is based on the consumer"s desire and the consumers get the best output to consume.
9. **Helps to control structural inflation.** Increasein production increases supply of commodities on market which controls scarcity and keeps general prices low.
10. **Increases government tax revenue.** Various taxes are imposed on various productive activities that emerge thus more revenue for public spending.
11. **Makes it easy to fight corruption and embezzlement in resource allocation.** Since production activities are in the hands of the private individuals, corruption tendencies are minimized.
12. **Attracts more foreign capital investments/resource inflows into the country and their associated advantages.** Many foreign investors are attracted to engage in the production hence high capital inflow.
13. **Educes income and wealth inequalities.** People get employed in various economic activities and this reduces income gap between the rich and the poor.
14. **Leads to improved quality of goods.** This is due to stiff competition among many producers to join production activities.
15. **Increased infrastructural development.** This is because of increased involvement in trade which necessitates construction of more roads improving power supply hence development.

DISADVANTAGES OF TRADE LIBERALIZATION IN AN ECONOMY.

- **It leads to income inequality.** Because of the abnormal profits earned by some investors and resource owners, income gap widens.
- **Results into consumer exploitation.** Because of the consumers' ignorance in the market, consumers end up being exploited through charging them high prices.
- **It leads to increased capital outflow.** This is through profit repatriation by various foreign investors who attract in business due to liberalized trade and increased expenditure on imports.
- **Creates danger of over utilization and quick depletion of resources.** Private individuals aim at maximizing profits and over utilize the available resources to produce more commodities with high prices.
- **Gives rise to monopoly powers and its evils.** Some inefficient and weak firms are out competed in the production processes by the large firms and these large firms establish as monopolies. This is dueto the lack of lack of protection and subsidization of infant industries.
- **Creates a danger of misallocation of resources.** Resources are mainly directed to the production of highly priced goods and services demanded by the rich and cheap necessary goods demanded by the poor are ignored.
- **Leads to then duplication of commodities.** This is because of many producers in similar production, ther is stiff competition which is resource wastage.
- **It creates flooding of the market which reduces the prices to uneconomic levels.** Because of many firms that are free to join production, output increases and forces prices to reduce sharply. This causes great losses on the part of the producers.
- **Distorts consumers choice.** Due to the various products on market and intensive advertising, sales, promotional activities, the consumer is confused on which commodities to consume.
- **Leads to unemployment** due to the stiff competition which pushes the weak firms out of production, workers are laid off.
- **Subjects the economy to economic instabilities such as inflation.** It creates large large private sector whose prices are never stable depending on changes in demand and supply.
- **Exposes the population to consumption of the harmful /undesirable products.** There are possibilities of private investors to engage in production of demerit goods such as expired drugs due to limited government controls which reduce consumer‟s welfare.
- **Leads to the collapse of local firms.** This is due to increased inflow of foreign of foreign owned firms, increased importation leading to stiff competition and closure of the local firms.

STRUCTURAL ADJUSTMENT PROGRAMS (SAPs) IN UGANDA.

SAPs refer to the package of policy instruments aiming at stabilizing and transforming the economy. Supported by the World Bank and I.M.F.Structural information and micro economic stabilization for sustainable economic growth.

Through this initiative, various projects and programmers have financed by I.M.F and WORLD BANK in Uganda and other developing countries.

Objectives of saps in Uganda.

- To increase GDP by stimulating production.
- To expand the private sector.
- To reduce the role played by the government budgetary deficits.
- To reduce on the burden of the public debt.
- To reduce on the problem of BOP deficit.
- To strengthen the value of the shilling internally by checking inflation and externally by stabilizing exchange rates.

UNEB 2011, 2003.

Mention any four structural adjustment programs of the I.M.F that your country has implemented. (04 marks)

Examples Of The Saps That Uganda Has Implemented.

- Restructuring of public service/retrenchment of workers or demobilization of soldiers.
- Liberalization of the economy/trade.
- Privatization of the public enterprises/expanding the role of private sector.
- Devaluation.
- Restructuring tax administration/improvement in the tax collection.
- Reduction in government expenditure on non essential services.
- Tightening monetary and credit policies.
- Cost sharing.

CHAPTER 6: UNEMPLOYMENT PROBLEM

This definition is given in relation to labor as a factor of production.
Unemployment is a situation where some members of labor forceare idle due to failure of getting jobs at a ruling wage rate despite ones willingness to work.
It is one of the biggest macro economic problems that most economies face today. Unemployment rate in Uganda most especially among the youth is commonly is rising due to increased number of graduates alongside limited job creation opportunities.

Unemployment rate =number of unemployed labourforce 100
Total number of labourforce.

NATURE OF UNEMPLOYMENT

It is divided into two categories;

- Voluntary unemployment.
- Involuntary unemployment.

A. VOLUNTARY UNEMPLOYMENT

Voluntary unemployment refers to the situation where the jobs areavailable but labor force is unwilling to take eon the available jobs at ailing wage rate. **Or**

This is a situation where labor is not willing to work at the ongoing wage rate yet there are jobs.
Labor force is not interested in the work however much the jobs are available due to either undesirable /desirable existing circumstances.

UNEB 1998.

a) Examine the causes of voluntary unemployment. (06 marks)
b) Examine the policies being under taken to solve unemployment problem in your country. (14 marks)

UNEB 2012.

a) Explain the causes of voluntary unemployment. (08 marks)
b) Suggest measures that should be taken to reduce the level of unemployment. (12 marks)

CAUSES OF VOLUNTARY UNEMPLOYMENT IN AN ECONOMY.

✓ **Laziness among some individuals.** Some individuals especially women are naturally lazy and unwilling to take on the available jobs hence remain unemployed.

- ✓ **Socially unacceptable jobs to be undertaken.** Socially some jobs are meant for specific sexes and age groupsfor instance a woman becoming a driver.
- ✓ **Desire by the unemployed to live on past saving.** The unemployed may decide to live on past savings so long as it can sustain one for some time.
- ✓ **Very low wages aid/poor remuneration on the available jobs.** This does not induce workers to take on the available jobs and forces them to remain unemployed.
- ✓ **Good economic background.** Where someone comes from a well off family and inherits property.it becomesdifficult for suchlabor to take on the jobs existing since one is able to provide all the basic needs.
- ✓ **Expectation of getting a better paying job in the near future than the available ones.** Therefore one does not take on the available job or the available ones which may be considered to be of a low status hoping to get a better job.
- ✓ **The unemployed being too qualified for the available jobs or the present job may be considered inferior to the worker.** For example a graduate being asked to become a nursery teacher .therefore labor cannot take up such jobs.
- ✓ **Unfavorable geographical location of the job.** If the available job is too far from the ones home area and if the area has un favorableclimatic conditions, very inaccessible and one prefers to remain unemployed.
- ✓ **Poor working conditions on the available jobs.** Where the available jobs are created for long hours, absence of accommodation facilities limited medical allowances force labor to remain unemployed.
- ✓ **High risks involved in doing the available job.** Some jobs are very risky and can cause loss of one"s life for instance heavy mining, heavy industrialization and people prefer to remain unemployed instead of risking their lives.
- ✓ **Preference of leisure to work.** Some individuals prefer enjoying leisure to work and therefore remain unemployment however much the jobs are available.

B. INVOLUNTARY UNEMPLOYMENT.

Involuntary unemployment is a situation in which laborforce is willing and actively looking for jobs but cannot find jobs at the ongoing wage rate.

Or

It refers to a situation in which people who are able and willing to work at the current wage rate are unable to find jobs.

Or

It is a situation in which labor force is able and willing to work but cannot find jobs at the ongoing wage rate. This implies that jobs are not available. This is the unemployment which most economies are facing today.

UNEB 1999.

i) Differentiate between voluntary unemployment and involuntary unemployment. (02 marks)

ii) State any two causes of involuntary unemployment in your country. (02 marks)

CAUSES OF INVOLUNTARY UNEMPLOYMENT IN AN ECONOMY.

- Rapid population growth rate.
- Inappropriate education system.
- Discrimination in the labor market.
- Political instability in some areas.
- High rate of rural urban migration.
- Unfavorable structural adjustment programmers of IMF.
- Technological advancement thus replacing human labor.
- Ignorance of labor about the existingjob opportunities.
- Physical and mental disabilities among labor.
- Seasonal changes especially in agriculture.
- Shortage of co operant factors of production especially capital.
- Decline in demand for products which labor produces.

TYPES OF UNEMPLOYMENT.

1) Transitional/Frictional/Search Unemployment.

Frictional unemployment refers to short-term unemployment faced by labor force while in the process of changing/switching from one job to another.

Or

This is a type of unemployment which occurs when labor is switching off from one job to another in the short run.

Or

It is unemployment due to a miss match between demand for labor and supply of labor in the short run.

It arises in the short run when people leave their jobs and take time to get other jobs.

Causes of frictional/search unemployment.

- ❖ Ignorance of labor about existing jobs elsewhere.
- ❖ Immobility of labor both geographically and occupationally.
- ❖ Technological advancement leading to technological unemployment in the short run.
- ❖ High degree of specialization leading to limited skills in other jobs.
- ❖ Political instability which forces workers to leave insecure areas.
- ❖ High level of bureaucracy in getting a new job.

- ❖ Temporary breakdown of machinery in production.
- ❖ Temporally shortage of raw materials.

Solutions to transitional/frictional unemployment.

- Extensive adverting of available job vacancies.
- Training of labor in a variety of skills.
- Emphasizing political stability.
- Increasing mobility of labor to areas where jobs are available.
- Developing necessary infrastructure.
- Encourage increased diversification of economic activities.

2) Structural Unemployment.

Structural unemployment refers to unemployment resulting from structural changes in conditions/patterns of demand and supply in an economy.

It arises from structural changes in an economy. It is experienced when an economy is undergoing structural economic transformation or adjustments. Such structural changes don"t match with supply of labor leading to limited jobs.

UNEB 1998.

a) *Examine the causes of structural unemployment in an economy. (04 marks)*

b) *What measures should be taken to curb unemployment in an economy. (14 marks)*

Causes of structural unemployment.

- ❖ **Change in demand patterns and fashion/fall in demand.** For instance when clay cups replace plastic cups, workers in the plastic cup industry would be unemployed, when laptop computers replace desk top computers, workers in industries producing desktop computers would be unemployed.
- ❖ **Political instabilities.** These lead to closure of existing business enterprises and scare away potential investors.
- ❖ **Infrastructural break down.** This is especially transport and communication lines.
- ❖ **Technological advancement.** i.e. more use of capital intensive technology than labor intensive technology.
- ❖ **Exhaustion of supply of major raw materials** such as minerals which limits further production as that concerned industries close down.
- ❖ **Structural breakdown of industries/production process** thus laying off some workers.

UNEB 2008.

i) *Distinguish between structural unemployment and seasonal unemployment. (02 marks)*
ii) *Suggest any two measures that should be taken to reduce structural unemployment in an economy. (02 marks)*

Solutions to structural unemployment.

- Diversification in production to enable workers shift to other occupations.
- Development of necessary infrastructure to encourage labor mobility.
- Provision of more training facilities to labor in more than one job/diversification of skills of workers.
- Flexibility in production which enables industries/production units to change with changes in tastes and fashions of consumers.
- Use of appropriate technology so that workers are not replaced by machines.
- Ensuring political stability.
- Widening markets through economic integration.
- Ensure proper man power planning.

3) Seasonal Unemployment.

Seasonal unemployment is unemployment as a result of variations in seasons especially due to climatic changes. For instance in agriculture. This leads to limited economic activities in given seasons thus fluctuations in demand for labor. Farmers after planting and harvesting crops become idle.

UNEB 2003.

i) *Distinguish between frictional unemployment and seasonal unemployment. (02 marks)*
ii) *Give any tow causes of seasonal unemployment in an economy. (02 marks)*

Causes of seasonal unemployment.

- Climatic changes especially in agriculture.
- Failure to tame the nature.
- Periodical changes in demand for goods and services.

UNEB 1999.

i) *Differentiate between seasonal unemployment and casual unemployment. (02 marks)*
ii) *Give any two remedies for seasonal unemployment. (02 marks)*

Solutions to Seasonal Unemployment.

- Diversification of agricultural activities. Planting many crops including drought resistant crops to employ laborthroughout the year.

- Training of labor to do a variety of jobs.
- Modernization of agriculture to reduce dependence on nature such as use of irrigation.

UNEB 2013.

i) Differentiate between casual and residual unemployment. *(02 marks)*
ii) State any two effects of unemployment in an economy. *(02 marks)*

4) Casual/Erratic Unemployment.

Casual unemployment is a type of unemployment where labor is only employed when there is demand for it but becomes unemployed for a short time after the job is accomplished.

Or

It refers to the type of unemployment where workers are employed on temporary basis and as soon as their contracts/work is over they become unemployed.

This is a type of unemployment experienced in occupations where labor is needed for specific tasks which are not continuous or permanent.

For instance car washers, shoe shiners, contract builders, private lawyers, repair workers and private doctors.

Causes of casual unemployment.

- ✓ Limited skills in other job s.
- ✓ Undiversified economy.
- ✓ Immobility of labor both geographically and occupationally.

Solutions to casual unemployment.

- ✓ Training labor in multiple skills.
- ✓ Diversifying the economy.
- ✓ Improve on the production methods and technique.

5) Technological Unemployment.

Technological unemploymentis the type of unemploymentwhich results from technological advancement and discovery of new machines which replace labor. **Or**

This is the type of unemployment which results from the technological advancement where some workers are replaced by the machines. For instance use of computers in production, tractors in agriculture where some workers are replaced.

6) Residual Unemployment.

This is the type of unemployment which occurs as a result of physical andmental disabilities /handicaps of labor making one to fail to get a job /work. Therefore, potential labor force is physically incapacitated to work.

Causes of residual unemployment.

- ✓ Accidents and hence physical disabilities.
- ✓ Long period of the illness of a person.
- ✓ Psychological complications i.e complications.

Solutions to residual unemployment.

- ✓ Development of the craft industry.
- ✓ Encouraging special needs education in higher institution of learning such as colleges and the universities.
- ✓ Development of the informal sector such as tailoring, welding, shoe making and shining.

UNEB 2009

a) *Distinguish between disguised unemployment and frictional unemployment. (02 marks)*
b) *Mention any two solutions to the problem of disguised unemployment. (18 marks)*

7) Disguised Unemployment/Hidden Unemployment.

This is the type of unemployment where the workers or labor appears to be fully involved in the production yet its marginal product is zero or negative or negligible. The additional worker can be removed from employment without a reduction in the level of output.

UNEB 2004, 2008

i) *Distinguish between disguised and cyclic unemployment. (02 marks)*
ii) *Give any two causes of disguised unemployment in your country. (02 marks)*

Causes of disguised unemployment in an economy.

- ➢ Limited information about the existing jobs/ignorance about the existing jobs.
- ➢ Nepotism and corruption in some sectors which results into over recruitment.
- ➢ Inadequate skills among the laborto engage in the other activities.
- ➢ Desire to retain labor for future use.
- ➢ High population growth especially In the rural areas.

- Poor manpower planning. High supply of the labor in given occupations than others.
- Poor land tenure system which leads to land shortage.
- Limited supply of capital.

Solutions to the disguised unemployment.

- Adopt population control measures to reduce the pressure on land.
- Encouraging economicdiversification.
- Advertising existing jobs/providing information about vacant jobs.
- Adopt land tenure system to avail land to the landless.
- Educational reforms to bring about the diversity of skills.
- Improve entrepreneurial ability.
- Promote development infrastructure.
- Availing firms with affordable capital for increased investment.

8) Open Urban Unemployment.

This refers to the unemployment that result from the rural urban migrationwhere people are openly doing nothing in the urban areas. It can be explained as a theory of the rural urban migration. This is either due to push factors or pulls factors.

Push factors are thosethat operate in rural areas and force people to migrate to urban areas. For instancepoliticalinstability, poor health services, over population, poor education services and unfavorable cultural values, epidemics, land pressure.

The pull factors are those which tat operate in urban areas and attract people to move to towns. For instance better social amenities such as schools, hospitals, goodhouses,security,peace and high opportunities for employment.

Causes of open urban unemployment.

- Rural urban migration due to economic gap between the rural and urban areas.
- Inappropriate education system which trains job seekers who prefer urban areas.
- Rapid population growth rate not matching with the rate of job creation in urban areas.
- Poormanpower planning by the government hence limited balance between demand for labor and supply for labor. This leads to excessive supply of labor. This leads to excessive supply of labor in certain fields.
- Increased use of inappropriate technology which is capital intensive.

- Increased employment of foreign personnel/expatriation urban firms.
- High rate of discrimination in the labor market/labor market imperfections.
- Slow growth of industrial sector/limited industrial development in urban areas hence excessive production in the urban areas.
- Retrenchment of the civil servants as a structural adjustment programmes.
- Limited information about the available jobs opportunities.

Solutions to the open urban un employment.

- ✓ Ensure proper manpower planning such as that laboris trained in relation to the available jobs in urban areas.
- ✓ Promote rapid industrial development so as to absorb redundant labor I the urban areas.
- ✓ Encourage the use of appropriate technology especially labor intensive techniques so as to reduce the rapid growth and migration.
- ✓ Changing the education system to equip labor with relevant skills in urban areas.
- ✓ To promote population control measures such as the use of modern family planning so as to reduce rapid rural migration.
- ✓ Encourage development of rural areas through improved infrastructure so as to reduce rural urban migration.
- ✓ Promote political stability throughout the country so as to minimize the migration of people from the rural to urban areas.
- ✓ Encourage urban rural migrationby providing incentives to people who are willing to migrate and establish projects.
- ✓ Restrict he employment of foreign manpower in the urban centre so as to create jobs for the existing local labor.
- ✓ Changing the land tenure system so as to enable people access land for carrying out the economic activities in rural areas.
- ✓ Advertising the existing jobs so that the unemployed get informed with the available existing jobs inurban areas.

UNEB 2015

(i) Define the term cyclical unemployment. (01 marks)
(ii) Suggest any three measures that should be adopted to minimise cyclic unemployment in an economy. (03 marks)

9) Keynesian/Cycclical/Mass/Demanddefeciet Unemployment.

Cyclical unemployment is a type of unemployment which arise due to deficiency in aggregate/effective demand for final goods and services especially in the times of economic depression/recession.

Causes of Keynesian /Cyclical Unemployment.

- A fall in the investment.
- A fall in the prices.
- A fall in the savings.
- A fall in the government expenditure.
- A fall in incomes.

UNEB 2009.

i) State the Keynesian theory of unemployment. *(01 mark)*
ii) Give any three solutions to the Keynesian theory of unemployment problem. *(03 marks)*

UNEB 2006,2000, 1997, 1999

a) State the Keynesian theory of unemployment. *(06 marks)*
b) To what extent is the Keynesian theory relevant to developing countries? *(14 marks)*

THE KEYNESIAN THEORY OF UNEMPLOYMENT (BY J.M LORD KEYNES)

The theory of unemployment states that unemployment arises durer to deficiency in the aggregate/effective demand for final goods and services especially in the times of economic depression/recession.

According to him, due to low/limited/inadequate demand for goods and services, employers reduce their output, income levels fall and investment is generally discouraged hence less labour and capital are employed.

The major remedy to unemployment according to Keynes is increasing aggregate demand through ,

- Reducing the taxation levels.
- Increasing wages.
- Subsidization of consumers.
- Improving investment climate by providing the investment climate.
- Increasing the government expenditure.
- Increasing money supply through expansionary monetary policy.

The Keynesian theory of unemployment is illustrated as follows.

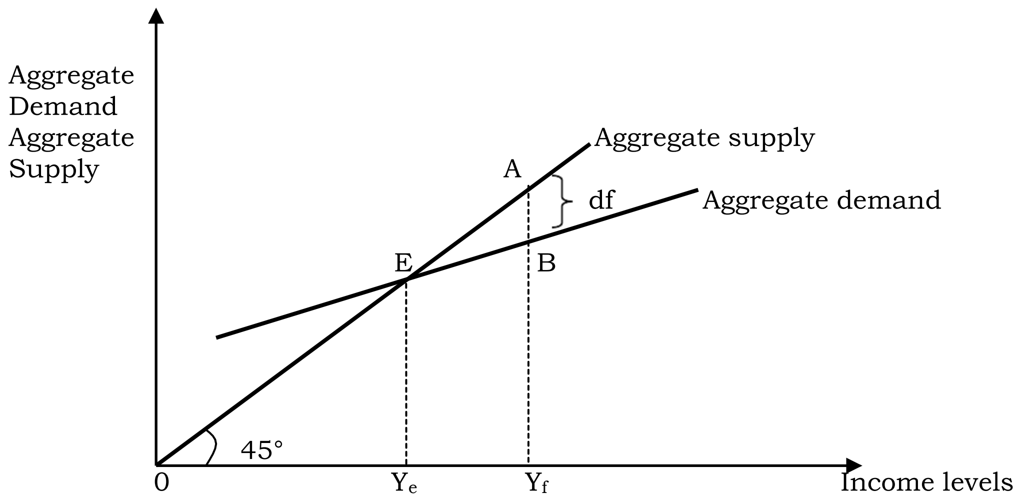


Figure 6.1: Keynesian unemployment

The level of unemployment YeYF is due to deficiency in aggregate demand shown by df. i.e. AB.

IRRELEVANCIES/CRITICISMS/ LIMITATIONS OF KEYNESIAN THEORY OF UNEMPLOYMENT TO UGANDA/LDCS.

To a larger extent, the Keynesian theory of unemployment is irrelevant to Uganda /LDCs.

(direct your explanation to where the question is meant to apply i.e. either to your country or developing countries).

1. The Keynesian theory is mainly concerned with deficiency aggregate demand and yet unemployment in LDCs/Uganda is basically from the supply side.
   There is shortage of co operant factors of production, supply rigidities to expand agriculture, industry to create more employment opportunities.
2. The theory is mainly applicable in industrialized economies and yet LDCs are mainly and largely agro based economies.
3. The theoryis based on an assumption of ahighly monetized industrial economy and yet most of the economies of LDCs are basically subsistence.
4. As a solution to unemployment, Keynes prescribes poliices to increase money supply which increases aggregate demand but these policies tend to be inflationary in LDCs/Uganda.
5. The theory emphasizes investment multipler as the major contributor to emlployment yet in most LDCs (Uganda inclusive), it is the export multiplier in existence.
6. The theory is based on a closed economy and yet economies of LDCs are open which makes the theory irrelevant.
7. The theory assumes a well functional factor, product and money markets and yet they are not as functional as in more developed countries.

8. The theory is applicable under conditions of full employment yet such conditions are not found in LDCs/Uganda since many resources are still underutilized/unemployed.
9. The theory is based on the existence of a big and a strong private sector and yet the private sector is very small and weak in LDCs/Uganda. It cannot easily respond to create more job opportunities.
10. Firms in LDCs/Uganda tend not to respond quickly and effectively to changes in aggregate demand because of structural difficulties such as industrial breakdown, limited supply of raw materials hence rendering the theory irrelevant to LDCs.

    Therefore even if there is increased aggregate demand, it may not necessary be accompanies by increased production to increase employment since firms cannot respond quickly and effectively to changes in demand.

RELEVANCY/APPLICABILITY OF KEYNESIAN THEORY OF UNEMPLOYMENT TO LDCS/UGANDA.

To a smaller extent, the keynsian theory of unemployment is relevant to Uganda/LDCs

(i) The use of expansionary monetary policy to increase purchasing power in LDCs/Uganda has tended to increase aggregate demand which stimulates more production and employment levels and prescribed by Keynes.

(ii) Investment climate affects employment levels as suggested by the theory and therefore increased investment incentives in LDCs/Uganda helps to expand employment opportunities as stated by Keynes.

(iii) In Uganda/LDCs there is an element of industrialization and hence the theory applies in the industrialsector.

(iv) At times unemployment in LDCs/Uganda results from afall in aggregate demand for final goods either in the domestic or in foreign market. This discourages production leading to unemployment.

For instance in recent years there has been a fall in employment in the coffee sub sector due to a fall in the prices of coffee hence making the theory applicable.

(v) In the long run, as supply of cooperant factors for labour increase such as capital, the theory becomes relevant to Uganda/LDCs. This is because increased acquisition of capital in the long run increases production and job creation.

Assumption of Keynesian theory of unemployment.

1. Assumes a closed economy.
2. Existence of full employment
3. A highly monetized economy.
4. A highly industrialized economy.

5. A strong and large private sector.

Causes of unemployment according to J.M Lord Keynes.

1. A fall in the level f exports especiallyfor a particular commodity thus low foreignexchange earnings.
2. A fall in prices of goods which forces employers to lay off some workers.
3. A fall in government expenditure leading to low employment thus low aggregate demand .
4. A fall in the rate of savings which later affects the level of investment.
5. A fall in incomes which reduces consumption and aggregate demand as well.

UNEB 2002

a) What according to J.M Keynes are the solutions to unemployment problem? (06 marks)

b) Explain the limitations of the Keynesian theory of unemployment in developing countries. (14 marks)

Remedies/Solutions To Unemployment According To J.M Lord Keynes.

The remedies/solutions to Keynesian unemployment are aimed at increasing aggregate demand to absorb more units oflabour that are originally unemployed thus increasing employment levels by.

1. Reducing direct taxes in order to increase disposable income and aggregate demand for goods and services which encourages more investment and creates more jobs.
2. Increased government expenditure to enhance investment, employment which increases earnings and later aggregate demand and creates more investment and employment.
3. Expansionary monetary policy. Increasing money supply by printing more money increases aggregate demand and creates more investment and employment.
4. Subsidization of consumers to increase their effective demand which increases investment and employment opportunities.
5. Improving on investment climate by givingincentives to investors to encourage private investments and increase aggregate demand which stimulates more production and employment and employment creation.
6. Increasing wages for workers so as to increase their incomes and later increase aggregate demand which stimulates more investment and employment creation.

UNEB 2001

a) Account for unemployment problem in your country. (08 marks)

b) Explain the measures being taken to tackle the unemployment problem in your country. (12 marks)

UNEB 2011

a) *What are the causes of unemployment in an economy.* *(10 marks)*
b) *Explain the effects of unemployment in an economy.* *(10 marks)*

UNEB 2014

a) *Explain the causes of unemployment in your country.* *(10 marks)*
b) *Suggest measures that should be taken by the government to reduce unemployment in your country.* *(10 marks)*

GENERAL CAUSES OF UNEMPLOYMENT IN UGANDA.

1) **Technological progress and increased use of capital intensive techniques.** Many workers are replaced by machines such as computers in production, machinery in agriculture where human labour has been replaced by machines thus causing technological unemployment.
2) **Rapid population growth rate compared to employment creation.** Population grows at high rate of 3.4% per annum implying that majority join the labour market and the rate at which jobs are created is limited due to problems associated with large population size hence causing unemployment.
3) **Inappropriate education system/limited skills.** The education system is not practical since it is dominated by theoretical and traditional subjects leading to limited skills. It trains job seekers instead of job makers hence limited entrepreneurship ability thus low self employment creation.
4) **Structural adjustment programmes of IMF of reducing government expenditure.** The government policy of restructuring civil service lays off workers in order to reducing the size of civil servants and government expenditure hence causing unemployment.

   Forinstance retrenchment of civil servants in Uganda led to loss of jobs.
5) **Limited cooperant factors of production especially capital.** There is limited capital to expand investment and create jobs through industrial establishments thus limited employment creation. Thisis because it is difficult to mobilize the required funds by most investors.
6) **Discrimination in the labour market.** High rate of labour market imperfections rampant in Uganda is based on political parties, age, sex religion, color, family background and some people fail to get jobs on such grounds. This leaves many qualified people with no jobs.
7) **Poor political climate in some areas.** This discourages meaningful economic activity which limits investment by both local and foreign investors and retards employment creation. Unstable political climate in some parts of Uganda scares away investors and redirects resources from economic activities to destructive war efforts thus limited job creation.

8) **Physical andmental incapacitations leading to immobility of labour.** Disabled individuals are immobile both occupationally and geographically and in most cases remain unemployed since most companies cannot absorb such labour leading to residual unemployment.
9) **Changes/variation in seasons especially in agriculture.** There are fluctuations in the level of employment especially in the agricultural sector dueto limited diversification and over reliance on nature thus creating differences in demand for labour leading to seasonal unemployment.
10) **High rate of rural urban migration.** Overwhelming majority of people move to urban areas especially the youth mainly due to social services gap and wage gap between rural and urban area. As result, they fail to get jobs leading to open urban unemployment.
11) **Poor land tenure system.** Land belongs to a few landlords who own large pieces of land who in most cases don"t use for serious production and majority of people do not have access to land toenable them participate in production and create self employment leading to disguised unemployment.
12) **Ignorance of labour about existing job opportunities.** Lack of enough information about availability of job opportunities in certain areas causes frictional unemployment. This is mainly due to limited access to information on existing jobs since there are no job centres thus increasing frictional unemployment.
13) **Unfavourable changes indemand and fashions/loss ofmarket/fall in demand.** This is due to low incomes and changes in tastes and fashions which discourages expanded production in specific sectors, laying off workers leading to structural unemployment.
14) **Poor manpower planning.** Manpower development programmes in Uganda are inappropriate and this leads to excessive supply of manpower in some sectors than demandfor labour and limited supply of labour in some sectors leading to unemployment.
15) **Changing of jobs causing frictional unemployment.** Labour is normally moving from one job to another especially after the expiry of contracts and in this process of looking for alternative jobs, such labour is unemployed.

UNEB 2003

a) *What are the causes of disguised unemployment iun your country. (04 marks)*
b) *Explain the measures that should be taken to increase the level of employment in your country. (16 marks)*

UNEB 2010

a) *Differentiate between voluntary unemployment and involuntary unemployment.* *(04 marks)*
b) *Suggest possible measures of reducing unemployment problem in your country.* *(16 marks)*

MEASURES THAT SHOULD BE TAKEN TO REDUCE UNEMPLOYMENT IN DEVELOPING COUNTRIES.

1. **Encourage use of appropriate technology.** This should be done by establishing cottage industries/small scale industries which use, mainlylaborintensive technology thus increasing employment of human labor both in rural and urban areas.
2. **Population control measures.** There is a need to control the growing population so as to match with the rate of investment through family planning methods, female education. This reduces adverseeffects o high population growth on labor supply in relation to available jobs.
3. **Promote and maintain political stability.** This helps to attract various investors and create more jobs through the multiplier process thus increasing production and employment creation. Good governance and peace talks with rebels to reduce a draw back on expansion of productive employment should be ensured.
4. **Further liberalization of the economy.** This is the removal of the unnecessary controls over trade thereby giving liberty to trade without undue government controls. Such a favorable trade policy helps to expand a job creation through expansion of the informal sector andcreation of more projects hence creating more jobopportunities.
5. **Expand market for goods and services.** This should be done by joining economic integrationssuch as COMESA,EAC to encourage labor mobility and increase investment to create more job opportunities.
6. **Setup and improve infrastructure.** The existing infrastructure inform of roads, railways, telecommunication services should be modernized to establish new ones where it is necessary to encourage production especially in rural areas, increase labor mobility and employment creation .
7. **Undertake educational reforms/serious manpower planning.** Educationalprogrammers" need to be vocationalisedso as to create graduates who are practical and job creators by equippinglaborwithrelevantskills that can easily be absorbed in the current labor market.
8. **Further privatization of public enterprises.** More transfer of the public enterprises to private sector thelong run due to improved efficiency because these investimentsare sized up on the by the private entrepreneurs and acquire capacity to employ more labor in the long run.

9. **Promote diversiofication of the economy.** This can be done by establishing small scale industries and diversifying the agricultural sector, introducing many economic activities which reduce seasonal unemployment.
10. **Set up more specialized institutions to encourage investment and job creation.** For instance institutions such as the Uganda investment authority are necessary to provide information to investors on various investment opportunities available and easy licensing to increase production and hence high investment and job creation.
11. **Increase advertisement of existing jobs.** Extensive advertising on available jobs in newspaperfs, radios, and televisions which helps to reduce ignorance among workers on the availability both public and private sectors which increases access to jobs.
12. **Adopt land reforms/facilitate access to land.** The ownership of land should be charged to enable the majority of people to have access to land and participate in serious production through land act to create their own businesses especially in rural area and expanmd production hence reducing disguised unemployment.
13. **Attraction of more foreign inevstors or improve investment climate.** More foreign investors with huge businesses should be attracted through investment incenytives such as tax holidays, tax exeptions, subsidies and extensive advertising in foreign media which helps to establish more investments that create more jobs in the long run.
14. **Provision of affordable credit or loans to local investors.** This enables the youth, women to acquire loans at low interest rates hence creating more jobs forinstance prosperity for all programes through whigh people start and expand self-help projects and create own jobs should be empasized hence increasing employment.
15. **Promote modernization and commercialization of agriculture.** This should be done with increased emphasis on such to improve the quality okf seed and animal varietie, irrigation practices to reduce overdependence on nature. This increases agricultural productivity and reduces seasonal unemployment.
16. **Provides special programes for persons with disabilities.** This helps to reduce residual unemployment.

INDUSTRIALIZATION AS A SOLUTION TO UNEMPLOYMENT IN UGANDA

industrialization is taking place in ugandna but it has failed to reduce rampat unemployment because of :-

- **Many industries are located in unrban areas.** This causes rural urban migration leading to open urban unemploying and worsens the situation.

- **Most industries use capital intensive technology especially large scale industries.** This leads to technological unemployment and reduces employment for labour.
- **Most large scale industries are owned by foreigners who prefer to employ their own man power.** This denies employment of the local man power.
- **Limited domestic market.** Market for industrial output is low implying that industries can not be expanded to absorb more labour in the urban areas.
- **Limited enterprenuer skills to be employed in the industries.** Enterprenuers are limitegd hence power organisation of other factors of production which leadcs to increased employment of foreign enterptrenuers hence living local man power unemployed.
- **Rapid population growth compared to the rate at which jobs are created through industrialization.** Population growthr increases at the high rate which increases the growth of labour and yet industrialization is not rapidly growth.
- **Many industries operate on small scale implying less labour is employed.** Many industries lack economies of scale absorb the redundant labour force in urban areas.
- **Limited skilled labour to work in industries.** Majority of the workers are semi skilled and unskilled and cannot work in urban industries.
- **Excess capacity in most industries.** Most industries produce at less than optimum and this leads to less demand for labour to work in such industries.

UNDER EMPLOYMENT

Under employment refers to as state of underutilizing of the available economic resources especially labor.

It‟s a state of underutilization of labor in terms of working for less time than the desired or laborengaging in the jobs far below his skills.

This is a situation where labor is underutilized or where the full potential of labor is not realized and a worker engages in a job far below his skills.

Under employment exists in the following ways.

- Being employed but with negative attitude towards that work.
- Fewer hours worked than expected.
- Working full hours on socially undesirable jobs.
- Taking up the jobs not in line with some ones training.
- When workers are overcrowded on a fixed piece of land which leads to disguised unemployment.

PROBLEMS OF UNDER EMPLOYMENT IN AN ECONOMY.

- ✓ Low tax revenue from peoples income.
- ✓ Increases income inequality.
- ✓ Increases dependence syndrome.
- ✓ Leads to loss of productivity because scarce labour is not fully utilized.
- ✓ Low GDP is realized because of low labour productivity.
- ✓ High crime rates among the under employed.
- ✓ Low aggregate demand for goods and services due to low income.
- ✓ Leadcs to emergency of social dualism i.e a class of the rich and the poor.

UNEB 2010

Mention any four causes of underemployment in an economy. (04 marks)

CAUSES OF UNDEREMPLOYMENT IN AN ECONOMY.

- ❖ Inadequate supply of co operant factors of production.
- ❖ High rate of rural urban migration.
- ❖ Poor land tenure system.
- ❖ Poor man power planning.
- ❖ Political instability.
- ❖ Negative attitude of people towards work.
- ❖ Desire to retain laboaur force by employers.
- ❖ Discrimination in the labour market.
- ❖ High population growth rates.
- ❖ Poor attitude of people towards work.
- ❖ Limited market for output.
- ❖ Limited skills for employment .
- ❖ Seasonal changes especially in agriculture.
- ❖ Ignorance of the people about availability of the jobs.

UNEB 2001

a) *What is meant by the term full employment. (04 marks)*
b) *Why is it difficult to attain full employment in an economy. (16 marks)*

FULL EMPLOYMENT.

This is the situation where everybody who is capable and willing to work can get a job or it is a situation where the rate of an employment in an economy is 3% or less. **Or**

It is a situation in which the number of people looking for jobs (job seekers) is equal to the number of available or unfilled job vacancies.

Or

It refers to a situation where there are more jobs than job seekers. It is a situation where all labour or factors willing to work can get work. The unemployment rate in an economy is 3% or less.

WHY IS IT DIFFICULT TO ATTAIN FULL EMPLOYMENT IN UGANDA AND OTHER LDCs.

In most developing economies, it is impossible to attain full employment because of the following:-

1. **Continued use of capital intensive technology.** Increases use of machines replaces human labour which leads to increase in technological unemployment hence making it difficult to attain full employment.
2. **High rate of rural urban migration.** This leads to open urban unemployment since the number of job seekers exceed job vacancies in urban areas which makes it difficult to attain full employment.
3. **Poor political climate which discourages investment.** This results into reduces job creation and involvement in work in affected areas making it difficult to attain full employment.
4. **High population growth rate.** This increases the size of labour force compared to the rate at which jobs are created making it difficult to achieve full employment.
5. **Seasonal changes due to heavy dependence on natural factors.** This causes seasonal unemploymentespecially in agriculture due to reduced demand of labour in some seasons making it difficult to attain full employment.
6. **Persistence of a large subsistence sector.** This discourages large scale production and limits job creation hence making it difficult to attain full employment.
7. **Limited domestic and foreign market.** This discourages expanded production and exployment creation hence making it difficult to attain full employment.
8. **Ignorance of labor about the existing jobs** thus frictional unemployment cannot be avoided in an economy. This makes it difficult to attain full employment.
9. **Shortage of co operant factors of production especially capital.** This limits creation of the investment opportunities making it difficult to attain full employment.
10. **Discrimination in the labor market.** This is based on age, sex, religion, family background, and political parties. High rate of social barriers in the labor market. These forces workers to remain unemployed make it difficult to attain full employment.

11. **Structural changes in an economy** such as the exhaustion of raw materials, frequent break down of production firms which lead to temporary unemployment making it difficult to attain full employment.
12. **Trade union restrictions which restrict entry of new employees in various occupations.** They limit employment of new employees so as to keep their wages high hence making it difficult to attain full employment.
13. **Poor education system.** This is basically theoretical education which trains the job seekers instead of job creators hence making it difficult to attain full employment.
14. **High levels of capital outflow.** Increased capital outflow by foreign investorslimits the level of investment as well as job creation hence making it difficult to attain full employment.

UNEB 2008

a) *Explain the causes of unemployment according to J.M.Keynes. (06 marks)*
b) *What are the effects of unemployment in your country? (14 marks)*

EFFECTS OF UNEMPLOYMENT /REASONS WHY UNEMPLOYMENT IS UNDESIRABLE IN ECONOMY/COSTS OF UNEMPLOYMENT

Costs of unemployment refer to the adverse effects unemployment has on an economy, the unemployed, their families and the society as awhole.

1) **Increases the dependence burden of the unemployed on the employed.** The unemployed can depend on the few employed individuals which reduces investments and saving.
2) **Leads to the decline in the standards of living and causes misery.** Unemployed people are unable to access all the essentials of life such as medical care, food and this causes more human suffering and poor standards of living.
3) **Increases the government expenditure on the unemployed.** The government spends heavily through providing unemployment benefits and on public goods and services since individuals have limited capacity to provide private goods hence budgetary deficits.
4) **Low government tax revenue through direct taxes.** In situations of high rate of an employment, income tax reduces since majority has low incomes to tax.
5) **Leads to social unrest/instabilities in families.** This is due to human misery especially where people do not have adequate means of subsistence leading to conflicts among families.
6) **Worsens incomes and wealthy inequalities.** This happens between those employed and the majority unemployed which exposes an economy to disadvantages of income inequality.

7) **Leads to high crime rates/immorality among the unemployed.** It is easy for the unemployed groups to engage in anti social behavior such as prostitution, murder, alcoholism, pick pocketing, robbery, rape in the process of trying to look for means of survival.
8) **Causes unpopularity of the government in power/results into political tension or unrest/instability.** High rates of unemployment erodes government popularity since it faces stiff opposition for the public. The frustrated unemployed can easily be convinced to join anti government organs or rebel groups. This leads to political instability/unrest, riots,protests and fertile grounds for armed conflicts.
9) **Reduces aggregate demand for goods and services.** High rates of unemployment imply limited income leading to limited capacity to purchase goods and services. This limits the level of further investment.
10) **Leads to brain drain.** High rates of unemployment are characterized by poor working conditions; low wages which forces the existing highly skilled and professional man power to migrate to other countries for greener pastures hence limited supply of skilled labour.
11) **Leads to low production levels hence low size of GNP.** Goods and services that would have been produced by unemployed labour cannot be realized hence retarding economic growth.
12) **Leads to declines in the level; of acquired skills.** Skills of the unemployed labour become increasingly outdated in relation to changing job requirements. This result from redundancy of labour after failing to get employment and therefore quality of labour reduced.
13) **Discourages investment in education.** As a result of wasting resources in training labour that ends up becoming idle reduced enrolment in educational institutions and quality of education. It discourages some people from investing further education.
14) **Leads to under exploitation of productive resources such as labour.** This is because the unemployed lack the necessary capital to employ other resources which leads to resource wastage.
15) **Increases rural urban migration and its associated adverse effects.** The unemployed tend to migrate to urban areas in large numbers due to high prospects of securing jobs in such areas.

CHAPTER 7: INFLATION

Inflation is the persistence increase in general price level for goods and services in a given period of time. During inflation, the value of money is continuously falling. This implies that the purchasing power of the countries currency is persistently falling and this is reflected by too much money purchasing too few commodities.

Inflation does not mean that prices are high. If prices increase and stabilize at a certain higher level for some time, such a situation is not referred to as inflation but just a high cost of living.

Inflation has been a major macroeconomic problem in Uganda and other developing countries with adverse impact on such economies which has been forcing the government to tighten monitory and fiscal policies.

STATE OF INFLATION.

This refers to the rate or speed at which prices are increasing in an economy. The state of inflation can be creeping or galloping.

a) **Mild/Creeping/Gradual/Go Slow Inflation.**
Mild inflation is where persistent increase in the general prices 9of commodities proceeds at a low rate usually not exceeding 10% per annum. **Or**
Its one which is characterized with the slow rise in general price level usually less than 10% per annum. It is a single digit inflation and desirable in the economy as it may even be induced by the government so as to stimulate investment and employmentlevels. The increase in the price may not easily be noticeable by the general public.

UNEB 2005

i) *Distinguish between creeping inflation and galloping inflation. (02 marks)*
ii) *Mention any two positive effects of creeping inflation In your economy. (02 marks)*

POSITIVE EFFECTS OF CREEPING INFLATION

- Promotes commercialization of the economy.
- Stimulates the effort/incentives to work harder.
- Generates more employment opportunities due to increased investment.
- Encourages more production hence high output.
- Increases the better utilization of resources.
- Increases profit margins of the firms.
- Encourages innovations and creativity.
- Encourages labour mobility.

- Promotes entrepreneur ability as more people are encouraged to risk in the business ventures..
- Increases the government tax revenue since production level is increased.

b) Hyper /Galloping Inflation /Runaway Inflation.

This is where the persistent increase in the general price of goods and services proceeds at a very high rate, the increase taking place in hours , days, weeks and usually above 20% per annum. The percentage point increase per annum is over 20%. or, it is one which is characterized by a rapid rise n the general price level of goods and services in a given period of time. The increase taking place in hours, minutes, days, or weeks. The percentage increase per annum is over 20%. For example in September 2011 in Uganda,it was 28.3% and the highest since 1993. This form of inflation can easily be noticeable by the public and it is generally undesirable since it discouragesconsumption, savings and investment .

UNEB 2010

i)) Distinguish between suppressed inflation and hyper inflation. (02 marks
ii) Mention any two effects of hyper inflation. (02 marks)

Effects of hyper inflation in an economy.

- Discourages savings.
- Leads to industrial unrest.
- Leads to loss of confidence in a country"s currency.
- Leads to uneven distribution of income.
- Makes government unpopular.
- Leads to low standard of living.
- Leads to unemployment.
- Leads to brain drain.
- Makes planning difficult.
- Discourages local and foreign investors.
- Landing is discouraging as creditors stand to lose.
- Worsens balance of payment problem.
- Fixed income earners suffer.
- Encourages illegal activities.
- Promotes speculation and its disadvantages.
- High costs of production may lead to reduced production.

Measurement of inflation.

Inflation is measured using price index and it is expressed in percentage over a period of a year.

The retail price index which records changes in the prices of goods and services will help.

$$\text{Inflation rate} = \frac{P1-Po}{Po} \times 100$$

Where,

Po is last year‟s price level.

P1 is the current year‟s price level.

UNEB 2006.

i) *Distinguish between demand pull inflation and cost push inflation. (02 marks)*
ii) *State any two causes of demand pull inflation in your country. (02 marks)*

TYPES/THEORIES OF INFLATION.

a) **Demand pull inflation/excess demand inflation.**

Demand pull inflation refers to (one) persistent increase in general price level which arises as a result of excessive aggregate for goods and services compared to aggregate supply in conditions of full employment.

Or

This refers to one or a form of inflation that arises out of excessive aggregate demand for goods and services over aggregate supply at full employment of resources.

Causes of demand pull inflation.

1. **Excessive government expenditure** which results into increase in income and aggregate demand leading to a rise in general price level.
2. **Excessive issuing of currency by the central bank.** Government printing more money through the central bank and circulating it into the public which increases money supply and aggregate demand leading to increase in general price level.
3. **Increased demand for exports** which reduces the amount of goods in the domestic economy leading to increase in general price level.
4. **Persistent increase in wages/salaries of workers** which increases their purchasing power and aggregate demand leadingto persistent increase in general price level.
5. **Un controlled credit creation by commercial banks** which increases money in circulation leading to arise in general price level.
6. **Excessive inflow of incopmes from abroad/increased capital inflows.** i.e. increased foreign investments, increased export earnings, grants and returns from nationals aboard leading to increase in general price level.

Solutions to demand pull inflation.

- Reduce excessive government expenditure so as to reduce income for spending thus reducing aggregate demand.
- Increase direct taxes. i.e. use of progressive taxation to reduce disposable income and aggregate demand.
- Use of wage freeze/control wages for workers especially those in high income brackets leading to reduced aggregate demand.
- Fix a minimum price for major commodities to bring about stability in general price level.
- Adopt a restrictive monetary policy to reduce money supply. For instance increase the bank rate and in turn commercial banks increase interest rates on loanable funds. This reduce money supply which cuts down aggregate demand.

UNEB 2002

i) Distinguish between structural inflation and demand pull inflation. (02 marks)

ii) Mention any two effects of demand pull inflation in your country. (02 marks)

POSITIVE EFFECTS OF DEMAND PULL INFLATION ON AN ECONOMY.

- Employment opportunities are expanded.
- Promotes productivity hence increased economic growth.
- Encourages hard work among people.
- Debtors stand to gain real terms if it is high.
- Increases investment when it is mild.
- Encourages innovations and creativity.
- Results into increased tax revenue.
- Increases resource utilization.

NEGATIVE EFFECTS OF DEMAND PULL INFLATION ON AN ECONOMY.

- Discourages increased savings in case it is very high.
- Leads to loss of confidence in a country"s currency.
- Worsens balance of payment problems.
- Fixed income earners lose and suffer.
- Worsens the problem of income inequalities.
- Creditors lose which discourages lending.
- High rates of demand pull inflation makes government planning very difficult.
- Raises interest rates which discourages borrowing.

b) **Cost push inflation.**

Cost push inflation is (one) persistent increase in general price level which arises as a result of increased/rising costs of production which increases prices of final products.

The increase in cost of production is shifted to consumers of final goods and services in form of high prices.

Inflationary spiral or spiral inflation.

Inflationary spiral is where persistent increase in general pricelevel is used to demand for higher wages by workers which increases coast of production leading to increase in prices which again increases demand for higher wages.

Causes Of Cost Push Inflation.

1. **Increases in indirect taxation** to producers which increases cost of production hence high prices.
2. **Increase in interest rate charged on borrowed capital/loans to producers.** This increases costs of production hence high prices.
3. **Increased cost of inputs** such as high [prices of raw materials. This increases cost of production leading to inflation.
4. **Increased wages and salaries of workers** usually influenced by tradfe unions and government fixing a minimum wage. These are reflected on high prices of goods produced.
5. **Increased in cost of transport** due to underdeveloped roads, railways.
6. **Increase in cost of advertising.** Extensive competitive sales promotional activities among producers especially where substitute commodities are produced is reflected on increased commodity prices.
7. **Increase in electricity charges** arising from power shortages.
8. **Increased storage costs.** This is especially due to high ware housing facilities especially due to high ware housing facilities especially during importation of commodities.

Solutions To Cost Push Inflation.

- **Use of maximum price legislation.** This helps to lower the prices of goods due to reduced cost of production hence reduced general price level.
- **Provision of subsidies to producers to cut down costs of production.** This reduces cost of production hence lowering general price level.
- **Selective taxation and granting of tax holidays to some producers.** This reduces cost of production hence lowering general price level.
- **Emphasize wage control through wage freeze.** Government control on trade union activities especially demand for higher wages thus keeping production costs low thus reducing general price level.
- **Encourage development of infrastrucrure.** This reduces cost qof trans[port hence reduce d price level.
- **Controlling interest rate on borrowed capital** through monetary policy such as reduced bank rate. This reduces cost of production and general price level as well.

- **Provision of non monetary rewards to workers.** This helps to reduce increased demand for higher wages hence reduced cost of production and general price level as well.

c) **Bottleneck/structural /scarcity inflation.**

Structural inflation is (one) persistent increase in general price level as a result of supply regidities leading to shortages in supply of commodities in the domestic economy.

Or

It refers to one or a form of inflation arising out of supply rigidities which cause shortages of goods and services in the domestic economy. It results from structural problems in an economy.

UNEB 1999

Give any four causes of structural inflation in an economy. (04 marks)

UNEB 2010

i) What is structural inflation? (01 marks)
ii) Give any three causes of structural inflation in your country. (03 marks)

UNEB 2014

(i) Distinguish between structural inflation and cost-push inflation. (02 marks)
(ii) Give any two causes of cost-push inflation. (02 marks)

UNEB 2012

i) Distinguish between cost push inflation and bottleneck inflation. (02 marks)
ii) Mention any two causes of bottleneck inflation in your country. (02 marks)

Causes Of Structural/Bottleneck Inflation.

- **Unfavourable natural factors/natural hazards.** Failure in agricultural production due to uncontrollable factors such as changes in weather leading to limited output leading to high prices.
- **Breakdown in industrial production** i.e. break down of machinery due to limited spare parts, limited skilled labour thus low output leading to high prices.
- **Infrastructural breakdown.** Whenever productive infrastructure breaks down, it limits supply of commodities to some areas. For instance poor road and railway network leading to high prices.
- **Persistent shortages of inputs/exhaustion of raw materials** implying that production levels reduce leading to high prices.
- **Speculation by the business community** which creates artificial scarcity of goods and services through hoarding thus high prices.

- **Existence of political instability.** This discourages production thus low output levels and high prices.
- **Persistent foreign exchnages** due to poor export performanbce ieless foreign exchange to increase imports and expand production at home thus high prices.

UNEB 2009

i) Define the term structural inflation. (01 marks)
ii) Mention any three measures that can be taken to control structural inflation in an economic. (03 marks)

Solutions To Structural Inflation.

1) **Improve infrastructure,** i.e. repairing exisisting railways and roads , building dams to generate hydro electric power and increase the output leading to reduced prices.
2) **Agricultural modernisaztion** to increase agricultural output thus reducing prices.
3) **Ensure political stability and security** to stimulate production leading to high output and reduced prices.
4) **Increased importation of then majour raw materials.** This increases production levels hence reduced prices.
5) **Improvement and expansion in the industrial sector** by rehabilitating crippled industries hence oincreasing the industrial output and reducing prices.
6) **Provision of investiment incentives** to encourage private local and foreign entrepreneurs to stimulate production levels and reduce the price.
7) **Encourage economic liberalization** to attract several economic activities and increase the output hence reducing prices.
8) **Adopt better methods of production.** This is intended to increase the output levels.

d) **Imported Inflation**.

Imported inflation refers to the persistent increase in the general price levels in an economy as a result of importing goods from inflation hit /prone economies.

Or

This is one which arises as a result of importing goods and services from countries experiencing inflation.

In 2011, the Uganda shilling was ranked one of the world"s worst performing currency .the shilling lost 21.5%against the dollar hence driving up the prices of imported goods.

Causes Of Imported Inflation.

- High prices for fuel on the world market .
- Importation of the consumer goods from a country facing inflation /importastion of the already inflated commodities.
- Rising prices for goods and services on the world market.
- Depreciation of the countrys currency . highn foreign exchange rate leading to high cost of importation .

Solutions To The Imported Inflation.

- Protectionism by restricting imports from the inflation prone countries.
- Adopt import substitution industrial strategy.
- Subsidize importers of raw materials and essential goods by the government so as to sell at low prices.
- Economic integration to allow trade creation. This leads to the importation of cheaper goods from the member countries.
- Control foreign exchange rates.

e) **Suppresed/Controlled Inflation.**

Suppressed inflation is a situation where demand exceeds supply but the effect of this on general price level is reduced by price controls and rationing.
It"s a situation where price when inflationary tendencies are present in an economy.
When the aggregate demand is greater than aggregate supply, the government can suppress inflation by the use of price controls through fixing the maximum price. The government comes in when the inflation becomes undesirable.

Effects Of Suppressed Inflation.

- Emergence of black markets.
- Discourages investment.
- Controls speculation.
- Increases the unemployment.
- Leads to the misallocation of resources.

f) **Monetary Inflation**.

Monetary inflation is one arises from the excessive increase in money supply which increases aggregate demand that is not accompqanied by corresponding supply of commodities in an economy.
According to monetarists, increase in the general price is caused by an increase in the money supply which is noit backed up by the increased production .

It occurs especially when the central bank prints more money into circulation and is not followed by increasd supply in the commodities.

Causes Of Monetary Inflation.

1. Increased supply of money by the central bank.
2. Reduction in the taxes.
3. Increase in the government expenditure.

However an increase In t he money supply may not necessarily lead to the inflation because of the following;

- When there is an effective price control measure and therefore inflation is suppressed.
- When there is a corresponding increase in the rate of production of commodities.
- Incase marginal propensity tosave is highimplying thatmoney is not spent.
- When an increase in the money supply is used to purchase capital goods and not consumer goods.

g) **Speculative Inflation/expectional inflation.**

This is one which rises due to expected shortages of commodities in the future which leads to excessive buying which forces the prices to rise high. When people predict that the prices will increase in future , they tend to purchase in the current period to avoid paying high prices in future but this leads to excessive buying wich forces the prices to rise.

NB;

Underlying inflation. This is the measure of the rate of inflation for all goods and services excluding food stuffs. This measures changes in the prices of goods excluding food stuffs in a given economy over time.

Headline inflation. This is the measure of the rate of inflation for all goods including food prices. This measures the changes in the price levels of goods and services including the food stuffs in an economy over time.

UNEB 2006

(i) Distinguish between the deflation and relation. *(02 marks)*

(ii) Mention any two instruments of reflationary policy. *(02 marks)*

DEFLATION AND REFLATION

Deflation.

Deflation refers to the persistent decrease in the general prices of the goods and services in an economy. This is mainly caused by the fall in aggregate demand. Prices of goods and services are on a downward trend.

Reflation.

Reflation refers to a deliberate government policy to stimulate production by increasing prices to recover an economy from a depression.

It is a policy taken by the government to lift an economy out of an economic depression by increasing prices.

Instruments of reflationary policy in an economy.

(how can reflation be achieved)

- Reducing direct taxes.
- Encouraging exports to other countries.
- Increasing wages of workers.
- Increasing government expenditure.
- Use of expansionary monetary policy.

UNEB 2007.

i) *What is meant by stagflation* *(01 marks)*
ii) *Suggest any three measures that can be taken to reduce stagflation in an economy.* *(03 marks)*

Stagflation.

Stagflation refers to a situation in which high rates of inflation co-exists with high levels of unemployment in an economy.

Or

It refers to a situation where there exits both high levels of unemployment and high rates of inflation in an economy.

Costs/Effects Of Stagflation.

- Increases the country‟s cost of living.
- Reduces levels of investment.
- Widens income inequality.
- Reduces tax revenue.
- Rapid decline in people‟s welfare or standard of living .
- Increases social tension and distress in society.
- Increases dependence burden.

Measures that can be taken to reduce stagflation in an economy.

1. Reduce taxes to increase disposable income to increase investment.
2. Increase government expenditure to encourage more production.
3. Increase output through reduction in factor input costs.
4. Liberalize monetary policy to reduce interest rate on capital and encourage more investment.

UNEB 2009.

(i) *Distinguish between cost-push inflation and demand-pull inflation. (04 marks)*
(ii) *Account for the persistent inflation in your country. (16 marks)*

UNEB 2011.

a) *Explain the causes of inflation in your country. (10 marks)*
b) *What policy measures are being undertaken to control inflation in your country. (10 marks)*

UNEB 1997.

a) *Examine the causes of inflation in your country. (12 marks)*
b) *Why may a low rate of inflation be desirable in an economy. (08 marks)*

UNEB 2015

a) *Explain the causes of inflation in an economy. (06 marks)*
b) *Suggest measures that should be taken to control inflation in an economy. (14 marks)*

GENERAL CAUSES OF INFLATION IN UGANDA

NB. These causes should be discussed as forces that lead to high money supply, increase supply rigidities that causes supply shortages and other direct forces that cause the general price level to increase.

Forexample in December 2011, inflation in Uganda was between 29-30.4% and was partly attributed to increased aggregate demand against constrained supply of commodities.

Over the years, inflation in Uganda has been a major macroeconomic problem. During 1970"s and 1980"s Uganda was faced with hyper inflation. The amount of money in an economy was increasing at an alarming rate leading to sky rocketing prices but in early 1990"s, it was reduced to about 23%.

Inflation over the years in Uganda has been due to the following factors.

1. **Excessive issuance of currency/excessive printing of money by the central bank.** Government normally directs the central bank to print more money into circulation which leads to excessive money supply leading to high aggregate demand compared to the growth of output levels/ production of commodities leading to persistent increase in general price level.
2. **Unfavourable natural factors in agriculture/natural hazards.** This leads to poor performance of the agricultural sector, reduces supply leading to persistent increase in general price level.

   Agriculture continues to perform poorly and this causes supply rigidities because of uncontrollable natural factors such as drought, pests and diseases thus increase in prices of food stuffs.
3. **Increased/excessive inflow of incomes from abroad.** More income continues to come from abroad inform of direct foreign investments, returns by nationals abroad, donations, grants and this is converted into local currency which increases money supply leading to excessive aggregate demand thus persistent increase in general price level.
4. **Greed for excessive profits by business community.** Traders persistently charge high prices in order to accumulate excessive profits very quickly as possible due to increased level of liberalized trade thus inflation.
5. **Excessive exportation of essential goods/increased demand for exports.** This is especially essential commodities especially in the neighbouring countries and accompanied by existence of black markets leading to shortages in supply in the domestic economy hence persistent increase in general price level.
6. **Excessive government expenditure.** This is not followed by increased production of commodities and as a result aggregate demand becomes excessive compared to aggregate supply thus persistent increase in general price level.
7. **Poor political climate/political instability in some areas.** This creates a poor investment climate which limits production and causes shortages in supply of goods hence persistent increase in general price level.
   Political unrest in Uganda normally disrupts production, takes large percentage of government expenditure on military hardware and deprives economic sectors money for investment causing scarcity of commodities in the entire country.
8. **Break down infrastructure.** Breakdown in transport and communication facilities imply high cost of transport for goods and services and limited supply of commodities in given areas, reduces industrial production leading to shortages in supply thus persistent increase in general price level.
9. **Declining value of local currency relative to other currencies/depreciation of the local currency.**

This creates foreign exchange shortages and makes it expensive to import, makes exports cheaper which increases exports and reduces domestic supply thus increase in general price level.

There is frequent depreciation of the Uganda currency against other currencies which increases import prices since many firms import raw materials and intermediate inputs.

10. **Uncontrolled/excessive credit creation by commercial banks.** Commercial banks continue to attract borrowers by production loans which lead to excessive money supply which creates excessive aggregate demand leading to persistent increase in general price level.

11. **Persistent rising costs of production.** This is through rising prices of fuel, interest ra6es, high indirect taxes, demand for high wages, fuel prices, high cost of advertising, interest rates which makes it expensive to produce and creates supply shortages which forces producers to transfer the inc5eased costs to consumer‟s hence persistent increase in prices.

12. **Speculation by businessmen who hoard commodities. This is very common among many traders.** This is intended to create artificial scarcity of commodities thus creating supply shortages which leads to persistent increase in prices.

13. **Increased importation of goods and inputs from economies experiencing inflation.** At times raw materials and final products are imported from economies experiencing inflation thus high production costs leading to high prices in the domestic economy.

Uganda is hit by rising prices of petroleum products which are imported at high prices.

UNEB 2001

Give any four measures applied to control inflation in your country.

(04 marks)

UNEB 2000

i) *Differentiate between creeping inflation and runaway inflation. (02 marks)*
ii) *Give any two policy instruments of controlling inflation in your country. (02 marks)*

POLICY MEAUSRES TO CONTROL INFLATION IN UGANDA/DEVELOPING COUNTRIES

NB. These measures are generally intended to increase aggregate supply, reduce aggregate demand, reduce cost of production, reduce supply rigidities, reduce money supply thus scaling down general price level.

- **Use of restrictive/contractionary monetary policy.** This is done by selling government securities to the public, increasing bank rate which reduces money supply hence reducing aggregate demand and finally reduce general price level.

For instance in September 2011, in a move to reduce inflation of 28% in Uganda, the bank rate was increased to 23% which forced commercial banks to increase interest rate on borrowed capital thus limiting borrowing for consumption.

- **Increase direct taxes through progressive taxation.** This reduces disposable income and aggregate demand due to reduced purchasing power. This reduces aggregate demand hence reduced inflationary pressure.
- **Control exportation of certain goods such as scarce goods.** This helps to control the volume of exports especially essential goods such as food stuffs hence maintaining increased supply in the domestic economy and controlled prices.
- **Encourage importation from cheaper and friendly sources.** The government encourages importation from alternative sources at relatively low prices which increases domestic supply of commodities thus reducing general price level. For instance from Asian countries such as china.
- **Provision of a conducive investment climate (investment incentives).** This is through giving tax holidays, tax exemptions and subsidies to potential producers of scare commodities. This stimulates production at a low cost hence increasing aggregate supply and reduces prices.
- **Further privatization of public enterprises.** Continued transfer of public to private sector stimulates more production in the long due to increased efficiency hence increasing supply of commodities and cuts down prices.
- **Further liberalization of the economy.** Giving more liberty to private individuals to participate in economic activities without undue government controls attracts many producers hence increased production and supply of commodities thus reduced general price level.
- **Control issuance of the currency/reduce government borrowing from the central bank.** This reduces money supply and cuts down excessive aggregate demand. This reduces chances of frequent printing of money especially in the periods of deficit financing. This ensures money supply matches with the growth of output hence reduced general price level.
- **Improve and build necessary infrastructure.** Building and modernizing roads, railways and power supply facilities helps to modernize production in sectors such as agriculture and industry at a reduced cost, increases mobility of factors of production leading to increased supply of commodities and reduced general price level.

- **Reduce excessive government expenditure on provision of non essential goods.** This helps to reduce excessive aggregate demand arising from increased money supply and stabilize prices.
- **Improvement in political climate to ensure political stability.** Stable political climate gives confidence to local land foreign investors to commit their resources in expanding the productive capacity of the country hence increasing the level of economic activity and supply of commodities thus reduced general price level.
- **Promote modernization of agriculture.** This helps to control bottlenecks or rigidities in supply of agricultural products as well as reducing dependence on nature through irrigation practices which reduces supply shortages thus reduced prices of food stuffs.
- **Encourage establishment of import substitution industries.** This helps to increase domestic production of formerly imported commodities which reduces imported inflation.
- **Reduce indirect taxes on essential goods.** A reduction in indirect taxes especially on goods demands by both the rich and the poor helps to reduce cost of production which forces prices to go downwards.

UNEB 2008.

a) Distinguish between creeping inflation and galloping inflation. (04 marks)
b) Explain the effects of inflation in an economy. (16 marks)

UNEB 2004.

a) Differentiate between imported inflation and structural inflation. (04 marks)
b) Assess the impact of inflation in your country. (16 marks)

UNEB 2003.

a) Distinguish between inflation and reflation. (04 marks)
b) Assess the impact of inflation in an economy. (16 marks)

EFFECTS OF INFLATION IN AN ECONOMY.

Inflation as a macro economic problem has both positive and negative effects on an economy depending on the state of inflation and the type of inflation.

POSITIVE EFFECTS /IMPACT OF INFLATION IN AN ECONOMY.

Inflation impacts positively on an economy especially when it is mild in the following ways.

1. **Stimulates people's effectors and hard work.** This is because, mild inflation makes people work harder to maintain their consumption habits. It acts as an incentive for people to engage in serious economic.
2. **Increases marginal efficiency of capital due to high profit margins.** Mild inflation increases profits among firms which makes it profitable to expand production which stimulates more investment.
3. **More employment opportunities are created/reduces the level of unemployment.** More job opportunities are created as entrepreneurs are encouraged where there is a lot of money to spend which stimulates production to take advantage of high profits during mild inflation.
4. **Promotes forced savings.** Mild inflation forces people to save to buy commodities and also invest in the near future which promotes investment in the long run.
5. **Increases utilization of idle resources.** High profits expected during mild inflation stimulate potential producers to fairly utilize he available resources and earn more income leading to economic growth.
6. **Increases government tax revenue.** This is through heavy taxation in away of taxing profit margins of firms during mild inflation.
7. **Helps to pull an economy from an economic depression.** Where there is a depression in an economy, mild inflation helps such an economy to recover since it forces prices upwards.
8. **Increases innovations and creativity in an economy.** Inflation makes people strive higher to find means of maintaining their former consumption and expenditure levels.
9. **Stimulates the level of investment thus economic growth.** Inflation attracts more investors to increase the level of production and enjoy the high prices charged on commodities which increases production levels.
10. **Debtors/borrowers stand to gain in real terms.** This because they pay back the borrowed money at a reduced value thus encouraging borrowing.
11. **Encourages mobility of labour.** In an effort to provide more labour services and earn income for a living so as to maintain the standard of living attracts more labour mobility both geographically and occupationally which reduces labour shortages.
12. **Helps to monetize/commercialize the economy.** Hyper inflation helps to break the large subsistence sector since production becomes highly commercialized during inflation thus reducing the size of subsistence sector.
13. **Encourages adoption of import substitution strategy of industrialization.** This promotes industrialization as the country tries to reduce imported inflation during mild inflation.
14. **High profits stimulate entrepreneurship.** This leads to development of a large entrepreneurship clas in an economy.

UNEB 1999.

a) *What is meant by stragflation. (04 marks)*
b) *Under what circumstances may inflation be desirable in an economy. (16 marks)*

Under what circumstances may inflation be desirable in an economy.

Inflation becomes desirable especially when it is mild in the following ways.

- When there is need to stimulate economic growth since it makes people work harder hence increasing more investment and the level of output.
- If there is need to increase marginal efficiency of capital by increasing profit margins of producers, inflation becomes desirable since high profits increase production andmakes it profitable to employ an additional unit of capital.
- Incase there is need to increase investment by the government, it helps to attract potential investors due high prices.
- When there is a need to lift an economy from an economic depression using mild inflation since it increased investment expenditure thus increasing aggregate demand.
- When there is a need to redistribute income from wageearners with low marginal propensity to save to profit earners with high marginal propensity to save.
- When the economy is producing at excess capacity, mild inflation becomes desirable to attract investors to exploit idle resources and ensure that they are fully utilized.
- Incase there is a need to promote forced savings hence encouraging investment in the longrun instead of introducing new taxes which may be unpopular.
- When there is need to increase employment where investors may be attracted by high prices. Leading to high investment and increased job creation.
- Incase the government wants to encourage people to invest in assets such as land and houses which normally gain value with inflation instead of holding cash which loses value very quickly.
- When there is a need to stimulate demand for commdoties in an economy, mild inflation becomes desirable.

UNEB 2013

a) *Distinguish between mild inflation and hyper inflation. (04 marks)*
b) *Explain the effects of hyper inflation in an economy. (16 marks)*

NEGATIVE EFFECTS/IMPACT OF INFLATION IN AN ECONOMY.

Inflation is generally undesirable because it produces serious social, political and economic problems in an economy. This happens during hyper inflation.

1. **Fixed income earners suffer.** Individuals living on pensions and past savings suffer because as prices rise their real income falls since they tend to remain fixed.
2. **Lenders/creditors stand to lose which discourages lending.** The value of capital repayment becomes less than the value of the original loan which discouraged more lending by commercial banks.
3. **Leads to loss of confidence in a country's currency.** As a medium of exchange, money loses value. During hyper inflation, large sums of money are used to purchase a few commodities than before thus the currency loses value.
4. **Widens problem of income inequality.** During hyper inflation, income groups such as businessmen become well off while fixed income earners and non income earners become worse off. The poor and the middle class become impoverished and the business community becomes well off as a result of charging high prices.
5. **Worsen balance of payment problems/encourages capital outflow.** Hyper inflation makes prices of domestic commodities increase more than those of competitors thus exports become expensive and lose market hence low foreign exchange earnings and increased preference of cheap imported goods.
6. **Leads to unemployment.** Inflation reduces level of savings and investment and some firmsa close down thus laying off of workers.
7. **Discourages investment by both local and foreign investors.** Prospective investors despise earnings in a weak currency and due to rising costs of raw materials and other inputs during hyper inflation, investment is discouraged. It also makes borrowing for investment more expensive due to high interest rate.
8. **Leasds to industrial unset.** During hyper inflation,there is constant demand for high wages by labour to match with increase in the cost of living.
9. **Makes economic planning difficult.** Various government development projexcts are likely not to be achieved since the value of government budget estimates is reduced at the time of implementing the plans especially during hyper inflation jence plan failure.
10. **Leads to brain drain.** hyper inflation forces skiklled and professional manpower wgo are fixed income earners to migrate to stable stable economies for greener pasturesand better conditions of work which limits inventive and innovative ideas at home.

11. **Encourages trade malpractices/illegal activities.** Inflation ncourages speculation , gambling and black marketing as people try to make quick profits and look for survival in a move to meet hgh cost of living.
12. **Reduces social welfare or standard of living/encourages consumption of inferior and low quality goods.** Hyper inflation increases the cost of living hence poor standards of living. This is because such commodities appear to be cheap during hyper inflation and this reduces standard of living.
13. **Discourage s savings.** This is due to constant loss of money value during hyper inflation and this may affect future investment negatively.
14. **Causes unpopularity of government in power/political unrest.** This is because during hyper inflation, people"s lives become miserable and they turn against the ruling government.
15. **It promotes speculation and its disadvantages in an economy.** This causes irregular supply of commodities in a move to earn excessive profits by producers.
16. **Reduces output/production.** This is because of increased cost of production which discourages producers as some firms close down.
17. **People are strained in an attempt to cope with the rising cost of living.** This is in an attempt to maintain standard living.

CHAPTER 8: ECONOMIC GROWTH, DEVELOPMENT AND UNDER DEVELOPMENT.

Economic growth refers toa sustained or persistent quantitative increase in the country"s volume of goods and services produced in a given period of time. **Or**

It refers to the persistent quantitative increase in the GDP/GNP of an economy overtime .**Or**

It is a steady process by which the productive capacity of an economy increase to bring about rising levels of national output and national income.

Economic growth is measured by an increase in GDP in a given period of time.

UNEB 2009.

a) *Explain the factors that determine economic growth. (10 marks)*
b) *Explain the benefits of economic growth to a country. (10 marks)*

DETERMINANTS OF ECONOMIC GROWTH IN AN ECONOMY.

NB. Neutral points are presented and explained in two sides showing how each factor favours/fosters growth and how it limits economic growth.

These factors are responsible for either increasing investment thus high output levels which promotes increased economic growth or discouraging investment thus low output levels which limits increased economic growth.

1. **Availability and level of utilization of natural resources.** Abundant supply of natural resources such as fertile lands, minerals and energy resources which are highly exploited increase investment and output hence high economic growth while limited natural resource potential leads to limited chances of increasing investment and output which limits economic growth.
2. **Level of technological progress.** High level of technologiy increases the country"s capacity to produce more goods and services leading to increased economic growth while low level of technology leads to low output which retards the level of economic growth.
3. **Size and quality of labourforce/level of skills.** A large size of labourforce with highly developed skills means an increase in productive capacity of manpower thus increase in invetsmen t and output which fosters increased economic growth whoile a small size of the labourforce with poor skills reduces production thus lokw outptut and limited chances of attaining economic growth.
4. **Size of existing capital stock.** The greater the country"s stock of plants and liquid capital, the greater its capacity to increase investment and

output hence increased economic growth compared to a small size of the capital stock which limits production thus limited possibilities of achieving economic growth.

5. **Government policy on investment/nature of government policies.** Favourable government policies such a s sound currency, tax holidays, tax exemptions and subsidies to producers encourage investment thus high output leading to economic growth while unfavourable government policies such as high taxes and limited subsidies to producers discourage production which retards economic growth.
6. **Political climate.** Political stability attracts all forms of investment that increase output and thus high economic growth while political instability discourages production which limits economic growth.
7. **Population growth rate.** High population growth rate increases dependence burden which reduces savings, investments thus low output which limits economic growth while a low population growth rate increases savings and investments leading to high output economic growth.
8. **Level of monetization of an economy/size of subsistence sector.** A highly monetized economy encourages increased production for market leading to economic growth while a large subsistence economy is associated with low output for domestic market which retards economic growth.
9. **Level of entrepreneurial ability.** Where entrepreneurial skills are available, other factors of production are well organized and used efficiently to increase investment and output thus high economic growth whereas a small entrepreneur class is associated with underutilization of other factors of production which limits investment and economic growth.
10. **Market size.** A large market size both at home and abroad for produced oputput facilitates more production thus high economic growth while a small domestsic and foreign market for produced output discourages more production whjich limits economic growth.
11. **Rate of inflation/economic climate.** A stable economy free from persistent inflation attracts more investments leading to high output and economic growth while an economy frequently subjected to inflation, interest rate changes discourages potential investors thus low output which limits economic growth.
12. **Level of infrastructure development.** High level of infrastructure development through sound and modern social-economic infrastructure helps to coordinate production leading to high output economic growth while underdeveloped social and economic infrastructure discourages investment thus low output which limits economic growth.
13. **Level of planning and plan implementation.** High level of planning and successful plan implementation facilitates increased production

hence high economic growth while unseccussful planning limits increased production which limits economic growth.

14. **Cultural factors.** Such as conservation. Unfavourable cultural factors limit social transformation leading to limited production and economic growth while favourable cultural factors promote economic growth.

15. **Natural of foreign influence.** Favourable foreign influence promotes increased domestic production leading to high economic growth while unfavourable foreign influence limits increased production thus limiting economic growth.

UNEB 2008.

a) *Distinguish between economic growth and economic development. (04 marks)*

b) *Examine the implications of economic growth in an economy. (16 marks)*

UNEB 2015

a) *Distinguish between economic growth and economic development. (04 marks)*

b) *Explain the benefits of economic growth in an economy (16 marks)*

BENEFITS/POSITIVE IMPLICATIONS OF ECONOMIC GROWTH IN AN ECONOMY

- **Increases employment opportunities which reduces unemployment.** This is because of new and expanding industries which increase the productive capacity and employ more labour.
- **Increases government tax revenue.** This results from increased investments and people"s income and the government is able to provide more social services.
- **Results into improvement in balance of payment position.** It increases production which expands the export docket of the country thus high foreign exchange earnings and reduced foreign exchange expenditure in imports.
- **Leads to development of necessary infrastructure.** Both social and economic infrastructure such as roads, railways, banking institutions, power supply, health centres and recreational facilities which are put in place to facilitate production.
- **Promotes industrial development and increased urbanization.** Economic growth is associated with the attraction of both local and foreign investors to participate in industrial production and therefore industries are setup.
- **Involves advancement in technology due to inventions and innovations.** There is high degree of dynamism and this improves the

quality of goods produced which makes them very competitive on the export markets leading to technological development.

- **Increases resource utilization which increases production.** Because of increased production in all sectors of the economy, the existing resources are fairly utilized thus reducing underdevelopment.
- **Improves labour skills.** In the process of production, workers are trained to increase output through on job training in the process of production thus increased supply of skilled labour.
- **Provision of avariety of goods and services.** This enhances consumers' choice and welfare of people because of increased economic activities coming up.
- **High economic growth promotes political stability.** As the population is more contented with service delivery from govern,ent due to increased output, political stability is achieved leading to increased government support.
- **Leads to removal of socil obstacles to growth.** Conservatism and backward cutlutres are reduced in the process of achieving growth leading to social transformation.
- **Leads to improved standard of living.** This is due to increased consumption of produced goods and services.
- **Reduced income inequalities.** This is especially when the benefits of economic growth are fairly spread across different sections of the population in relation to employment opportunities.
- **Leads to increased humanitarian activities.** This is because the rich societies will reach out of the poor societies.
- **Promotes price stability.** This is due to increased output on the market which keeps prices at a lower level thus encouraging further production.
- **Reduces external dependence.** This results from increased domestic production leading to reduced importation of commodities leading to a self reliant economy.

UNEB 2012

a) *Distinguish between economic growth and economic development. (04 marks)*
b) *Explain the costs of economic growth in your country. (16 marks)*

UNEB 2005,1999

i) *What is economic growth. (01 marks)*
ii) *State any three costs of economic growth in an economy. (03 marks)*

COSTS OF ECONOMIC GROWTH/NEGATIVE IMPLICATIONS OF ECONOMIC GROWTH

NB. These are given as negative effects that result form the process and activities of achieving economic growth.

1) **Involves foregoing leisure so as to increase production.** People overwork and leisure is foregone in the short run in ordre to increase the volume of goods and services thus low standard of living. Economic growth requires more hourfs of work as individuals are engaged in various economic activities.
2) **Involves foregoing/sacrifice of current consumption.** People forgo/postpone current consumption to save and invest for the future. Growth which promises more goods tomorrow is only achived by consuming fewer goods today. This is a primary cost of economic growth thus decline in welfare.
3) **Increases social costs** such as noise pollution, water pollution and air pollution in the process of production through industrial activities thus environmental degradation. The current serious pollution problem results directly from the activities of rapid economic growth.
4) **Increases technological unemployment.** Due to increased use of capital intensive technology to increase output, labour is made redundant as it is replaced by machines.
5) **Leads to over exploitation of available resources.** Existing natural resources are over utilized so as to increase output, which results into resource depletion. The current high rate of resource depletion in most economies results directly form the struggle to achieve high rates of economic growth.
6) **Increases rural urban migration and its evils.** Because major production units are located in urban areas, more people are attracted to such areas and this is associated with congestion, traffic jam and slum development.
7) **Leads to increased public debt burden due to increased borrowing.** External debts are acquired in a move to increase production activities and output which increases public debt servicing problems and increased external dependence.
8) **Leads to erosion of social cultural values.** People tend to ignore the traditional culture in favour of the modern culture. Most of the time is devoted to serious commercial production and therefore modernization and urbanized life styles are emulated.
9) **Increases/widens income inequality leading to dualism.** Resource owners and those who have access to finance accumulate more income at the expense of other groups of the population. This happens where the activities of economic growth are concentrated in a few sectors of the economy.
10) **Leads to occupational or industrial hazards** such as accidents caused by machines and lung cancer caused by chemicals in production process in a move to increase output which reduces standard of living.
11) **Leads to profit/resource repatriation.** This is especially when most productive ventures are owned by foreign investors who tend to

take part of profits to their home countries thus limiting further investment.

12) **Results into displacement of people.** Due to increased economic activities through industrialization, people are displaced.

ECONOMIC DEVELOPMENT

Economic development refers to the persistent quantitative and qualitative increase in the volume of goods and services produced in an economy over along period of time. It involves positives structural changes in the political, social and economic set up of the country.

Or

It is the persistent quantitative and qualitative increase in the productive capacity of the economy. It involves positive structural changes in the political, social and economic set up of the country.

To attain economic development, economic growth has to be followed by positive structural changes such as reduced dependence on nature, fair income distribution, increase in employment opportunities and developed infrastructure.

Therefore economic development is wider than economic growth. In other words, it includes improvement in economic, social and political aspects of the whole society.

INDICATORS OR FEATURES OF ECONOMIC DEVELOPMENT IN AN ECONOMY.

For a country to be considered to have achieved economic development, desirable conditions must be imbedded in the social, political and economic set up of the country.

- ✓ Expansion of monetary production. i.e. an economy is highly commercialized.
- ✓ Increased volume of savings.
- ✓ High level of consumption per person/increased consumer choice for goods and services.

  Increased purchasing power among individuals implying high disposable income.
- ✓ Reduced dependence on nature i.e. there is agricultural modernization.
- ✓ High level of economic stability therefore no constant changes in price, increase in interest rate and therefore low cost of living.
- ✓ Increased infrastructure development both social and economic.
- ✓ Reduced social hindrances to development, therefore there is reduced conservatism and other backward social beliefs (social transformation).
- ✓ High level of literacy which implies increased access to quality education.
- ✓ Desirable population growth rate i.e. regulated birth rates.
- ✓ High life expectancy and low mortality rate therefore.

- ✓ Reduced economic dependence. High level of indigenization of the economy and forces of development are firmly rooted in the domestic economy.
- ✓ High quality of goods and services produced.
- ✓ High level of political maturity i.e. there are free and fair elections and respect of human rights such as freedom of press, religion and association.
- ✓ Creation of more employment opportunities. Low levels of unemployment and under employment of human resource.
- ✓ Fair distribution of income/wealth and reduced poverty.

UNEB 2011

State any four features of economic development in aneconomy. (04 marks)

Indicators/features of economic development in Uganda.

- Expansion of monetary production/reduced subsistence production.
- Increased literacy levels.
- Improved infrastructure development.
- Improved political climate.
- Reduced cultural rigidities implying social transformation.
- Expansion of manufacturing sector.
- Improvement in technology
- Increased production of consumer goods.
- Reduced economic dependence.

UNEB 2000

Mention any four reasons why economic growth may not be accompanied by corresponding rate of economic development.(04 marks)

CIRCUMSTANCES UNDER WHICH ECONOMIC GROWTH MAY NOT NECESSARILY MEAN ECONOMIC DEVELOPMENT/(WHEN MAY HIGH RATES OF ECONOMIC GROWTH NOT NECESSARILY MEAN ECONOMIC DEVELOPMENT.)

1. When there is uneven distribution of income and therefore, the economic distance between the rich and the poor is wide. Increase in GNP is in the hands of few individuals and majority is suffering from absolute poverty.
2. When the quality of goods and services produced is poor and therefore living standards are not raised, there no economic development.
3. When there is increased production of capital goods than consumer goods which limits consumer choice. These capital goods do not improve welfare directly.
4. In case there is still high level of, conservation and illiteracy and people's attitudes have not changed.
5. When there is high rate of economic instability such as inflation. This reduces aggregate demand.
6. When there is high rate of unemployment and under employment with in the growing economy.

7. When people are overworking and foregoing leisure. This implies that workers are overstrained without enjoying leisure.
8. In case there are high social costs such as air pollution which implies poor standards of living due to reduced life span.
9. When there are unfavorable conditions of economic policies such as high taxation, retrenchment and cost sharing in government institutions.
10. When the majority of the people forego current consumption to increase output and hence high output does not mean that there is no development.
11. Whenthere is persistent political instabilities leading to loss of lives and property.
12. Incase there is no change in the techniques of production implying increased use of labor intensive techniques of production.
13. When there is more spending on the non productive activities such as military expenditure rather than spending on the social services.

UNEB 2002.

Mention any four objectives of economic development in your country. (04 marks)

OBJECTIVES OF ECONOMIC DEVELOPMENT IN UGANDA.

- To reduce economic dependence and attain self sustenance.
- To reduce unemployment.
- To attain price stability.
- To attain equal and fair distribution of income.
- To improve on labor skills through improved training and education.
- To create security for life and property.
- To control population growth rate to desirable levels.
- To attain high rates of economic growth.

STAGES OF ECONOMIC GROWTH ACCORDING TO W.W ROSTOW.

Professor W.W Rostow explained the path of the economic growth in a historical perspective. Development according to him follows specific stages. MDCs were once 3rd world countries but later they progressed through various stages of growth.

He classified the societies according to their level of economic growth and he used capital accumulation as a driving force of the economy through the various stages of economic development from the subsistence to highly industrialized economies.

In 1960, in his book, he identified 5 stages of economic growth.

1. The traditional stage.
2. The pre-condition for take off stage /transitional stage.
3. The take off stage.
4. The drive to maturity stage.
5. The age of high mass consumption.

a) THE TRADITIONAL STAGE.

According to ROSTOW, the economy in this stage is stagnant or STATIC. Stagnation is undesirable economic period of static economic activities characterized by no new investments coming up, low levels of incomes, no more job opportunities and constant GDP growth rates.

According to him this is the first stage of economic growth and this stage is characterized by the following.

1. Rudimentary technology is used.
2. Agriculture dominates the economy and subsistence level.
3. Incomes are very low leading to low savings of almost 0% of GDP.
4. The economy is closed and therefore no external sources to influence the society.
5. Traditional and cultural beliefs play a very important role in resource allocation, there is communal ownership of most resources.
6. High level of illiteracy in an economy.
7. There is barter trade exchange in an economy.
8. Vicious circle of poverty prevails.
9. Limited degree of specialization in production.

UNEB 2015

State any four features of Rostow's transitional stage of economic growth. (04 marks)

b) PRE- CONDITION FOR TAKEOFF/TRANSITIONAL STAGE.

This is a transitional stage in which traditional attitudes are overcome and the economy starts growing.

The economy lays a foundation for takeoff into a self sustained growth.

This stage is characterized by-

- The society starts to imitate the advanced society"s beliefs.
- Low but rising rates of investment of about 5% of GDP.
- Low but rising rates of savings of about 5% of GDP.
- Investments are directed towards the development of social –economic infrastructure such as banking institutions, insurance companies, roads and health facilities.
- New enterprising people begin to come forward/increasing entrepreneur class.
- Reduction in illiteracy rates due to improvement in formal education.
- Technological improvement is realized in some sectors such as agriculture.
- More foreign capital resources begin coming into the economy.
- Small-scale industries start to develop especially the manufacturing industries.
- Dualism becomes the major characteristic.
- There are changes in political systems i.e. form chiefdoms to colonization and then to political independence.

NB. Looking at the above characteristics, one would suggest that Uganda‟s current level of development is at this stage and most of other LDCs.

UNEB 2009, 2001.

- *What are the characteristics of Rostow's take off stage of economic growth (02 marks)*
- *Give any two limitations of this theory. (02 marks)*

c) TAKE OFF STAGE.

At this stage, the economy becomes self sustaining and reduces on foreign dependence. An economy experiences a breakthrough in the viscous circle of poverty and overcomes obstacles of development.

This stage is characterized by.

- ❖ High level of investment of between 10% to 15% of GDP/ national income/ GNP.
- ❖ High level of savings of between 10% to 1`5% of GDP/national income/GNP.
- ❖ High level of employment due to increased economic activities. A big proportion of the labourforce becomes employed in the industrial sector.
- ❖ High level of modern technology especially in agriculture which increases output to support the growing urban and commercialized labourforce.
- ❖ High level of industrialization with both backward and forward linkages.
- ❖ High level of urbanization.
- ❖ Emergence of new economic and political institutions.
- ❖ High literacy rates/social transformation.
- ❖ Self sustained growth/self reliant economy. Reduction in foreign dependence as the economy becomes self sustaining in most of its requirements.
- ❖ Emergence of new markets both domestic and foreign markets.
- ❖ High level of infrastructure development. High level of investment in social, economic and capital infrastructure.

The take off stage is the most critical of all stages in which an economy starts to develop.

At this stage there is emergence of some leading or significant sectors of the economy for instance USA, RUSSIA, CANADA began with grain production.

UNEB 1999.

State any four features of Rowstow's drive to maturity stage of economic growth. (04 marks)

d) DRIVE TO MATURITY STAGE

This follows after a long period of sustained growth. The economy progressively grows and drives to extent modern technology over all its economic activities. It is characterized by.

1. High rate of savings of between 15% to 20% of GDP.

2. Heavy industrialization and productivity is rising, goods formerly imported are produced at home.
3. Increased use of modern and efficient technology in the production process. i.e. new production techniques replace the old ones in all sectors of the economy.
4. High rate of investment of between 15% to 20% of GDP.
5. Increased employment opportunities. Increase in the proportion of white collar jobs arising from the expansion of tertiary sector such as banking, insurance companies, telecommunications, transport sector and tourism.
6. Increased urbanization and most people, prefer to live in urban areas.
7. Population growth rate is very low.
8. Existence of bureaucracy and high level of management and the economy is highly sophisticated.
9. High level of monetization of an economy.
10. Increased use of professional and highly skilled labour.
11. High level of infrastructure development.

NB. New import requirements develop and new export commodities are developed to match with imports. The economy starts experiencing BOP surplus.

The economy finds its place in the international economy. i.e high export trade and reduction in level of importation.

e) AGE OF HIGH MASS CONSUMPTION.

Countries which have reached at this stage include USA, Japan, Germany, UK and France. It is the stage where an economy is at its climax. It is characterized by;

- ❖ Large section of the skilled labourforce which is employed in tertiary sector.
- ❖ High level of technological maturity in all sectors of the economy.
- ❖ Most of the resources are allocated to social welfare and security which leads to emergence of a social welfare state/high preference of leisure to work as working hours generally reduce. There is increase in leisure enjoyed by the majority and the population is highly adventurous.
- ❖ Mass production of advanced consumer luxury goods and services such as refrigeration‟s, cookers, cameras, cars and televisions, electronic equipment.
- ❖ The country experiences balance of payment surplus.
- ❖ The savings rate is more than 30% of GDP.
- ❖ There is heavy investment in foreign economies.
- ❖ The country becomes more influential in political, social and economic aspects of other economies.
- ❖ The investment rate is more than 30% of GDP.
- ❖ Industrialization is at maximum and it involves production of high quality goods.
- ❖ The economy starts giving‟s a lot of foreign aid to needy countries.

- Population is predominantly urban and many people live in cities and big towns.
- Full utilization of resources. Al resources are fully utilized.

The problem in this stage is not how to make income but how to consume the already accumulated income. The problem of the economy is not how to produce but how to consume.

CRITICISMS OR WEAKNESSES OF ROSTOW'S STAGES OF ECONOMIC GROWTH.

1) There is considerable over lapping of stages. He was not clear on the demarcations and boundaries between different stages i.e. it is difficult to distinguish stage four from stage five since characteristics of one stage are found in another stage.
2) It is not true that all countries go through all stages of growth because some countries skip some stages. The traditional stage is not essential for development. Some countries such as USA, Canada were born free of traditional stage.
3) He looked at capital accumulation the major driving force for growth and ignored other factors such as availability of natural resources, political atmosphere, skills which influence economic growth.
4) He assumed that there is no discontinuity in the road of growth i.e. one stage leads into another stage and that this trend is continuous which is unrealistic because there are factors that lead to a decline/ delays in economic growth.
5) Resources are not homogenous in different countries hence countries cannot take the same trend of development.
6) He did not consider external factors that influence economic performance and later growth such as foreign aid.
7) It doesnot consider the nature of distribution of income.
8) High level of savings may not necessarily lead to economic growth.

THE CONCEPT OF UNDERDEVELOPMENT.

Underdevelopment refers to a situation where there is underutilization of resources and low standards of living characterized by poverty, low level of productivity, low rate of economic growth, low consumption levels, low level of productivity.

Or

Underdevelopment is a situation where a country has not fully utilized her productive resources and has low levels of productivity.

It involves a situation where a country has the resources but has failed to put them to maximum exploitation to increase economic growth and economic development. It is a situation where the country"s resources are not fully utilized.

Such countries are often referred to as third world countries, low income countries, less developed countries and they are mainly found in Africa, Latin America and Asia.

CHARACTERISTICS/FEATURES OF UNDERDEVELOPED ECONOMIES OR UNDERDEVELOPMENT.

- **High debt burden.** This is due to consent extern al borrowing to finance persistent budget deficits hence high expenditure abroad in form of debt servicing.
- **High income inequality.** Incomes are unevenly distributed and majority of people live on income below the poverty line.
- **High population growth rate closer to the rate of growth of GNP.** This is due to high birth rates and thus heavy dependence burden on the economy.
- **Agriculture dominates the economy and other primary sectors.** Farmers see themselves as subsistence rural cultivators and over 60% of the population lives in rural areas and their occupation is agriculture.
- **High illiteracy rates.** Many people in these economies cannot read and write.
- **Low life expectancy.** Many people in underdeveloped economies die at an early age due to various causes such as poor health, poor nutrition, homelesses and diseases.
- **High rates of unemployment and underemployment.** This is due low levels of investment and limited skills. Open urban unemployment is rampant, structural unemployment and seasonal unemployment are also wide spread.
- **BOP deficits are experienced and unfavourable terms of trade.** This is because of high foreign exchange expenditure on expatriates, military hardware and low prices of exports.
- **Poor quality of human resource capital/prevalence of unskilled labour.** Most of the workers are unskilled and semi-skilled due to poor training and poor education system.
- **High level of economic dependence.** Most of these economies rely on other countries for basic resources such as capital and consumer goods, skilled labour. This is in form of trade dependence. External resource dependence and direct economic dependence.
- **High traditional rigidities and conservation.** Most people do not want to change from traditional ways to modern ways of life. People do not work or travel on certain days, children are looked at as source of wealth, most of the time is spent on parties and cultural ceremonies.
- **Limited entrepreneurial ability.** There are few entrepreneurs to organize other factors of production in these economies and therefore foreign entrepreneurs and expatiates dominate economies of underdeveloped countries and have played an important role in economic development.
- **Limited domestic and foreign markets.** Domestic consumers have low purchasing power and foreign markets are highly competitive through protectionism because of exportation of low quality output.

- ❖ **Weak/small industrial sector.** The industrial sector is very small where major industries exist in urban areas and produce basically low quality products and consumer goods and it contributes less to national income.
- ❖ **Underdeveloped infrastructure.** Both social and economic infrastructure are in poor state especially roads, railways an some times impassable.
- ❖ **Large substance sector.** Many people basically produce for home consumption which leads to low output.
- ❖ **Under utilization of resources.** Most of the natural resources such as minerals, water resources remain untapped due to poor technology and inadequate capital.
- ❖ **Existence of political instability and high political immaturity.** Most under developed economies are politically unstable and this tends to discourage production.
- ❖ **Prevalence of economic dualism.** This leads to high rate of rural urban migration, income inequality
- ❖ **Low income levels.** This limits savings and investment leading to low capital accumulation.

UNEB 2008,2001.

State any four features of underdevelopment in your country. (04 marks)

UNEB 1999.

What is the difference between economic growth and economic development? (04 marks)

Explain the features of economic underdevelopment. (16 marks)

FEATURES/CHARACTERISTICS OF UNDERDEVELOPMENT IN UGANDA.

- ✓ Weak industrial sector.
- ✓ Predominance of subsistence agriculture.
- ✓ Low income levels/GDP.
- ✓ Dualism such as rural areas and urban areas.
- ✓ Underutilization of productive resource s.
- ✓ Prevalence of economic depednece.
- ✓ Political immaturity/political instability.
- ✓ Low level of skills
- ✓ High population growth rate.
- ✓ Limited domestic and foreign markets.
- ✓ High rational rigidities and conservatism.
- ✓ Use of poor and inappropriate technology.
- ✓ Underdeveloped /poor infrastructure.
- ✓ Low standard of living.
- ✓ Low levels of life expectancy.
- ✓ High rates of unemployment and underemployment.

UNEB 2004.

a) *Explain the concept of underdevelopment. (04 marks)*

b) *Account for the low rate of economic devlopenmnt in your country. (16 marks)*

UNEB 2010.

a) *Distinguish between balanced growth and unbalanced growth strategies. (04 marks)*

b) *Account for the low rate of economic development in your country. (16 marks)*

UNEB 2009, 2006.

a) *Define the term economic under development. (04 marks)*

b) *Explain the causes of underdevelopment in your country. (16 marks)*

CAUSES OF UNDERDEVELOPMENT IN LDCs/UGANDA.

(Reasons for low levels of economic development in LDCs).

The causes of under development in the thirdworld countries are both internal and external .these factors are responsible for limiting investment, production levels leading to low levels of resource utilization.

- **Poor infrastructure.** The social and economic infrastructure is not well established to coordinate production and increase resource utilization which discourages investment and productivity which leaves resources not utilized.
- **Inadequate supply of basic/strategic natural resources.** This is in terms of their quality, quantity and variety. Most LDCs lack enough strategic resources such as minerals to lead to rapid industrialization and employ factors of production thus low investment leading to the under utilization of resources.
- **Low levels of technology.** Rudimentary tools dominate most o the economic sectors such as agriculture, mining, industry and this limits the large scale production and volume of exports leading to the under utilization of resources.
- **High rate of brain drain.** Experienced professionals overwhelmingly migrate to other countries for greener pastures and this limits innovative and inventive ideas in various aspects of the investment which leaves local resources underutilized.
- **Heavy dependence on foreign aid.** Most LDCs depend on the various forms of the foreign aid which kills initiatives at home, its unreliable, inconsistence and inadequate hence retarding the development and implementation of the plans which leads to under utilization of the resources.
- **Existence of the unfavorable terms of trade.** There is a exportation of the cheap and low quality goods and services which implies low earnings from exports and therefore less revenue from the exports is available to increase investment hence increase in the resource utilization.
- **Poor political climate.** Political unrest in most LDCs scares away the potential investors, disrupts economic activities and takes a large

percentage of government expenditure through the military hard ware instead of investing in the resourceutilization which leaves the resources underutilized.

- **High rate of capital outflow/high rate of the income and profit repatriation.** Majority of the nationals in the LDCs prefer to keep their money in the foreign economies which are stable and there is high rate of profit repatriation.
- **Narrow domestic and external markets.** There is internal poverty and people cannot afford to purchase on the large scale and the foreign market is highly competitive and has high levels of protectionism, this discourages large scale production hence limiting resource utilization.
- **Insufficient supply of the entrepreneurs/poor managerial skills** Entrepreneurs in most LDCs are limited implying inability to organize other factors of production hence poor organizationof the scarce .low level of the entrepreneurial skills implies limited managers to undertake risks in profitable investments thus resource underutilization.
- **High population growth rate.** The growth rate of the population is above 3% in most LDCs and this creates high dependence burden and limits the levels of savings and investment to increase resource exploitation.
- **Heavy dependence on the agricultural/low levels of the industrialization.** Most LDCs depend on agriculture and it is associated with the diminishing returns and constant fluctuations in the prices and this denies economy constant revenue for economic development.
- **High levels of corruption and embezzlement/low levels of accountability.** Most funds are diverted from the productive projects and misused by the planners and project implementers and this retards the rate at which the resources are utilized since it reduces funds for the investment thus resource under utilization.
- **Poor investment culture.** This is characterized by the limited subsidies to the producers, heavy taxation on producers and high cost of trade license. Such policies discourage production which limits resource utilization.
- **Price and exchange rate instabilities.** These are in form of hyper inflation and foreign exchange instabilities increase cost of production which discourage increased investment and resource utilization .
- **Unfortunate structural adjustment programs of IMF** such as retrenchment of civil servants thus reducing their income, dictating unfair economic policies countries. This limits proper development planning relevant to increase resource utilization.
- **Poor land tenure system.** Few individuals in LDCs have access to large expanses of land and such people do not utilize it productively leading to low production and resource underutilization.
- **High level of conservation/poor attitude towards work.** Some cultures do not welcome new and innovative changes in development,

there are food taboos and a lot of time is spent oon cultural ceremonies. This limits adoption of new methods of production to increase resource utilization.

- **Heavy public debt burden and problem of debt servicing.** Most LDCs are faced with huge debts both internal and external and therefore high expenditure on debt servicing which limits capital for investment leading to underutilization of local resources.
- **Existence of large subsistence sector/dominance of subsistence sector.** Most LDCs are dominated by subsistence production thus low productivity and this limits increased resource utilization.
- **Limited labour skills/limited skilled manpower.** Large section of the labourforce does not possess the required skills due to inappropriate education system which leads to low productivity leading to resource underutilization. This leads to heavy dependence on expatriates to manage key sectors.
- **Low income levels/poverty.** This is due to wide spread unemployment and underemployment which limits the level of savings, investment leading to low capital accumulation.

UNEB 2013, 2006.

i) *What is meant by a development goal? (01 mark)*
ii) *Give any three economic development goals in your country. (03 mark)*

GOALS OF DEVELOPMENT IN UGANDA.

A development goal is a present target or objective of development that is to be achieved in an economy in a specific period of time.

Or

It refers to an intended growth and development objective a country aims at achieving in a given period of time. This target may be social, political or economic.

Uganda like any other developing nation has certain specific goals of development. According to policy statements, Uganda has several long term social, political and economic goals to achieve.

Goals Of Development In Uganda Include.

- Achieving fair distribution of income and wealth.
- Reducing all forms of economic dependence/building an independent and self sustaining economy.
- Controlling and regulating population growth rate to desirable levels.
- Achieving a higher rate of economic growth and GDP.
- Attaining a stable/favourable balance of payment position.
- Attaining full employment of resources especially labour.
- Achieving price stability by reducing inflation.
- Eliminating illiteracy/attaining a large pool of highly skilled labour.
- Providing security to people and their property/to attain and maintain political stability.

CHOICE OF DEVELOPMENT STRATEGY.

A development strategy refers to a broad policy of guideline that a country takes on and follows in formulation and execution of its policies aimed at attaining specific development goals and objectives. It therefore shows the right course of action that will cause development to take place in an economy.

Major components/elements of a development strategy.

1. **Choice of appropriate implementation machinery.** i.e. whether by private sector or public sector or by both in planning process and production. Uganda is a mixed economy and both the private and public sector participate in planning and production.
2. **Choice between import substitution industrial development strategy and export promotion industrial developments strategy.** More emphasis in Uganda has been put on import substitution industrial strategy.
3. **Choice of the pattern and the rate of capital accumulation.** i.e. whether to mobilize domestic savings or external resources and Uganda relies on both to achieve high levels of capital accumulation.
4. **Choice between balanced growth strategy and unbalanced growth strategy.** The one selected will depend on the available resources in a country.
5. **Choice of appropriate technology.** I.e. whether to use labor intensive technology or capital intensive technology. Uganda places more emphasis on labor intensive technology to use the abundant labourforce.
6. **Choice between leading production sectors.** I.e. whether industry, agriculture or infrastructure development. In Uganda, the leading sector is agriculture but the industrial sector is also steadily growing and emphasis is also being put on development of social and economic infrastructure.
7. **Choice of goals and objectives to be achieved.** I.e. self reliance, human liberty, attaining full employment, political stability and security. These are necessary to guide the economy in the trend of growth and development.
8. **Choice of the social economic organization.** i.e. whether to pursue socialism, capitalism or mixed economy. Uganda is a mixed economy.

STRATEGIES OF GROWTH.

For economic growth and development in an economy to be achieved, choice should be made with the sectors to begin with and which sectors to develop the economy later and majorly three theories have been put forward for sector priorities.

These include;

1) Balanced growth strategy.
2) Unbalanced growth strategy.

3) The big push theory.

A. BALANCED GROWTH STRATEGY (By Ragnar Nurkse).

Balancedgrowthstrategy is the one which emphasizes harmonious and simultaneous development of all the sectors of the economy so that they complement each other and grow at a more or a less the same pace.

This strategy emphasizes a simultaneous and harmonious development of different sectors of the economy so that they all grow at a more or less pace. It requires a balanced between the different sectors of the economy during the process of the economy growth.

Different sectors of the economy should match with each other in terms of demand and supply.

Since there is investment in all sectors of the economy at the same time, a certain minimum investment capital termed as „**Critical minimum effort"**is required to enable investment in all sectors of the economyat the same time.

CRITICAL MINIMUM EFFORT.

Critical minimum effort is the minimum investment/sacrifice required to attain massive capital stock necessary for an economy to take off.

The lowest level of initial investment required for the massive investment in all sectors of the economy which are developed simultaneously after which they become the interdependent and self sustaining.

The balanced growth strategy calls for;

- A balanced between investment in agriculture and industry which are complements.
- A balance between direct productive and activities such as agriculture, industry and developmental industry and social over head capital such as health, education and transport facilities.
- A balance between investment in human capital and physical capital.
- A balance between consumer goods industries and producer goods industries.
- A balance between production for domestic market and production for foreign market.

UNEB 2003.

a) Distinguish between balanced growth and unbalanced growth strategies of development. (04 marks)

b) Examine the advantages and disadvantages of balanced growth strategy in developing countries. (16 marks)

ADVANTAGES OF BALANCED GROWTH STRATEGY IN LDCs.

1. **Widens the tax base.** Various sectors developed together act as tax bases on which the government imposes taxes for increased public expenditure.

2. **Increases utilization of local resources.** Since resources such as minerals, land, forests are demanded in all sectors of the economy, there are high chances of being fairly and maximumly utilized thus reducing underdevelopment.
3. **Increases employment opportunities.** various production units in different sectors help to absorb the existing labourforce and this reduces unemployment of human labour.
4. **Reduces regional imbalances in development.** This is because all sectors of the economy in different regions grow at a more or less the same pace thus promoting harmonious development.
5. **Leads to fair distribution of income.** Since all sectors are developed at the same rate, the chances of given individuals to accumulate more income at the expense of others are very minimal.
6. **Reduces economic dependence.** The economy reduces dependence on their economies suince most of the goods and services are produced at home. Dependence on foreign resources reduces since there is production of various goods and services in several sectors which reduces importation thus promotes self reliance.
7. **Creates inter-sectoral linkages**. Both backward and forward linkage are created by sectors which are complementary and interrelated such as agriculture and industrialization thus inter-sectoral development.
8. **Leads to acquisition of skills in different fields.** This results from the fact that labour is employed in different fields of production and this leads to efficiency in the long run.
9. **Eases the country's balance of payment deficit.** High output from all sectors helps to increase the volume of exports thus high foreign exchange earnings and reduction in the volume of imports.
10. **Promotes rapid development of infrastructure.** The strategy encourages improvement in infrastructure such as roads, railways, power supply so as to enhance coordination and development of different sectors thus increased production.
11. **Facilitates economic growth and increased in gross domestic product.** The strategy is associated with high output from different sectors of the economy and this increases the country"s GDP.
12. **Widens consumer's choice due to a variety of goods.** This is because of a variety of economic activities in different sectors of the economy. A variety of economic activities in different sectors help to reduce dangers of over reliance on one or a few sectors of the economy.
13. **Widens market for goods and services.** This is because of increased economic activities in different sectors of the economy especially where sectors are interdependent leading to further production.

DEMERITS OF BALANCED GROWTH STRATEGY IN LDCs.

- ❖ **Leads to heavy losses in case of project failure.** There is high level of interdependence between sectors, incase of project failure, it leads to a heavy economic losses nationally due to heavy dependence on foreign aid which is not reliable.

- **Leads to resource wastage because of limited markets.** The strategy leads to over production and yet in LDCs there are limited markets both at home and abroad to absorb increased output resulting from development of all sectors of the economy.
- **Leads to heavy borrowing which increases public debt burden and debt servicing problems.** The critical minimum effort would require the country to borrow to invest in all sectors hence debt serving problems.
- **It is very expensive and costly.** Investment in all sectors of the economy requires a lot of capital which developing countries are not able to raise.
- **It over strains government planning machinery.** Most developing countries have limited qualified man power in the planning sector and a lot of pressure is put on the existing government planning machinery to plan for various sectors.
- **It results into an inflationary situation in the short run. Because of massive expenditure in all sectors.** It increases money supply which increase aggregate demand thus resulting into high prices.
- **Leads to over exploitation of resources thus quick depletion.** This is due to high demand for inputs among different sectors.
- **Promotes external dependence.** This is because it involves dependence on skilled manpower, capital and foreign investors to enable investment in various sectors of the economy.

UNEB 2004,2003.

i) *Define the term "critical minimum effort" as used in balanced growth strategy.* *(01 mark)*

ii) *Give any three factors which limit the operation of balanced growth strategy.* *(03 marks)*

UNEB 2014

(i) *What is meant by the balanced growth strategy of economic development? (01 marks)*

(ii) *State any three factors that limit the application of the balanced growth strategy in developing countries.* *(03 marks)*

LIMITATIONS OF BALANCED GROWH STRATEGY IN LDCs

1. **Inadequate capital to invest in all sectors.** Investment in all sectors of the economy at the same time would require a lot of capital which LDCs are not able to raise.
2. **Poor investment climate.** This is characterized by high indirect taxes, limited subsidies, costly trade license, limited credit facilities to investors to enable private individuals invest in different sectors.
3. **Corruption and embezzlement of funds.** LDCs economies are mismanaged through rampant corruption and embezzlement of funds for development thus limiting investment in some sectors.

4. **Poor political climate.** Political instability in most LDCs hampers sectoral development in given areas, scares away potential investors and takes a large percentage of government expenditure and yet the strategy requires a stable economy politically.
5. **Weak linkages existing between sectors.** There is a need for sound linkages between sectors for it to be successful, but sectoral linkages are very weak in LDCs.
6. **Uncoordinated economic planning.** Comprehensive planning is not effective in LDCs due to limited supply of planning machinery and therefore there is poor planning and coordination between plan implementers and formulators.
7. **Poor infrastructure.** Existence of poorly developed social and economic infrastructure exist in LDCs thus difficulty to coordinate production in all sectors of the economy.
8. **Small size of entrepreneur class.** The strategy requires the presence of many entrepreneurs to organize other factors of production for increased investment in all sectors and yet the entrepreneur class in LDCs is still limited.
9. **Inadequate/limited markets.** The small markets in LDCs cannot sustain the development of all sectors at the same time. Local and foreign markets are not enough for increased output from all sectors of the economy thus wastage of resources.
10. **Poor technology.** Low levels of technology in LDCs limit production in all sectors of the economy at the same time and yet the strategy requires modern technology.
11. **Limited skilled labour.** LDCs do not have enough skilled labour to be employed in different sectors of the economy.
12. **High level of conservatism.** This implies that some people are not ready to receive new changes in methods of production in various sectors.
13. **Poor land tenure system.** The strategy requires supply of adequate land and yet there is increased land fragmentation in developing countries thus limiting investment in given sectors such as agriculture.

B. UNBALANCED GROWTH STRATEGY (by Prof. Albert Hirschman).

Unbalanced growth strategy advocates for investment in one or few vital/key /leading sectors of the economy that would ultimately lead to growth of other sectors through linkages.

Or

It states that leading sectors with strategic importance be selected and expanded so that they pull up or develop other sectors through linkages.

Given limited resources in LDCs, large investments should be made in strategic leading sectors which will create external economies of scale to stimulate investment in other sectors.

It advocates for maximum forward and backward linkages and export oriented industrialization strategy.

ADVANTAGES OF UNBALANCED GROWTH STRATEGY IN LDCs.

- **It is cheap and affordable/requires relatively less capital resources which LDCs can easily raise.** LDCs do not have adequate capital resources and the little available are channeled to a few leading sectors to pull other sectors in the longrun.
- **Forward and backward linkages are maximumly enjoyed.** For instance agriculture and industry if they are developed together ensure maximum linkages.
- **Encourages specialization which increases benefits from international trade.** This happens on the basis of comparative cost advantage theory which results into fair competitiveness of commodities on the world market.
- **Suits LDCs small domestic and foreign market.** The strategy is more appropriate in countries where market is limited and can only sustain few sectors. There is limited market for produced goods and services in LDCs and this makes unbalanced growth strategy suitable since it associated with manageable output.
- **Development is easy to plan for and coordinate.** Since there are few sectors to handle, it does not necessitate comprehensive planning which is very difficult to effectively carryout. Plan formulation and implementation is made easier since there are few sectors to handle.
- **No huge economic losses are likely to be incurred in case of project failure.** It is not very risky because of limited resources invested in a few sectors.
- **Saves the country's resources from quick exhaustion.** Existing natural resources are used by few sectors.
- **Minimize on public debt burden since it does not necessitate heavy borrowing.** This is because the strategy reduces borrowing implying limited debt serving problems.
- **Does not require presence oflarge skilled personnel.** It makes it easy for LDCs to acquire the required skilled labour to work in the leading sectors.
- **It suits the limited technology in LDCs.** Most developing countries lack developed technology to employ in all sectors which makes this strategy suitable.
- **It suits LDCs with insufficient planning machinery.** Lack of sufficient planning machinery in most LDCs makes this strategy suitable for development.

NB. Most MDCs depended on certain leading sectors to develop their economies, so LDCs to should adopt unbalanced growth strategy to accelerate growth in specific sectors and later overall development.

DISADVANTAGES OF UNBALANCED GROWTH STRATEGY.

- **It is associated with income inequality.** Few people are employed in few developed sectors and accumulate more income at the expense of others.
- **Limits exploitation of domestic resources.** Some natural resources cannot be absorbed in the key leading sectors implying production at excess capacity.
- **Leads to balance of payment problems.** The strategy leaves a room for high import expenditure as most of the requirements are not produced internally and limited export revenue is realized.
- **Leaves a room for economic depended.** The strategy leaves behind a room for external dependence because there is importation of goods which are not produced locally.
- **Limits government tax revenue.** Tax base remains narrow since some areas of production are ignored.
- **Leads to limited job opportunities.** The strategy is not likely to reduce unemployment problem affecting most of LDCs especially in sectors that are not developed in the short run.
- **Results into regional imbalance in development.** Some regions where sectors are prioritized develop at the expense of others. This creates social and political problems.
- **Associated with inflationary tendencies.** Shortage of commodities in sectors which are neglected in the short run result into structural inflation.
- **Limits production of a variety of commodities.** It discourages diversification and consumer"s choice is reduced thus reduced standard of living.
- **Leads to low economic growth and gross domestic product.** Unbalanced growth strategy leads to low output from the few sectors which limits economic growth.
- **Promotes rural urban migration and its evils.** People migrate to towns where given projects have been established leading to congestion, high crime rate.

UNEB 2008, 2005.

(i) State the big push theory of economic growth. *(01 marks)*

(ii) Mention any three limitations of the big push theory in developing countries. *(03 marks)*

C. THE BIG PUSH THEORY (by Paul Rodan).

The big push theory states that, LDCs require a massive investment programme in industries and economic infrastructure in order to take off into a self sustained growth.

Or

The big push theory states that, for a developing economy to take off into a self sustained growth, a massive investment programme in industries and economic infrastructure is required.
The strategy emphasizes massive investment in industries and economic infrastructure so as to transform the economy from backward to a self sustaining economy.
A large comprehensive programme is needed in form of a high minimum amount of investment to overcome the obstacles of development in LDCs. Proceeding step by step will not launch the economy on the development map.
It calls for a sudden sharp increase in the rate of investment. It therefore requires,

1. Adequate natural resources.
2. Maximum government direction.
3. Mobilizing enough savings.
4. Investment in social overhead capital on a large scale.
5. A sizeable market to ensure favourable returns.
6. Political stability.
7. Adequate skilled man power.
8. Economic stability.
9. Strong private sector.

ADVANTAGES OR MERITS OF BIG PUSH THEORY.

- Rapid economic growth is attained.
- More employment opportunities are created.
- Promotes external economies of scale due to large scale production.
- Increases intersectoral linkages. It leads to agglomeration of industrial activities.
- Increases inter sectoral linkages. It leads to large scale production.
- Increase supply of goods whi9ch reduced inflation.
- Reduces dependence of the economy on other economies sic e there is reduction in the volume of imports.
- Encourages maximum and fair utilization of the employed natural resources.
- Increase direct foreign investments because of foreign investors in the industries.
- Promotes acquisition of kills by labourers.
- Promotes technological development due to infrastructure and industries.
- Government tax revenue is widened as the industrial sector is promoted.
- Promotes the growth of manufacturing sector.

DISADVANTAGES OF BIG PUSH THEORY.

- Leads to excessive government expenditure.
- Leads to technological unemployment.

- Creates income inequality in the short run when other sectors of the economy are not yet developed.
- Ignores immediate development of other vital sectors of the economy such as agriculture.
- Leads to rural urban migration since industrialization and infrastructural development normally target urban areas.
- Promotes resource or profit repatriation since industries in LDCs are normally owned by foreigners.
- Leads to heavy debt burden because the country is to borrow to undertake such investment.
- Increases social costs.
- Leads to inflationary pressure in the short run because of high investment expenditure alongside shortage of consumer goods.

LIMITATIONS OF BIG PUSH THEORY IN DEVELOPING COUNTRIES.

1. **Limited skilled man power** for planning and get employed in industrial and infrastructure development hence dependence on foreign manpower.
2. **Limited capital.** Launching of a high initial investment capital inn social overhead is very expensive for LDCs.
3. **Poor and tenure system.** This discourages investment in certain regions and scares away potential industrialists.
4. **Political instability.** This discourages investment in certain regions and scares away potential industrialists.
5. **High level of corruptionand embezzlement in resource allocation** This frustrates investors in industrial production.
6. **Unfavourable investment climate.** This is inform of limited subsidies and high taxes on industrialists.
7. **Limited supply of entrepreneurs or poor managerial skills.** This results into failure to initiate industrialization in LDCs.
8. **Limited supply of basically raw materials.** This failed to support massive investment in industrial sector**.**
9. **Limited basic infrastructure.** These are inform of poor roads, limited railways and this limits investment in the industrial sector.
10. **Inadequate market for the produced goods.** Both domestic and foreign are limited which limits large scale production in industrial sector.
11. **Low levels of technology.** This limits large scale investment in industrial sector.

UNEB 2010

a) *What is meant by the term economic development strategy. (04 marks)*
b) *Explain the merits of diversification in production and an economic development strategy. (16 marks)*

Economic development strategy is a broad policy guideline which a country takes on and follows in the formulation and execution of its policies aimed at attaining specific development goals and objectives.

MERITS OF DIVERSIFICATION PRODUCTION AS AN ECONOMIC DEVELOPMENT STRATEGY.

1. **Widens consumers' choice by providing a variety of goods and services.** This is because, it involvesproduction of various goods and services hence improving welfare of consumers.
2. **Overcomes the problem of inflation or price fluctuations and its negative effects.** Diversification leads to high output which keeps prices stable leading to further production.
3. **Reduces the problems of dependence on a few products or one sector.** This implies that diversified output helps to reduce effects of failure in one sector.
4. **Helps to avoid risks and uncertainties in some sectors such as agriculture.** This is because of diversified agricultural production.
5. **Promotes linkages between different sectors (market and raw materials).** This promotes intersectoral development especially those that are highly related such as agriculture and industry.
6. **Reduces regional imbalance in development.** It accelerates growth in various economic activities in different regions since different sectors are promoted.
7. **Expands the tax base.** Various economical activities act as tax bases on which government imposes taxes for increased public revenue.
8. **Widens the export base hence increase on foreign exchange earnings.** This is because of increased diversified production for export hence increased forex earnings.
9. **Expands employment opportunities.** Many people get employed in various economic activities thus reduced seasonal unemployment.
10. **Increases utilization of existing resources.** Resources such as minerals forests are fairly utilized in various economic activities undertaken thus reducing under development.
11. **Reduces income and wealth inequalities.** Various economic activities promote fair income distribution due to increased employment opportunities.
12. **Increases the country's GDP.** This is due to increased output from different economic activities under taken.
13. **Leads to development of infrastructure.** Venturing in various economic activities necessitates development of different forms of infrastructure such as road network to accelerate further production.

CHOICE FOR INDUSTRIAL DEVELOPMENT STRATEGY.

Industrialization is the process of building up the country"s capacity to process raw materials to manufacture consumer and producer goods as well as building up infrastructure.

A proper industrial development strategy involves choice of industrial policy guide line to achieve objectives of industrialization and development.

There basically two industrial development strategies namely;

1. Import substitution industrial strategy. (Inward looking strategy).
2. Export promotion industrial strategy (Outward looking strategy).

UNEB 2010.

i) *Differentiate between import substitution and export promotion strategies of industrial development.* *(02 marks)*

ii) *Mention any two merits or import substitution strategy in industrial development.* *(02 marks)*

UNEB 2014

(i) What is meant by the term import substitution strategy of industrial development? *(01 marks)*

(ii) State any three disadvantages of adopting this strategy in developing countries. *(03 marks)*

IMPORT SUBSTITUTION INDUSTRIAL STRATEGY (INWARD LOOKING INDUSTRIAL STRATEGY).

It refers to an industrial development strategy of producing domestically or internally the formally imported industrial goods.

Or

It refers to a strategy of establishing industries in the domestic economy to produce goods that were formed imported.

This is aimed at reducing foreign exchange expenditure. Production is undertaken to produce the formally imported commodities for domestic markets to minimize the outflow of forex.

NB. Import substitution industries are industries that are set up in the domestic economy to produce formally imported commodities. This mainly intended to reduce foreign exchange expenditure.

Examples of import substitution industries in Uganda are sugar processing industries, beer brewing industries, textile industries, soft drink industries, cement manufacturing industries, food processing industries and mattress industries.

UNEB 2007.

"developing countries should adopt import substitution strategy for industrial development if there are to achieve their development goals. Discuss. (20 marks)

UNEB 1998, 2003, 2001

a) *Distinguish between export promotion and import substitution strategies of industries development.* *(04 marks)*

b) *Explain the merit and demerit of adopting import substitution industrial development strategy.* *(16 marks)*

UNEB 1997.

To what extent is the inward looking industrial development strategy ideal for your country. *(20 marks)*

ADVANTAGES OF IMPORT SUBSTITUTION INDUSTRIAL STRATEGY.

- ✓ **Helps to save scarce foreign exchange.** Theforeignexchange that would have been used on the imports is saved.
- ✓ **It reduces the extent of foreign dependence.** It promotes the spirit of the self reliance since goods formerly imported are produced locally. This reduces foreign influence at home.
- ✓ **Facilitates the development of the local skills.** The strategy facilitates the development of the local skills in the industrial sector.
- ✓ **It controls the imported inflation.** Because of the limited imports since most commodities are domestically, chances of importing from the inflation prone countries are minimal.
- ✓ **More domestic resources are exploited.** Import substitution industries use the available resources to produce commodities. Local resources such as the minerals are exploited to provide raw materials to support he industries which increases the output level hence economic growth.
- ✓ **Increases employment opportunities.** As the domestic industries expand, more laboris employed by such industries especially both skilled, semi skilled and the unskilled labourfore hence reducing the unemployment.
- ✓ **Improves on the balance of payment position.** Reduced expenditure on theimports leads to the limited foreign exchange expenditure hence improvement in the BOP position.
- ✓ **Promotes and expands the industrial sector.** LDCs are striving for industrial growth and this strategy is suitable to achieve this because the strategy increases the number of the industries hence industr8al development.
- ✓ **It facilitates the transfer of the technology and development.** This strategy attracts more foreign investor"s o start up industries and also come up with new and modern technology in the production hence increase in the quality of the commodities.
- ✓ **Facilitates the infrastructural development.** The establishment of the industries requires the necessary infrastructure such as roads, railways, andpower supply which are established by the government which promote transport.

- ✓ **Widens the tax base which increases the government revenue.** More revenue is generated by taxing the different industries established and people employed in such industries. This is necessary for the increase government revenue.
- ✓ **Foreign exchange is earned I the long run through exports.** In the long run, these industries start prioducing for the export. When surplus output is produced and sold to the outside world when the domestic markets are satisfied, foreign exchange is earned.
- ✓ **Encourages increased inflow of the foreign capital.** It tends to attract more foreign investors into the country in the industrial sector hence increased international relations.
- ✓ **Creates linkages in the industrial sector.** This pth development of a variety of industries especially among related industries.
- ✓ **Increases incomes of producers.** This is basically those that a engaged in the production for foreign exchange which promotes the savings and investment.

DEMERITS /NEGATIVE ARGUMENTS AGAINST/ NEGATIVE IMPLICATIONS OF IMPORT SUBSITUTION INDUSTRIAL STRATEGY.

- ✓ **Leads to the production of low quality goods due to protectionism.** This strategy advocates for the protectionism which reduces the level of competition between the local Industries and the imported gods thus low quality products.
- ✓ **Leads to the high government expenditure on the subsidies.** This is through increased government subsidies to attract the investors in such industries. It is very expensive to the government because it requires a lot of the protection and the subsidies from the government.
- ✓ **Leads to the high domestic prices.** This is because of the high production costs since the industries are infant in nature leading to the reduced demand.
- ✓ **Leads to the production ofthe excess capacity due to the limited markets.** In LDCs there is insufficient domestic consumer market.
- ✓ **Increase capital outflow on the intermediate inputs.** It requires importation of the machinery, raw materials and capital equipment from abroad to support such industries which worsen balance of payment problems.
- ✓ **Tends to concentrate on the production of the consumer goods than the capital goods.** This leads tp limited capital goods for development thus low rate of economic growth.
- ✓ **Promotes monopoly tendencies.** This is because of the high level of the protectionism for the domestic industries from the foreign competition and therefore consumer exploitation and the poor quality products are realized.
- ✓ **Leads to the beggar-my-neighbor policy/retaliation.** This is due to the problem of over protectionism which reduces foreign earnings in an

economy, as a country stops the importing, other countries revenge by doing the same which also limits the smooth international trade.

- ✓ **Leads to the technological unemployment.** This is because it encourages the use of the capital intensive techniques of production which replace humanlabor hence increasing the unemployment.
- ✓ **Leads to the limited variety of goods and services on the market.** Consumer‟s choice is limited dueto the increased protectionism that limits importation of the substitute goods. This lowers the consumer sovereignty and the standard of living.
- ✓ **Leads to a fall in the government tax revenue.** This is due to the decline in the import duties since the importation is reduced hence budgetary deficits.
- ✓ **Leads to a high profit repartition** because most of the industries are usually owned by the foreigners which worsens the budgetary deficits.
- ✓ **Leads to high social costs** such as pollution of air, water, land and water. This is due dangerous to the human life.

UNEB 1998.

a) *Why should developing countries industrialize? (08 marks)*

b) *Examine the limitations of import substitution strategy of industrial development. (12 marks)*

LIMITATIONS OF IMPORT SUBSITUTION INDUSTRIAL STRATEGY IN LDCs.

1. **Limited capital resources.** LDCs do not have the required capital and this limits the establishment and expansion of thebse industries.
2. **Inadequate skiled manpower.** There are few skilled people in the LDCs to start work, and manage import substitution industries.
3. **Inaxdequate basic raw materials.** LDCs lack the wnough raw materials to use in these industries limits further industrial production .
4. **Narrow market for goods and services.** The domestic market is still low in most LDCs thus encouraging small scale production.
5. **Poor infrastructure.** Theseare in form of the poor roads, poor railways, and this limits access to the raw materials and market hence high costs of production.
6. **Low levels of technology.** Poor techniques of production in LDCs limit thelevel of domestic production.
7. **Political instability in some areas.** Political unrest in some LDCs discourages the establishment and expansion of such industries.
8. **High inflation rates thus high production costs.** Persistent inflation in most LDCs discourages industrialists.
9. **Demonstration effect on the consumption.** There is high marginal propensity to import due to high preference of imported commodities to locally produced goods in most LDCS thus discouraging producers.

10. **Weak private sector and therefore government can not afford to invest in such industries alone.** The private sector is still weak in most LDCs and therefore limited investment in such industries.

11. **Excessive capital outflow.** High profit repatriation and the nationalspreferring to invest in then foreign economies deny economy resources to invest in these industries.

12. **Unfavorable government policy in relation to the subsidization and taxation.** Heavy taxes are imposed on the industrialists and limited subsidies discourage industrialists.

13. **Low level of entrepreneurial skills.** This leads to the failure to effectively organize other factors of production and expand import substitution industries.

14. **A lot of protectionism is required which is very costly and disadvantageous.** This is necessary to protect the established industries from foreign competition.

EXPORT PROMOTION INDUSTRIAL STRATEGY
(OUTWARD LOOKING STRATEGY).

It is an industrial strategy of promoting domestic manufacturing industrieswith the aim of increasing goods for export.

Or

It is a deliberate government policy to expand the volume of exports by setting up the domestic manufacturing industries to produce for export.

NB. Export promotion industries are industries set up to produced manufactured goods purposely for foreign markets. This is intended to increase foreign exchange earnings from the exports.

UNEB 2006.

a) What are the merits of adopting the export promotion strategy of industrialization? (08 marks)

b) Explain the factors that limit theadoption of this strategy in your country. (12 marks)

UNEB 2000.

a) Differentiate between import substitution and export promotion strategies of industrialization. (04 marks)

b) Examine the merits and demerits of export promotion strategies of industrialization. (16 marks)

ADVANTAGES OF EXPORT PROMOTION INDUSTRIAL STRATEGY.

- **It increases the foreign exchange earnings.** This results from the increased export volume which can be used to acquire goods which are not locally produced.
- **Increases the employment opportunities.** More labor gets employed because of the increased production especially where labor intensive techniques of production are used thus reducing unemployment.

- **Widens the tax base.** As the export promotion industries increase, the government gets the capacity to impose more taxes on those industries hence increased revenue.
- **Helps to diversify foreign markets/expands market for goods and services.** Increases the production for export in the different markets hence reducing the geographical concentration of trade and this promotes trade between various countries hence promoting further production.
- **It adds value to agricultural products/raw materials.** LDCs normally export primary agricultural products but this strategy provides a chance to process them before they are exported so as to fetch high prices.
- **Encourages exploitation of idle resources.** Domestic natural resources such as minerals are exploited and used as raw materials in the industries to expand production for export thus reducing under development.
- **It promotes international understanding and relationship between countries.** Mutual understanding between trading countries is developed and this is important for international trade, political stability, and foreign aid.
- **Facilitates development of the necessary infrastructure.** Because of the need to stimulate large scale production for export, infrastructure such as roads, poor supply facilities, railways are established hence promoting further production.
- **Encourages technological development.** In order to produce high quality goods to meet the export market demands, modern technology is employed.
- **Leads to the production of the high quality commodities.** Export promotion is associated with the production of the high quality goods that can compete favorably on the world market.
- **Improves the balance of payment position of a country.** This is through increased production for the export hence high foreign exchange earnings.
- **Reduces dominance of the subsistence production.** This promotes commercial production.
- **Increases the economic growth /GDP/output.** This is due to the increased production since most of such industries produce on a large scale.
- **Promotes the growth of the industrial sectoer.** This leads to the basis of comparative advantage thus increasing the benefits of international trade.
- **Promotes specialization in the production.** This happens on the basis of comparative advantage thus increasing benefits of international trade.
- **Promotes development of the entrepreneurship/innovations and inventions.** This promotes further investment.

DEMERITS OF EXPORT PROMOTION INDUSTRIAL STRATEGY.

- **Leads to the production of the highly produced goods.** Most export promotion industries involve high costs of production thus high prices for exports.
- **Leads to high expenditure on the imported raw materials and technology/involves a need for high investment capital.** This is because most LDCs import the technology and required raw materials needed in these industries.
- **Causes shortage of the commodities in the domestic market.** This is because the production is mainly aimed at external market and creates shortage in the domestic market.
- **Involves high government expenditure on the market research.** It requires a lot of research and advertising n he foreign media and giving subsidies to the industrialists.
- **Leads to over exploitation of the domestic resources.** Due to increased production to meet the foreign market, available natural resources are over utilized.
- **Increases social costs.** Export promotion industries normally pollute theenvironment hence affecting the standard of living among the people.
- **Promotes economic dependence.** It increases the extent to which the country relies on other countries for market, raw materials and skilled labor.

UNEB 2013.

a) *why may a country adopt an export promotion strategy of industrial development. (10 marks)*

b) *Explain the limitations of the export promotion strategy of industrial development. (10 marks)*

LIMITATIONS OF EXPORT PROMOTION INDUSTRIAL STRATEGY IN LDCs.

- **Inadequate capital.** Capital in most developing countries is not enough to establish and expand export industries.
- **Limited market among LDCs due to production of the similar commodities.** Most developing countries produce similar primary products hence cannot utilize their own markets and this leads to flooding of the foreign markets.
- **Low levels of technology.** Most LDCs use poor technology of production of low quality products whose market at the international market remains inadequate.
- **Limited supply of the skilled man power /limited skills.** Shortage of the manpower in the LDCs leads to the increased over dependence on the foreign expatriates who are very costly to pay.
- **Poor infrastructure to stimulate production.** Existing infrastructure is not modernized in form of poor roads, limited railways in most

LDCs and this is cannot expand export promotion industries throughout the country.

- **Productions of the expensive goods due to high costs of production/firms are usually high cost producers.** Since most of these industries are infant in nature, they produce at high average costs which reduce demand for highly priced items on the world market.
- **Protectionist policies of developed countries/imposition of trade restrictions by the MDCs.** MDCs normally impose trade barriers against the commodities from the LDCs through tariffs and non tariff barriers thus reducing volume of the LDCs exports.
- **Limited entrepreneurial skills/ poor managerial skills.** Most LDCs lack enough highly trained managers to promote the development of then established export promotion industries.
- **Limited local natural resources and inter mediate inputs.** Inadequate supply of necessary inputs cannot expand the capacity of the established industries to produce more output for export.
- **High levels of corruption and embezzlement/low levels of accountability.** This is in the process of resource allocation for instance in giving subsidies. This frustrates investors intending to invest in the export promotion industries.
- **Political instability.** The existence of political unrest discourages large scale investors into expanding export promotion industries.
- **Low quality output that cannot favourably compete on the world market.** Most LDCs produce low quality commodities and such out cannot compete favorably on the world market for fair price.
- **High cost of advertising /market research.** This should be carried out in the foreign mediate increase market for the produced commodities.
- **Limited export promotion facilities/institutions.** These are necessary to encourage and direct exporters but they are less developed.
- **Poor land tenure system.** This discourages establishment of the large scale industries.

CHOICE OF THE APPROPRIATE TECHNOLGY.

LDCs are faced with the problem of deciding on the technique to employ in the production because of their economic constraints.

There are basically three types of production techniques.

1. Labor intensive techniques of production.
2. Capital intensive of production.
3. Intermediate intensive of production.

1. **LABOUR INTENSIVE TECHNIQUES OF PRODUCTION.**

It is a method of production which relatively /proportionately more labor than other factors of production especially capital. For instance hand craft and cottage industries in LDCs it is canalso be referred to as **capital saving technology.**

Capital saving techniques of technology refers to the method which employs less capital than other factors of production especially labor. **Or** These are methods of production that employ a big proportion of labour relative to capital and other factor

2. **CAPITAL INTENSIVE TECHNIQUE OF PRODUCTION**.

This is a method of production that uses relatively more capital and other factors less especially labor. It is also referred to as **labor saving technology.**

Labor saving techniques of production refer to production methods which employ less labor than the other factors of production especially capital.

Or

These are methods/techniques of production that employ a big proportion of capital relative to labour and other factors.

UNEB 2007.

i) *What is technology transfer.* *(02 marks)*

ii) *Distinguish between labor saving and capital saving techniques of production* *(02 marks)*

UNEB 2005.

"Developing countries should mainly adopt labor intensive techniques of production." Discuss. *(20 marks)*

ADVANTAGES OF LABOUR INTENSIVE TECHNOLOGY IN LDCs.

- **It does not require complex skills.** It is appropriate to LDCs because of limited skilled manpower and technical managerial know how to handle complicated capital intensive technology. This makes it affordable and sustainable.
- **Does not encourage employment of foreign manpower or expatriates.** Foreign expatriates are only familiar with capital intensive technology and this reduces foreign dependence and capital outflow.
- **Reduces social costs** inform of air pollution, since it is not associated with the activities of heavy industrialization to pollute the environment.
- **Reduces external dependence and save scarce foreign exchange.** This is because it is not associated with importation of the heavy machinery of the commodities to aid with production and uses locally available resources.
- **Reduces income inequality.** A big percentage of labor force gets employed and therefore has access to the income earnings.

- ❖ **Increases the government tax revenue.** This is through taxing the incomes of the salaried individuals. This is because many people get employed in this technology.
- ❖ **It is cheap and relatively affordable.** This is because labor is abundant and it requires simpler tools and equipments such as pangas, hoes, and axes especially in the agriculture and does not need spare parts from other countries.
- ❖ **It helps to reduce the unemployment existing in the LDCs.** the technique employ employs mainly a large section of the unemployed laborforce.
- ❖ **It is required where the human judgment** is vital for instance in tea picking and coffee picking where the capital intensive technology is difficult to use. This makes it suitable for agricultural sector which is dominant in the LDCs.
- ❖ **Increases exploitation of the rural vast potential which minimizes rural urban migration.** This is because most of the activities which are of labor intensive are of small scale in nature which is carried out in the rural areas.
- ❖ **Reduces the over exploitation of the resources.** This is due to the limitedcapacity to over utilize the available resources.

DISDVANTAGES OF LABOUR INTENSIVE TECHNOLOGY.

- ❖ **Does not maximize output per unit of labor/labor productivity is low.** This limits economic growth due to the use of rudimentary tools and low levels of education among workers.
- ❖ **Low quality output is produced.** This is because majority of people employed are either unskilled or semi-skilled and such commodities are not likely to compete favorably on the world market.
- ❖ **Discouraged private foreign investments.** This is because most foreign investors are only familiar with capital intensive technology and cannot easily cope up with labor intensive technology.
- ❖ **The method is very expensive and costly in the long run.** In the long run, it increases the wage bill, cost of welfare facilities, housing and medical facilities to workers. This reduces profit margins of producers because of increased production costs.
- ❖ **Limited technological development.** Labor intensive technology is associated with limited innovations and inventions in production thus limited introduction of new technology.
- ❖ **Leads to high chances of industrial unrest.**Workers are likely to strike and demonstrate over demand for higher wages, good conditions of work which retards production.
- ❖ **Results into under utilization of resources.** Labor intensive technology has inadequate capacity to fairly utilize the available natural resources.

- ❖ **It is slow and time consuming.** Labor intensive technology takes a lot of time for labor to perform a given task for instance in cultivation, mining and quarrying.
- ❖ **Makes it very hard to standardize output.** Output produced is never identical and this makes transactions very difficult especially on the international market.

ADVANTAGES OF THE LABOUR INTENSIVE TECHNIQUES OF PRODUCTION.(CAPITAL –SAVING TECHNIQUES) OF PRODUCTION.

- They reduce the social costs.
- Do not encourage employment of the foreign manpower or expatriates.
- They are cheap and relatively affordable.
- Reducerampant unemployment existing in the LDCs.
- Reduce income inequality.
- Yield high government tax revenue.
- They do not require complex skills.

DISADVANTAGES OF LABOUR INTENSIVE TECHNIQUES (CAPITAL-SAVING TECHNIQUES) OF PRODUCTION.

- Result into under utilization of the resources.
- Are slow and time consuming.
- Make it very hard to standardize output.
- Lead to high chances of industrial unrest.
- They do not maximize output per unit of labor.
- They limit technological development.
- Low quality output is produced.
- Discourage foreign private investments.

UNEB 1998.

Examine the merits and demerits of using capital intensive techniques of production in your country. (20 marks)

UNEB 2012.

- ***i)*** *What is meant by labor-saving techniques of production? (02 marks)*
- ***ii)*** *Mention any two merits of labor-saving techniques of production . (02 marks)*

UNEB 2015

- *(i) Define the term capital intensive technology. (01 marks)*
- *(ii) Give any three factors that limit the adoption of capital intensive technology in your country. (03 marks)*

ADVANTAGES OF CAPITAL INTENSIVE TECHNIQUE OF PRODUCTION.

1. **It is useful where labor is scarce and expensive.** In LDCs where there is limited supply of skilled labor, this method of production is suitable.

The net output per unit of labor is high and this stimulates more investment.

2. **Encourages the large scale production/economies of scale are enjoyed due to large scale production.**Laborproductivity is high with the capital intensive technology thus mass production which accelerates economic growth.
3. **Leads to the production of high quality products.** Output of the high quality is realized with the capital intensive technology and this can compete favorably for the high prices on the world market.
4. **Promotes infrastructure development.** Capital intensive technology is used in construction of the roads, storage buildings, bridges, railways and this is an indicator of economic growth and development.
5. **Reduces the industrial/labor unrest.** With capital intensive technology,chances of strikes are high and demonstrations by the workers over wagesincrement, conditions of work are very minimal since few workers are employed and therefore production is not disrupted.
6. **It is time saving and less tiresome.** A lot of work is done within the shortest time possible by the machines therefore its operations are quicker and faster.
7. **Facilitates fair utilization of the resources.** The rate of the resource utilization such as minerals, land, isveryhigh with the capital intensive techniques of production and this reduces under development.
8. **Equips the labor with modern skills/increases the lab ourefficiency.** This increases laborefficiency. It is a source of training of the labor so as to be able to use the machines effectively which leads to the acquisition of the skills.
9. **Reduces wage bill and costs of other incentives at work** such as medical facilities, housing facilities and transport facilities to workers. This reduces the cost of production hence high productivity of business.
10. **Facilitates technological transfer and development.** It encourages importation of major technology which accelerates technological development through inventions and innovations.
11. **Promotes rapid growth of the industrial sector.** Most of the industries require machinery in their operations and this helps to industrialize the economy by employing such technology.
12. **Makes the output easy to standardize.** Output produced using capital intensive technology is ever identical or of the same quality which makes trade transactions continuous and profitable.

DISADVANTAGES OF THE CAPITAL INTENSIVE TECHNIQUES OF PRODUCTION

1. **It is associated with the technological development.** It replaces workers andemploys limited labor force thus increasing the problem of unemployment.

2. **It is very expensive and costly to import and maintain.** LDCs are faced with the problem of the shortage of the foreign exchange to import the machines due to the limited capital.

3. **Leads to the regional imbalances in the development and rural urban migration.** It tends to concentrate in the urban areas where there are the necessary facilities such as electricity, roads, and banking facilities and the rural areas are ignored thus high rural urban migration.

4. **Promotes income inequality.** It employs a few section of the labor force with the required skillsand it is owned by the few firms and the income concentrates to the limited sections of the employed population.

5. **Worsens the balance of payment problems due to the high foreign exchange.** Heavy imports of capital and spare parts lead to high foreign expenditure.

6. **Leads to the high social costs.** It is responsible for the air pollution and the current global warming is highly attributed to rapid advancement.

7. **Encourages over exploitation of the available resources.** Natural resources such as minerals, forests, and waterresources are over utilized and this leads to their quick decision.

8. **Increase foreign dependence and dominance.** Most capital intensive techniquesof production used I the LDCs are imported from the MDCs hence increased foreign domination by the foreigners.

9. **Requires complex skills/involves high training of the labor for the required skills.** This leads to the importation of the skilled man power to run such technology hence retarding the development of the indigenous skill.

10. **Leads to the marketing problems due to the surplus output.** It leads to excessive production which leads to the resource wastage. This makes it not suitable for the existing market in the LDCs.

11. **It is not applicable where the human judgment is needed such as in the tea picking.** This means that it cannotbe avoided especially in the agriculture.

INTERMEDIATE TECHNOLOGY

Intermediate technology is a technique of production which is neither capital intensive nor labor intensive but combines both capital and labor in the fair proportions. **Or**

This is a techniqueof production that liesbetween the advanced expensive capital intensive technology and cheap labor intensive technology.

Features Of Intermediate Technology.

- It is mainly rural based i.e. basically rural oriented technology.
- It is mainly based on the local; production.
- Suits the geographical and ecological conditions of a country.
- It is mainly based on the local research and expertise.
- It is based on the prospects of the local inventions and innovations.

- ❖ It is geographically spread.
- ❖ It relatively uses more units of labor than capital.
- ❖ It is technically and economically efficient.

UNEB 2004.

i) What is appropriate technology (01 marks)

ii) Give any three factors which have affected the developments of the appropriate technology in your country. (03 marks)

FACTORS WHICH AFFECT OR INFLUENCE THE DEVELOPMNT OF THE APPROPRIATE TECHNOLOGY IN UGANDA.

- ❖ Availability of funds.
- ❖ Influence of the natural factors.
- ❖ Cultural factors.
- ❖ Level of inventionsand innovations.
- ❖ Degree of the external influence.
- ❖ Level of entrepreneurship skills.
- ❖ Market size.
- ❖ Government influence on the technological development.
- ❖ Level o the skills and education.

FEATURES OF THE APPROPRIATE TECHNOLOGY.

- ❖ Should improve efficiency and productivity.
- ❖ Should encouragecapital formationstimulate growth.
- ❖ It should solve the local problems of a country.
- ❖ It should make use of the local resources.
- ❖ I should b simple and comparatively cheap.
- ❖ It should be static and dynamic with time.

TECHNOLOGY TRANSFER.

This is the movement of new and efficient production techniques from one economy to another mainly from the developed counties to the less developed countries.

It involves movement of the managerial, administrative technical knowhow and capital equipment from one country to another especially from the developed countries of the less developed countries.

REASONS FOR TECHNOLOGYTRANSFER.

- ✓ To overcome the backwardness and increase skills.
- ✓ To reduce the production costs.
- ✓ To accelerate the rate of the economic growth.
- ✓ To reduce the labor unrest rampant I the LDCs.
- ✓ To increase the labor productivity and efficiency.
- ✓ To reduce the technological gap between the LDCs and MDCs.
- ✓ To stimulate rapid industrialization.
- ✓ To develop the key and basic infrastructure such s power supply, roads, railways, banking facilities and telecommunication facilities.

- ✓ To increase exploitation of the resources which involves high costs such as oil mining?
- ✓ To improve on the quality of goods and services produced/ to make the products from the LDCs more competitive on the world market.
- ✓ To attract foreign investments.

DANGERS OF THE TECHNOLOGY TRANSFER IN THE LDCs.

- ➢ Worsens the problem of technological unemployment. This technology replaces human labor.
- ➢ Retards the development of the local skills that suit the local conditions.
- ➢ Worsens balance of payment problem because it requires the large foreign exchange expenditure.
- ➢ Contributes to high social costs. Itleads to heavy pollution of the environment.
- ➢ Worsens income inequality due to a considerable volume of foreign investors who are concentrated in the urban areas and employ a few technical manpower.
- ➢ Breeds foreign domination and dependence.LDCs continue to rely on the technical manpower, spare parts from the MDCs
- ➢ Worsens the rural urban migration. It tends to concentrate in the urban areas and attracts the people from the rural areas to urban areas and associated problems such as slum development.
- ➢ Leads to over exploitation of the available resources. Modern technology exploits resources at a high rate leading to the resource depletion.
- ➢ Worsens the profit repartition due to the use of the foreign expatriates and it is normally owned by the foreigners.
- ➢ Leads to the over production. This results into wastage of the resources when the surplus output is not purchased.

MAJOR OBSTACLES TO THE TECHNOLOGY TRANSFER FROM THE MDCs TO THE LDCs.

1. **Limited scientific skills to maintain the technology.** LDCs do not have the required skills to adoptand maintain the technology.
2. **Limited capital resources in the LDCs.** Most of the developing countries do not have the required money purchase the modern technology which is very expensive.
3. **Prohibition by the patent rights.** The owners of such technology want to remain monopoliesand do not sell their technology to other countries.
4. **Limited size of the market.** LDCs have limited market which does not require mass production using modern technology.
5. **Poor infrastructure to facilitate the technology.** Modern technology requires supportive infrastructure such as roads, railways which are in short supply in most MDCs.

6. **High levels of conservation.** People in most MDCs are still conservative in nature and do not want to change from their traditional technology to modern technology.
7. **High levels of protectionism by the MDCs.** Developed countries do not want to extend their modern technology to LDCs and therefore impose heavy restrictions on its transfer.

UNEB 2004.

"Uganda should adopt an agricultural rather than industrial development strategy if it is to attain a faster rate of economic growth" discuss. (20 marks)

AGRICULTURAL DEVELOPMENT STRATEGY AND INDUSTRIAL DEVELOPMENT STRATEGY.

MERITS OF AGGRICULTURAL DEVELOPMENT STRATEGY.

1) **Source of food to the rapidly growing population.** This increases investment in agriculture. Provides food for the growing population.
2) **Provides more employment opportunities** as it is labour intensive. Employs many people either directly or indirectly thus reducing unemployment.
3) **Generates more foreign exchange.** This is through increased exportation of agricultural products.
4) **Supplies raw materials to agro based industries at relatively low prices.** This promotes rapid industrialization.
5) **Generates government tax revenue.** Taxes are imposed on agricultural activities which is used for development.
6) **Promotes equitable income distribution/reduces income inequality.** This is because it *encourages* participation of the majority.
7) **Reduces rural urban migration.** This is because many people get employs in agriculture in rural area.
8) **Promotes regional balance in terms of development**. This is because it can be widely spread in different rural areas thus promoting harmonious regional development.
9) **Encourages rapid development of infrastructure**. Encourages establishment of infrastructure such as roads, railways.
10) **Contributes greatly to GDP.** This results from increased agricultural output.
11) **Provides backward and forward linkages which provides market to industrial goods.** This is especially with industrial sector.

DEMERITS OF AGRICULTURAL DEVELOPMENT STRATEGY.

1. **It is affected by natural vagaries of weather such as drought and floods.** This leads to low output.
2. **Causes seasonal and disguised unemployment.** This increases unemployment problem and its disadvantages.

3. **Suffers from frequent price fluctuations** because of over production and perishability of agricultural products. This leads to instability in income.
4. **It yields low government tax revenue** because production is largely done on subsistence level and low prices are offered for marketed output.
5. **It requires a lot of land which is increasingly becoming scarce** because of high population growth rate. It is land intensive.
6. **Agriculture is subject to diminishing returns.** There is reduced fertility due to continued use of land and in the long run output reduces.
7. **Leads to unfavourable terms of trade.** This is because prices of agricultural products tend to fluctuate greatly compared to prices of imported manufactured commodities.

MERITS OF INDUSTRIAL DEVELOPMENT STRATEGY.

- **Generates high employment opportunities in the long run.** This is especially in tertiary and secondary industries.
- **It widens tax base.** Generates more revenue to the government through taxation since it widens the tax base.
- **It leads to increased economic diversification.** Promotes production of a variety of commodities which increases consumers" choice.
- **Provides market for agricultural products.** Provides linkages with other sectors for instance the agro-based industries which provides market to output from such sectors.
- **Promotes innovations, inventions thus technological development.** In a move to expand industrial production and compete with imported products, extensive research is carried out.
- **It supplies the agricultural sector with required inputs** such as fertilizers, machinery.
- **Increases utilization of idle resources.** This reduces underdevelopment.
- **It is not much subject to vagaries of weather** such as drought because it is not dependent on nature and this sustain the economy through out.
- **Results into rapid economic growth.** Its gestation period is very short and output is increased in the short run. This contributes highly to GDP.
- **It is a source of foreign exchange which improves balance of payment position.** This is achieved by establishing export promotion industries and import substitution industries.

DEMERITS OF INDUSTRIAL DEVELOPMENT STRATEGY.

- **It is very expensive in terms of costs.** Promoting rapid industrialized requires a lot of money which is insufficient in LDCs.
- **Encourages external economic dependence** through importation of major raw materials and machinery to run industries.
- **Results into high social costs** such as air pollution and associated negative impacts.

- **Encourages rural urban migration** and its associated negative effects since most industries tend to be located in urban areas.
- **Worsens the problem of income inequality.** This is because it employs more of skilled labour and few people have the capacity to start industries.
- **Leads to over exploitation of resources** such as minerals which leads to their quick depletion.
- **Leads to regional imbalances in development.** Most industries tend to concentrate in urban and strategic areas with suitable infrastructure and such areas develop at the expense of other areas.
- **Low prospects of employment creation especially in the short run.** Most industries use capital intensive technology and employ a small section of the labourforce.
- **Promotes capital flight.** Most industries especially large scale industries tend to be owned by foreign investors who repatriate profits to their home countries thus low multiplier effect.

CHAPTER 9: POPULATION AND LABOUR

Population refers to the total/aggregate number of people living in a given country at a given period of time. The population of an area includes both permanent and temporally residents. The size of the population of a country is known by carrying out population census.

POPULATION CENSUS

This is the physical counting of people living in a given country at a particular period of time. In most countries including Uganda, population census is carried out once in 10years.

Statistics reveal that Uganda"s population has been increased over theyears.

1984..5.0 Million people
1959..6.5 Million people
1969..9.5 Million people
1980..12.6 Million people
1991..16.5 Million people
2002..24.6 Million people
2014..37.58Milllion people

From the above statistics, it is clear that the population growth rate is high. This is due to birth rates and declining death rates.

REASONS WHY POPULATION CENSUS IS CARRIED OUT.

- To establish the correct size of the population in numbers which acts as a basis of government planning.
- To establish the age distribution of the population so as to determine the size of labourforce.
- To discover population distribution among different regions.
- To establish sex composition/sex ratio of the population.
- To establish the rate of migration i.e. local and international migrations.
- To establish the quality of the population in terms of the level of education and health.
- To establish the population growth rate of the country. i.e. borht rates and death rates. This helps to formulate necessary population policies.
- To compute percapita income of people living in the country. This is a good measure of standard of living.
- To establish the occupational distribution of the population. This is important in manpower planning.
- To establish the rate of unemployment. This helps to put in place relevant policies to reduce unemployment.
- To establish the number of dependents i.e. the young and old.
- To solicit foreign funds to finance various population programmes.

IMPORTANT TERMS/CONCEPTS USED IN POPULATION.

-Population explosion. This is the a rapid increase in population of a given area more than what the available resources can sustain. **Or**

It is a rapid/sudden increase in population size which is above what the available resources can sustain. It is normally brought about by increased immigrations which may be due to wars or epidemics, a sudden increase in birth rates,a sudden decrease in death rates.

-**Life expectancy.** This I the average number of years an individual is expected to live under the prevailing conditions after birth. For instance in 2002, life expectancy for females was 43years and for males 42years in Uganda.

-**Fertility rate.** This is the number of births or children per 1000 which a woman bears in her productive period. It tends to be higher in developing countries and lower in developed countries. It is determined by region, traditional beliefs.

-**Dependence ratio.** This refers to the proportion of dependants to the total population in a given country.

$$\text{Dependence ratio} = \frac{\text{Total number of dependence}}{\text{Total population.}} \times 100$$

Worked example.

1) Given that the working population in a country is 12,000,000 people, young population is 14,000,000 and the elderly is 4,000,000. Calculate the country"s dependence ratio.

$$\text{Dependence ratio} = \frac{\text{Total number of dependence}}{\text{Total population.}} \times 100$$

$$\frac{14{,}000{,}000 + 4{,}000{,}000}{14{,}000{,}000 + 4{,}000{,}000 + 12{,}000{,}000} \times 100$$

$$\frac{18{,}000{,}000}{30{,}000{,}000} \times 100$$

$$\underline{\text{Dependence ratio} = 60\% \text{ or } 3:5}$$

Demerits of such a population.

- Low savings and investment.
- Underutilization of resources leading to underdevelopment.
- Low labour productivity in the economy.
- Heavy government expenditure to provide essential services.

2) Given that the size f labour force in a country is 15,000,000 people, young population is 4,000,000 and those above 64 years is 6,000,000 people. Calculate the country"s dependence ratio.

$$\text{Dependence ratio} = \frac{\text{Total number of dependants}}{\text{Total population.}} \times 100$$

$$\frac{4{,}000{,}000 + 6{,}000{,}000}{4{,}000{,}000 + 15{,}000{,}000 + 6{,}000{,}000} \times 100$$

$$\frac{10{,}000{,}000}{25{,}000{,}000} \times 100$$

$$\underline{\text{Dependence ratio} = 40\%}$$

- **Mortality rate.** This is the number of people who die before reaching their life expectancy. It may be infant mortality, child mortality or adult mortality.
- **Population projection.** This is the estimation of future population in a country basing on the prevailing rate of population growth. Predications are made on future population size.
- **Population growth rate.** This is the rate at which a given population of a country increases over a given period of time. It is measured by annual percentage increase in population. In Uganda it has been 3.4% on average over the period of 1991-2011.

Types Of Population Growth.

1. **Natural population growth.** This is due to birth rates and death rates.
2. **Artificial population growth.** This results from migrations i.e. emigration and immigration.

MAJOR DETERMINANTS OF POPULATION GROWTH.

There are basically three determinants of population growth i.e.

1. Birth rate.
2. Death rate.
3. Migration

BIRTH RATE.

Birth rate refers to the number of children who are born alive in a year out of 1000 population/per 1000 population. The higher the birth rate, the higher the population growth and the lower the birth rate the lower the population growth.

DETERMINANTS OF BIRTH RATE.

- ❖ Fertility rate of women.
- ❖ Proportion of women getting married.
- ❖ Average age of marriage. The earlier the women get married, they are likely to bear many children compared to those that get married at an old age.
- ❖ Cultural values and beliefs among the population.
- ❖ Willingness/desire to have children.
- ❖ Level of education among men and women.
- ❖ Sex composition of adults. High number of women in society than men, birth rates are likely to be high.
- ❖ Influence of birth control measures.
- ❖ Status of women in society. If women are regarded as child bearing women, birth rates become high.
- ❖ Level of urbanization and cost of living.

DEATH RATE.

Death rate refers to the number of people who die in a year per 1000 of the population. The higher the death rate, the lower the population growth and the lower the death rate, the higher the population growth.

DETERMINANTS OF DEATH RATE.

- Nutritional levels/standards.
- Level of occurrence of natural disasters such as earth quakes, floods and landslides.
- Quality and quantity of medical facilities available.
- General political climate.

Migration rate (emigration and immigration).

When immigrants exceed the emigrants, the population growth rate is likely to increase and when emigrants exceed the immigrants, population growth rate becomes low.

MEASUREMENT OF POPULATION GROWTH.

The growth rate of population is expressed as a percentage. The calculation is carried out when the births and deaths have been established or expressed in rates per 1000 people in a given period of time.

$$\text{Population growth rate} = \frac{\text{Birth rates} - \text{death rates}}{1000} \times 100$$

UNEB 2007, 2003

a) *What is meant by the term optimum population.* *(04 marks)*
b) *Examine the implications of a high population growth rate in your country.* *(16 marks)*

UNEB 1997.

a) *Distinguish between under population and over population.* *(04 marks)*
b) *Explain the effects of a high population growth rate in an economy.* *(16 marks)*

ADVANTAGES OF A LARGE POPULATION SIZE OR A RAPIDLY GROWING POPULATION/AN INCREASING POPULATION IN AN ECONOMY.

1. **Leads to high market potential.** It raises the number of potential customers for goods and services leading to a bigger market for commodities.
2. **High potential for labour force/increases labour supply.** Young people are energetic, inventive and willing to receive new ideas and this implies that various productive sectors such as agriculture, industry are able to get the required workers thus expanding production.
3. **Creates high tax revenue potential.** In case such a large population is employed, the government becomes able to obtain enough revenue through taxation for public spending which helps to develop different sectors of the economy.

4. **An incentive for future investment/stimulates investment levels.** High population induces business men to establish various investments opportunities due to prospects of increased demand.
5. **Increases innovativeness and inventions among the young.** A large population stimulates a spirit of innovativeness and inventiveness especially among the young.
6. **It encourages high mobility of labour.** Young energetic labour moves form one occupation or geographical area to another in the process of securing employment which promotes employment thus reducing labour shortages in some areas.
7. **Awakens the government to provide necessary infrastructure.** The government is forced to provide necessary infrastructure such as roads, power supply, hospitals and schools which in turn leads to development and caters for the population.
8. **It increases resource utilization.** Facilitates fair and optimum utilization of resources such as agricultural land, forests, water sources and minerals to support the growing population thus reducing underdevelopment.
9. **It initiates efforts to work harder.** This is intended to sustain the predominantly dependent population.

DISADVANTAGES OF A LARGE POPULATION SIZE OR A RAPIDLY GROWING POPULATION/AN INCREASING POPULATION.

i) **Leads to high dependence burden.** This is especially when the majority are below working age and above 65yeras. This proportion consumes without producing hence low capital accumulation leading to low savings.

ii) **It overstrains the available infrastructure.** A large population creates excessive demand for social services such as hospitals, schools and roads thus over utilizing such facilities.

iii) **Increases problems of unemployment and underemployment.** As the population size increases, the number of people entering the labour market also increase but in most cases the population doesn't match with increase in investment leading to low rate of job creation.

iv) **Increases rural urban migration and its associated problems.** As the population size increases, many people move to urban areas in search for jobs which leads to congestion,theft, prosititution, shortage of housing facilities, water and sanitation problems, development of slums and shanty towns.

v) **It results into demand pull inflation.** Unless there is increased production to support the increase in population, there is increased aggregate demand over aggregate supply and country sufferes from inflation.

vi) **Worsens balance of payment problem.** There is increased demand for imported commodities to support the population and reduced exportation because of increased consumption. This leads to excessive foreign exchange outflow relative to foreign to foreign exchange inflow.

vii) **It leads to over utilization of resources.** Large population creates strain on land, water bodies, forests and wetlands leading to deforestation, land and air population, soil exhaustion thus a decline in productivety of such resources which limits future production.

viii) **Increased income inequality.** Large population is accompanied by shortage of educational facilities, increase in illiteracy, unemployment and income concentrates in the hands of few educated people.

ix) **Increases government expenditure on social services.** An s an increase in population size implies an increase in national budget to support this population in provision of public services thus budgetary deficits.

x) **Worsens external dependence.** Dependence on foreign economies(foreign aid) increases and its associated problems in order to support the growing population.

xi) **It leads to low percapita income and poor standard of living.** Because of associated problems of high population such as high dependence burden, there is limited rate of saving and investment to increase national income thus low standard of living.

UNEB 2015

a) *Describe the population structure of your country.* *(08 marks)*

b) *Examine the economic implications of such a population structure.* *(12 marks)*

UNEB 2005

a) *Describe the population structure of your country. (08 marks)*

b) *Examine the economic importance of such a population structure. (12 marks)*

STRUCTURE OF UGANDA'S POPULATION.

- It is dominated by young people who constitute approximately over 40% and the aged above 65 years contribute the smallest portion.
- Females are more than males where females constitute 51% and males constitute 49%
- It has a high population growth rate of approximately 3.4% per annum due to high birth rates.
- The population is mainly rural based and approximately 80% of the population live in rural areas.
- There is uneven spatial population distribution and it is mainly concentrated in central part with Kampala approximately having 7360 persons per square km and Moroto with 20 persons per square km.
- Production force of the population is mainly engaged in primary activities such as agriculture.

- There are mainly high illiteracy rates and approximately 32% of the population do not know how to read and write.
- Majority of the population are semi skilled and unskilled which reduces labour productivity.

IMPLICATIONS OF UGANDA'S POPULATION STRUCTURE.

Positive Implications Of Uganda's Population Structure.

NB. *Explanation must be justified by the feature from the population structure.*

1. **Leads to high market potential.** This is because of high population growth especially for essential commodities which stimulates further production.
2. **High potential for labour force.** The high population growth rate creates a large section of people gradually joining the laboring for various productive sectors. This increases labour supply and expands production.
3. **Awakens the government of its responsibility to provide social infrastructure** such as education, hospitals, roads due to high population growth which increases demand for such services which helps to cater for the high population.
4. **An incentive for increased future investment/encourages and stimulates more investments.** There is increased effort in production so as to meet the increasing aggregate demand created by a high population growth rate.
5. **A high potential for increased resource utilization.** Resources such as minerals, land, water resources are fairly utilized due to increased demand for food to support the high growing population which reduces underutilization of resources.
6. **Encourages efforts to work harder.** High population growth rate leads to high dependence burden which forces people to work so as to support the large number of dependants.
7. **Increased labour mobility.** This is because of high population density and high dependence burden which force labour to move to different places and occupation for employment. This reduces labour shortage in some areas.
8. **Increased innovations and inventions among the young.** It leads to emergence of a young population that is usually innovative and inventive.

UNEB 2000

Mention any four problems of an increasing population in a country.
(04 marks)

Negative Implications Of Uganda's Population Structure.

NB. *Explaination must be justified by the feature from the population structure.*

1. **High dependence burden thus low savings.** Majority of the population are in the age bracket of 0-15 years who are economically unproductive and depend on the small percentage of working population and this reduces savings.
2. **Increases unemployment and underemployment problems.** The population growth rate is greater than the rate at which jobs are created and majority are semi skilled thus low income.
3. **Worsens balance of payment problems.** More is imported to support the rapidly growing population, increases external borrowing and less is exported in return leading to high foreign exchange expenditure.
4. **Over straining the available infrastructure** due to high growing population, congestion is experienced in public hospitals, schools and roads due to excessive demand for such infrastructure.
5. **Lead to rural urban migration and its problems.** The rate of job creation in villages to absorb the rapidly growing population is low and majority of the population opt to migrate to urban centres leading to development of slums, high crime rates.
6. **Over utilization of resources leading to a decline in their productivity and quick depletion.** This is due to high pressure on land, existing forests created by a rapid growing population thus creating environmental threats which limits future production.
7. **Leads to high government expenditure.** Government spends heavily to support high population growth in provision of social services and this leads to budgetary deficits.
8. **Results into demand pull inflation.** There is rising aggregate demand as a result of population increase leading to increase in general price level.
9. **Increased income disparities.** This is between the few skilled and very many unskilled and semi-skilled labour. This is worsened by high dependences burden and limited access to jobs.
10. **Encourages external resource dependence** such external dependence on foreign man power due to limited skills possessed by local labour, foreign capital which limits local initiatives.
11. **Leads to brain drain.** This is because of high unemployment rates, low wages and poor working conditions created by a rapidly growing population.
12. **Leads to low per capita income and standard of living.** Majority of the people still live below the poverty line, there is low labour productivity and large number of dependants leading to poor standard of living.
13. **Leads to high social costs.** This is in form of pollution due to rapidly growing population which negatively affects the population.
14. **Makes effective planning by government very difficult.** This is due to rapidly growing population hence plan failure

UNEB 2009, 2004, 1999

a) Explain the Malthusian theory of population (06 marks)

b) To what extent is this theory relevant in developing countries (14 marks)

UNEB 1998

a) Explain the Malthusian population trap theory. (08 marks)

b) To what extent is the theory applicable to your country? (12 marks)

UNEB 2012

a) State the Malthusian population theory. (04 marks)

b) Explain five ways in which the Malthusian population is relevant to developing countries. (10marks)

c) State six limitations of the theory. (06 marks)

MALTHUSIAN THEORY OF POPULATION.

The theory was put forward by a British economist Rev Thomas Malthus who lived in England at the time of industrial revolution.

- The Malthusian theory explains the relationship between population growth and food growth rate or supply i.e. population growth depends on food supply.
- The theory states that whereas population grows at a much faster rate in a geometric progression/rate i.e. 2,4,8,16,32,64,................, food supply grows at a slow rate arithmetic progression/rate (by a constant amount) i.e. 2,4,6,8,10,12,.............
- The theory further states that there will be a point when population growth equals food supply i.e. population trap beyond which food production would not be enough to sustain the population leading to famine, suffering, starvation and death.
- To reduce this calamity, Malthus suggested use of negative checks such as celibacy and late marriages, moral restraint to control population, otherwise positive checks like wars and diseases would start operating to reduce population growth to match with food supply.

The Malthusian theory of population is illustrated as below.

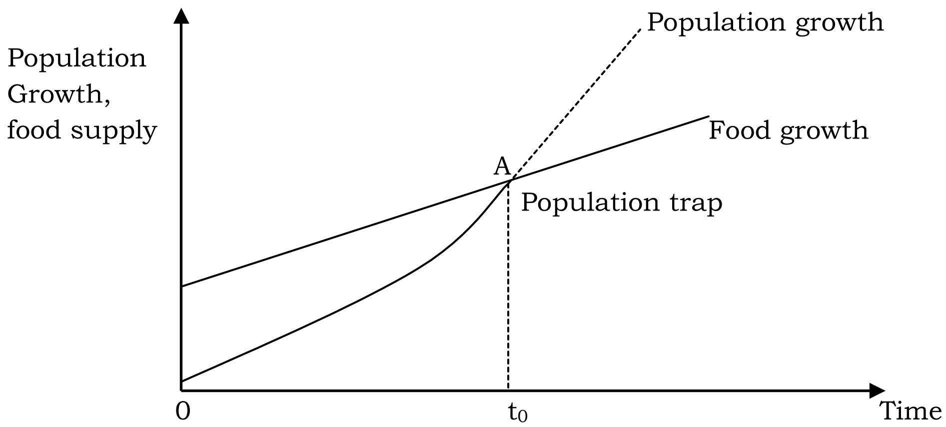


Figure 9.1: The Population Trap

- Point A is the population trap

RELEVANCY/APPLICABILITY OF THE MALTHUSIAN THEORY OF POPULATION IN UGANDA/LDCS

The Malthusian theory is population is to a lesser extent applicable / relevant to my country/developing countries in that;

- Land problems are common issues in Uganda today because of high rate population growth rate such as in Kisoro.
  In Uganda, there are communal land quarrels and disputes which have to some cases resulted into high population.
- Food shortages are being experienced in some areas in Uganda such as Karamoja, Kisoro, Bunyoro region due to rapid population growth.
- Natural family planning methods are being used to control population such as late marriages, celibacy and these were suggested by Malthus.
- Land is fixed in supply and subject to diminishing returns, this is due to an increasing population and
  Malthus" theory is based on this situation.
  As the population size increases there is less and less amount of land to be worked upon by each person. For instance in Kigezi region.
- Positive checks such as epidemics, wars, famine have controlled population growth in Uganda today. This is also prevailing in many LDCs such as Somaria, Rwanda and DRC.

LIMITATIONS/IRRELEVANCIES/CRITICISMS OF THE MALTHUSIAN THEORY OF POPULATION IN UGANDA/LDCs

To a greater extent, the Malthusian theory of population is not relevant in my country/ developing countries.

(Direct your explanation to where the question is meant to apply i.e. either to your country of developing countries.)

Malthus was however criticized by several scholars on grounds that he looked at the world in a very narrow perspective.

1. The theory does not foresee technological improvement since it assumes constant technology and yet technology is ever changing in Uganda/LDCs with time which increases food production.
2. There is no mathematical relationship as regards food supply and population growth in my country, population does not grow at a geometric rate and food supply does not grow at an arithmetic rate in my country.
3. Malthus ignored the possibility of getting foreign aid and resources from other countries yet this enables my country/LDCs to get additional food supplies to support the growing population.
4. The theory ignores other factors that affect population growth other than food supply and yet there are other factors such as culture which affect population growth.

5. Malthus ignored current deliberate and scientific birth control measures yet these are used in Uganda/LDCs such as use of condoms, contraceptives to control population growth.
6. The theory assumes a subsistence economy and yet Uganda"s economy is not predominantly subsistence any longer. Uganda is growing out of subsistence level and sell some of their produce and this increases supply of food in areas of scarcity.
7. He did not foresee the importance of labour mobility to reduce population pressure in crowded areas such as Kigezi to increase food production.
8. Malthus did not foresee great improvement in infrastructure/transport such as roads, air transport, railways that would ease the movement of food from one region to another to support the growing population.
9. He did not realize that the rising standard of living and cost of living today would result into a fall in birth rates and therefore reduce population growth to match with food supply.

   The theory ignores agricultural modernization/improvement and yet this is taking place in Uganda through irrigation, fertilizer application to match food supply with the growing population. This means that diminishing returns in agriculture is not wholly true.

   The theory assumes a closed economy and yet my country is an open economy, therefore through international trade some food is imported to support the rapidly growing population.

   The theory ignores the possibility of emigration/encouraging international migrations, yet this eases pressure on resources and have enough land for production to support the growing population.

Note

- He expressed fear that time would come when population growth out paces/exceeds food growth rate (means of subsistence) i.e. beyond the population trap and people would die of famine, hanger, starvation, misery and congestion. Population becomes too much to be fed by the available food.
- Population trap is a point where population growth equals food supply. Beyond this point, any additional population would have to starve to death.

  This is the inevitable population level at which population increase was bound to stop because after that level, the lie sustaining resources would be insufficient to support human population.
- Malthus identified two types of checks to control population growth so as to match with food supply.
  (i) **Preventive checks/negative checks.** These are population checks which lower birth rates such as abstinence, late marriages and celibacy.
  (ii) **Positive checks.** These are population checks which increases death rates. If the negative checks fail then positive checks which

reduce the population in a crude automatically apply such as famine, wars, earthquakes and epidemics.

- The limits of population growth would be determined by the supply of food.
- The theory was based on the belief that man"s biological capacity to reproduce himself is far better than the capacity to produce food for himself.

Assumptions Of Malthusian Theory Of Population.

1. Assumes that land is fixed and subject to the law of diminishing returns.
2. Assumes operation of positive and negative checks to control population.
3. Assumes fixed technology
4. Assumes a closed economy
5. Assumes a subsistence economy where everything is meant for domestic consumption.

UNDER POPULATION, OPTIMUM POPULATION AND OVER POPULATION.

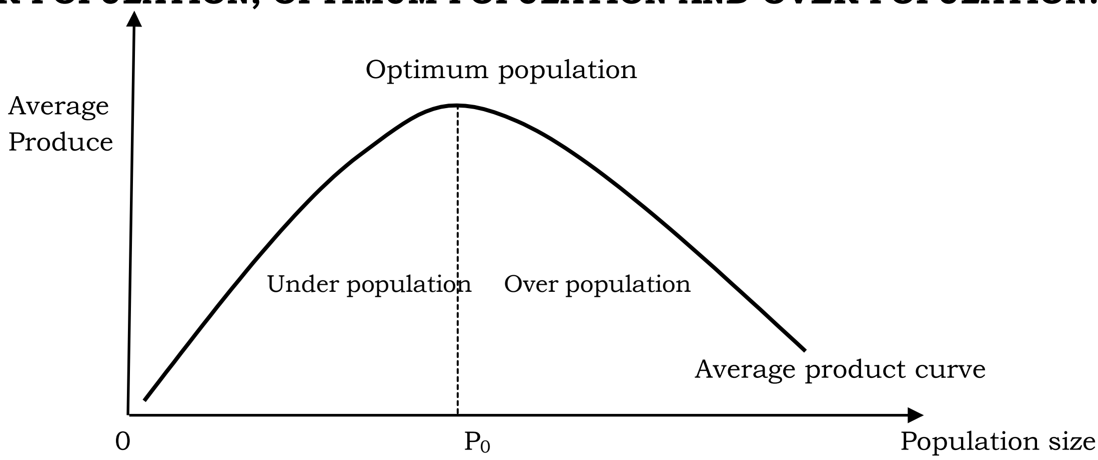


Figure 9.2: Under population, optimum population and over population

- P_0 represents optimum population

2010

(i) *Define the term under population.* *(01 mark)*

(ii) *Mention any three disadvantages of under population in your country.* *(03 marks)*

UNDER POPULATION

Under Population is the population size which is lower than the existing cooperant factors of production leading to low average product/low income per capita.

Or

It is the population size that supplies insufficient labourforce relative to other existing factors of production (other resources) leading to low output per worker/low income per capita.

There is insufficient laboruforce relative to other factors of production to make the best use of them thus low output per worker. Output per person increases as the population increases.

Effects Of Under Population

- Shortage of labourforce/limited supply which forces a country to depend on expatriates.
- Under utilization of economic resources.
- High expenses of government in providing social services per head.
- Limited market size which discourages investment and a disincentive to large scale production.
- Limited government revenue as the tax base is narrowed.
- Low investment levels
- Low level of inventions and innovations.
- Low output hence economic growth.

OPTIMUM POPULATION.

Optimum population is the population size which supplies sufficient labourforce which when combined with other existing cooperant factors of production (other resources) yields maximum output per worker/average product/income per capita.

Or

This is the population size that supplies labourforce to exploit existing available resources leading to maximum output per worker.

Below the optimum population, there is under utilization of resources (under population) while above the optimum population, resources are over utilized (over population)

Effects Of Optimum Population.

1. High per capita income.
2. High standard of living.
3. Fair utilization of resources.
4. Limited desire for population increase or decrease.

OVER POPULATION.

Over population is the population size that is greater than what the available resources can sustain resulting into a fall in average product as population increases.

Or

It is the population size that is greater than the available cooperant factors of production leading to a fall in average product as population increases.

Or

This is the population size where the ratio of population to other resources is very great making average output to fall as population increases. The existing resources cannot sustain the existing population.

UNEB 2011

(i) Distinguish between optimum population and over population. (02 marks)

(ii) State any two demerits of over population in an economy. (02 marks)

Demerits Of Over Population In An Economy.

- Leads to high rate of unemployment and underemployment
- Overstrains the existing infrastructure
- Leads to over population of existing resources
- Leads to dependence burden hence low savings and re investment
- Leads to unfavourable balance of payment position
- Causes demand pull inflation.
- Increases crime rates.
- Makes planning difficult.
- Leads to income inequality.
- Worsens rural urban migration and its evils.
- Leads to increases government expenditure on social services.
- Leads to brain drain.
- Creates pressure on land thus land conflicts.
- Leads to food shortages.
- Leads to low per capita income.

AGEING POPULATION.

Ageing population is the population where the number of old people above 64 years is higher than other age groups in the country. This is brought about by good feeding, improved health care, education that delays marriage age, rapid industrialization and urbanization, rise in the cost of living, increased status of women and control of diseases. This is a common feature of developed countries such as USA, Britain, France and Switzerland.

Positive Implications Of An Aged Population.

- Low pressure on natural resources such as land.
- Reduced pressure on social infrastructure.
- Limited brain drain and its disadvantages.
- Limited rural urban migration.

Negative Implications Of An Aged Population.

- Low labour supply because most of them are unproductive
- High dependence burden on few productive labourforce.
- Changes in consumption patterns hence reduction in investment i.e. demand for walking sticks, hats and long clothes.
- Increased labour immobility both geographically and occupationally.
- Reduced labour efficiency and productivity since they are less energetic.

- High conservation and low levels of innovativeness. This retards development hence technological stagnation.

DECLINING POPULATION

A declining population is the population that is continuously reducing in terms of numbers in relation to the available resources. This is due to death rates, falling birth rates, rising emigration and falling immigrations.

Positive Implications Of A Declining Population.

- Reduces pressure on existing infrastructure
- Eases planning on side of the government.
- Reduces pressure on natural resources.
- Reduces dependence burden on working labourforce and government.
- Increases job opportunities.

Negative Implications Of A Declining Population.

- Reduction in size of labourforce.
- Reduction in government revenue as the tax base narrows
- Fall in aggregate demand for goods and services which limits investment.
- Underutilization of natural resources
- Reduces people"s efforts to hard work tends which tends to reduce inventions and innovations

MAN POWER PLANNING.

Man power planning refers to a long-term government forecast/projection between demand and supply of labour in order to establish a balance where for labour is equal to supply of labour. This is where forecast is made on man power demand to match with man power supply depending on the existing economic conditions in the country.

It is intended to establish a balance where demand for jobs is equal to supply of jobs.

It about a balance between demand for labour and supply of labour.

MAN POWER PROBLEMS IN LDCS.

1. **Shortage of skilled man power** such as doctors, engineers, accountants and economists.
2. **High rate f brain drain.** This is due to poor conditions of work and low wages in the domestic labour market.
3. **Excessive supply of labourforce in some fields and shortage of manpower in other fields.** For example high supply of teachers than doctors.
4. **Inappropriate education system** which is theoretical and creates more job seekers instead of job makers.
5. **High levels of unemployment and underemployment.** Many people are not employed and some who are employed are not fully employed due to high rate of disguised unemployment.

6. **Misallocation of available skilled man power. i.e.** a tendency of appointing individuals on jobs which they are not academically qualified to do. For instance a doctor being employed on a political job.
7. **Excessive use of expatriates in some fields.** This undermines man power development programmes since they are not permanent and are very costly.
8. **High level of discrimination in the labour market.** There are imperfections in the labour market based on age, sex, religion and family background thus failure to get jobs among some job seekers.

Solutions To Man Power Problems In Developing Countries.

- Ensure proper manpower planning which helps to balance and supply of labour
- Setting up more training institutions to equip labour with modern skills.
- Train local labour to reduce heavy dependence in expatriates.
- Educational reforms to encourage more practical subjects and increase job creators.
- Improve working conditions and this helps to discourage brain drain.
- Encourage population control measures to reduce unemployment.

WAGES.

A wage is a reward for hiring labour as a factor of production for services rendered in population process. It differs from a salary because a salary is a fixed reward for labour as a factor of production and it mainly applies in activities where time spent on work is considered for instance teaching.

IMPORTANT TERMS.

Nominal wage/money wage. This is a payment to labour expressed in monetary terms. For example Ugs shillings 500,000 per month.

Real wage. This is the purchasing power of the nominal wage in terms of goods and services.

Or

It is the amount of goods and services which one"s nominal wage can purchase.

$$\text{Real wage} = \frac{\textit{Norminal wage}}{\textit{Market price of goods and services}}$$

Determinants of Real wage.

- General price level
- Size of nominal wage
- Availability of subsidiary earnings/side income
- Level of non pecuniary benefits on occupation i.e. accommodation, medical services
- Level of direct taxation.

Living wage: This is a payment to labour which is sufficient to providehis basic needs of life.

Or

It is a wage sufficient/adequate to a worker to provide his basic necessities of life.

It enables a worker enjoy a reasonable standard of living. It is sufficient to provide basic needs to a worker.

It is a reward that is adequate for a worker and his family to subsist comfortably.

Basic wage: This is a payment to labour without benefits or allowances attached.

Subsistence wage: This is a payment to a worker which is just enough to meet only basic needs and nothing more.

UNEB 2015

a) *How are salaries and wages determined in your country? (06 marks)*
b) *Account for the differences in salary and wages rates in your country. (14 marks)*

UNEB 2008

a) *Account for the wage differentials in an economy . (10 marks)*
b) *Examine the merits and demerits of setting a high minimum wage. (10 marks)*

UNEB 1997

a) *What is meant by a subsistence wage? (04 marks)*
b) *Account for existing differences in wages in your country. (16 marks)*

CAUSES OF WAGES DIFFERENTIALS IN AN ECONOMY.

NB. *This requires one to employ the phrase DIFFERENCES and each point should be explained in two sides showing an element of high wages and low wages.*

- **Differences in level of education and skills.** Highly educated and skilled workers are more efficient at work and earn higher wages compared to their counter parts with low level of education and skills who get low wages. For instance a degree teacher holder is paid more than a certificate teacher holder.
- **Differences in cost of living.** Workers in areas where the cost of living is high especially in urban areas are usually paid higher wages while those in areas where cost of living is low especially in rural areas are paid low wages.

- **Differences in working experience/seniority and responsibility.** Senior and experienced workers get higher wages in most organizations compared to junior and less experienced workers who get low wages.
- **Differences in nature of jobs/occupations.** Workers doing highly risky jobs are paid a higher wage than those who do less risky jobs who receive low wages. For instance pilots are paid highly than mere taxi drivers.
- **Differences in bargaining strength of individual workers.** Workers with high bargaining power and ability to negotiable for wages and better terms of service get higher wages while workers with weak bargaining power for wages are paid low wages.
- **Differences in physical strength/ability to do work.** In occupations where wages a based on how much work has been done (piece rate method), those who are physically strong and willing to work earn higher wages.
- **Difference in the number of hours worked.** In occupation where wages are based on the number of hours worked (time rate method),those who are physically strong and willing to work earn higher wages while physical weak labour produces less output and receives low wages.
- **Differences in elasticity in demand for the product which labour produces.** Where demand for the product is high, employers earn a lot of profits and pay their workers high wages while where demand for the product is low, workers are paid low wages.
- **Discrimination in the labour market.** Labour that is highly favoured is paid higher wages while that is not favoured is paid low wages. This is based on age, sex, religion, colour, political parties, family background and some workers are therefore given high wages even when they do the same jobs with their counter parts who are paid low wages.
- **Differences in natural talents.** Highly talented workers such as musicians, and footballers usually exploit their talents and receive high wages than less talented workers are paid low wages in such fields.
- **Differences in elasticity of labour supply.** Inelasticity supply of labour is mostly associated with high wages while elastic supply of labour leads to low wages since there are limited chances of agitating for an increase in the wage. For instance surgical doctors are paid more highly than Nurses.
- **Differences in strength of trade unions.** Strong trade unions are able to agitate for higher wages for their members while weak trade unions are unable to agitate for high wages for their members. For instance members of Uganda law society are paid more highly than UNATU.
- **Government policy on wages which tends to be non-matching.** Workers end up being paid different wages depending on the salary scale fixed by the government. For instance from U1 – U8.
- **Differences in employer's ability and willingness to pay workers.** Labourers who work with employers whose ability to pay is high are paid

higher wages while those who work with employers whose ability to pay is low, are paid low wages.

WAGE LEGISLATION.

Wage Legislation is a government policy of fixing/setting ages by law in an economy either a minimum wage or maximum wage. This is intended to favour both workers and employers.

MINIMUM WAGE.

Minimum wage a payment to labour/wage set by the government above the equilibrium wage (ruling market wage) below which it is illegal for employers to pay workers. This wage is normally set when labour market conditions are expected not to favour workers especially during high rates of unemployment. The government sets this wage because it considers the equilibrium wage to be too low for workers.

MINIMUM WAGE LEGISLATION.

Minimum wage legislation is a government policy of setting/fixing a wage above equilibrium wage below which it is illegal to pay a worker.

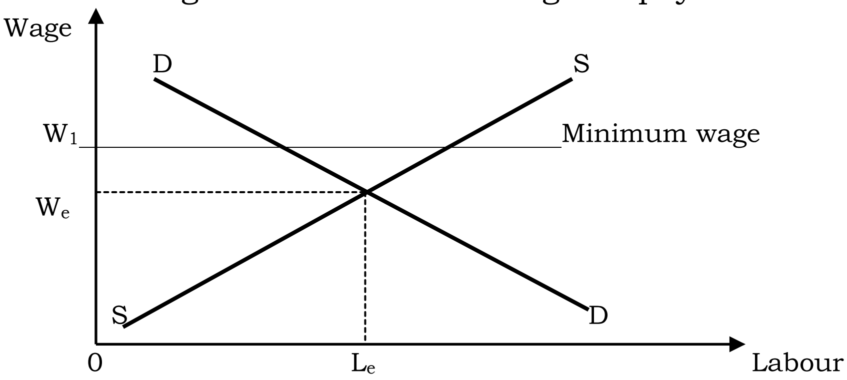


Figure 9.3: Minimum wage

UNEB 2008

a) *Account for wage differentials in an economy.* *(10marks)*
b) *Examine the merits and demerits of setting a high minimum wage.* *(10marks)*

ADVANTAGES / POSITIVE EFFECTS OF FIXING A MINIMUM WAGE

1. **Helps workers to meet increasing cost of living/improves standard of living workers.** It is fixed at a higher level that covers worker"s basic necessities which helps them to meet increasing cost of living.
2. **Protects workers against exploitation/low wages by their employers.** This reduces low wages among given workers.
3. **Increases efficiency and productivity or workers.** It boosts their morale hence high labour productivity and effectively.
4. **Minimizes brain drain.** It is an attractive payment to skilled workers and become interested in working in the domestic country.

5 **Minimizes industrial unrest/promotes industrial peace.** Strikes and riots by workers over higher wages are reduced hence industrial peace.

6 **Increases demand for goods and services**. This is because of increased workers" purchasing power hence more production due to increased incomes.

7. **Enables the government to win political support/good for political reasons**. It helps the government to win political support especially towards general elections since it is a high wage. This encourages public participation in development.

8 **Reduces wage differences between different categories of workers**. There are limited chances of under paying some workers if it rationally implemented.

9 **Increases supply of labour/attracts more labourforce.** It attracts more labourforce thus reducing voluntary unemployment.

10 **Discourages malpractices among workers such as corruption and embezzlement.** This is because it is a high wage for labour which increases satisfaction among workers.

11. **Increases revenue to the government through taxation.** This is important for government spending.

12 **Increases savings and investment.** This is because it increases income among workers thus increasing their savings.

DISADVANTAGES/NEGATIVE EFFECTS OF A MINIMUM WAGE.

- **Results into technological unemployment.** Employers decide to replace workers using capital intensive technology which is considered to be cheap.
- **Increases rural urban migration and its associated evils.** Such a wage is normally emphasized and maintained in urban areas where the cost of living is high which attracts workers to urban areas.
- **Discourages investments.** This is a very high wage and scares away both local foreign investors which this reduces the rate of foreign capital inflow.
- **Increases income inequality between the employed and unemployed.** This happens if it is not evenly implemented. This happens especially between rural Pleasants and urban wage earners.
- **Increases cost of production leading to cost push inflation.** Increases costs of production due to high labour costs .i.e. increases average cost of such a wage is reflected on prices in form of increased prices of final commodities produced by such labour. This reduces standard of living.
- **Leads to excessive supply of labour in relation to its demand.** This increases unemployment.
- **Reduces profit levels of producers which discourages entrepreneurship.** This results from the high cost of production.

MAXIMUM WAGE.

Maximum wage a payment to labour/wage fixed by the government below the equilibrium wage/ruling market wage above which it becomes illegal for employers to pay workers. It is normally fixed to favour producers. The government sets this wage because it considers the equilibrium wage to be a very high wage to be paid by employers.

Maximum Wage Legislation.

Maximum wage legislation is a government policy of setting/fixing a wage below equilibrium wage above which it is illegal to pay a worker.

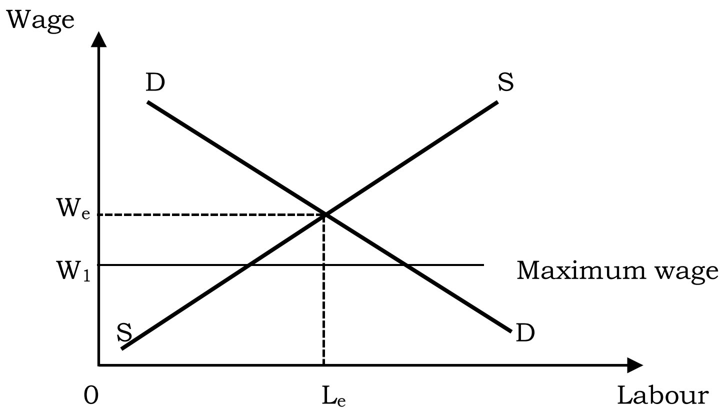


Figure 9.4. Maximum Wage

THE ECONOMY OF HIGHER WAGES.

Economy of higher wages is a situation where wages are increased with hope that the practice increase efficiency of labour to compensate employers for the greater cost of labour. The government and other employing agencies set high wage levels to motivate workers and increase their productivity. This increases costs of production.

It is a situation where workers are paid higher wages in order to stimulate their productivity. Its existence is recognized by big firms which strive to encourage permanence and higher labour productivity.

ADVANTAGES OF THE ECONOMY OF HIGHER WAGES.

- Reduces brain drain
- Reduces labour unrest by trade unions
- Increases labour productivity
- Reduces voluntary unemployment
- Increases aggregate demand hence market expansion.

DISADVANTAGES OF THE ECONOMY OF HIGHER WAGES.

- Results into an inflationary spiral
- Worsens income disparity between wage earners and non wages earners
- Labour is overworked to compensate for a higher pay given.

- Leads to increased cost of production.

METHODS OF WAGE PAYMENT/HOW ARE WAGES DETERMINED IN AN ECONOMY.

a) The piece rate.

Piece rate is a method of wage payment where workers are paid according to the amount of work done/task accomplished.

Workers who work for more output get higher wages while workers who work for less output get low wages. The wage depends on the effort of the worker. The greater the effort, the higher the wage and the lower the effort, the lower the wage for instance in brick making, tea picking.

UNEB 2006

a) Distinguish between piece rate and time rate methods of wage payment. (04 marks)

b) Explain the merits and demerits of piece rate method of wage payment. (16 marks)

UNEB 1999, 2010

(i) What is meant by piece rate method of wage payment? (01 marks)

(ii) Mention any three advantages of piece rate method of wage payment. (03 marks)

MERITS OF PIECE RATE METHOD OF WAGE PAYMENT.

1. **Workers become more creative and innovative.** This is an attempt to finish the work in a short time and they come up with unique methods of production.
2. **Workers do the work at their own pace.** This is due to the fact that payment is done according to amount of work done.
3. **Employers can easily forecast/predict output.** This is because the work is measurable and one can determine time to be taken on a task.
4. **Higher output is realized.** Since workers intend to get a higher wage, they increase output.
5. **Eliminates a need for constant supervision of workers.** Less supervision is required since the work done is visible, measurable and workers proceed at their own pace.
6. **Lazy and weak workers are stimulated.** This is because they are easily identified from the output produced. This therefore stimulates them to work harder in order to increase their earnings.
7. **Promotes a spirit of team work.** This is especially with workers who work in small groups.
8. **Protects employers from falsified payments.** This is because employers pay for exact output produced by workers.

9. **Tasks are completed faster.** This is because of high level of concentration of workers on the activity to get payment on spot.
10. **Faster workers get more remuneration/are fairly paid.** Faster workers are highly rewarded.
11. **It is easier to calculate the wage.** This is because output is in most measurable.
12. **Helps employers in identifying suitable employees.** This is based on the amount of output realized by each worker.
13. **It eliminates disagreements/conflicts over payments.** This minimizes industrial unrest thus promoting production.

DISADVANTAGES OF PIECE RATE METHOD OF WAGE PAYMENT.

- **Leads to over working among workers.** This is because of the need to earn high wages and therefore an attempt to do much work hence worsening health conditions of the workers.
- **Workers are no assured of regular payment.** Income keeps on fluctuating from time to time depending on one"s ability and when one misses work or falls sick, he is not paid for the days missed.
- **Does not apply to certain occupations where output cannot be quantified.** For instance medical practice, teaching and office work.
- **Reduces the quality of work done.** Leads to decline in quality of output because workers are interested in quantity than quality.
- **Very slow but careful workers are discouraged.** Slow workers but producing high quality work are demotivated.
- **Results into over production.** Workers produce high output to get high wages thus wastage of resources in case there is limited market.
- **There are disagreements about wage payment.** This is because it is very difficult to fix a fair rate and when work is done poorly.
- **High risks of industrial hazards.** Such as industrial accidents. This is because workers become very speedy in a accomplish work quickly.

b) Time rate.

Time rate is a method of wage payment where workers are paid according to the time spent at work. it can be in terms of hours, days, weeks and months. The period is agreed up by both parties i.e. the employer and the employee.

UNEB 2000

(i) *Differentiate between piece rate and time rate methods of wage payment (02 marks)*

(ii) *State any two advantages of using time rate method of wage payment. (02 marks)*

ADVANTAGES OF TIME RATE METHOD OF WAGE PAYMENT.

- It is applicable where output is difficult to measure such as teaching, legal service and medical service.
- It is easy to calculate the wage to be paid to workers.
- It is easily understood by both the employer and the employee which leads to industrial peace.
- There is regular income to workers even during the time of sickness, absenteeism. This leads to stability in income.
- High quality work is done. The work cannot be speeded up for increased output by the worker and it under close supervision.
- Encourages unity among trade unions because of uniformity in wage payments.
- Risks and accidents at work are reduced.

DISADVANTAGES OF TIME RATE METHOD OF WAGE PAYMENT.

- Requires a lot of supervision which is very costly.
- Less output is realized. Where workers are lazy, inefficient and work for less hours, low output is realized.
- Reduces incentives to work. it is unfair since both hard working and lazy workers get the same payment.
- Very difficult the value of output per worker thus a possibility of paying a high wage than the marginal product value.
- Encourages laziness among workers because regular payment is assured.
- It is tiresome for the employer to record all the number of hours worked.

c) Sliding scale system.

This is a method of wage payment based on changes in the cost of living. When the cost of living increases, the wage rate increase and when the cost of living reduces the wage rate also reduces. This enables a worker to maintain his real income.

d) Profit sharing.

This is where an employer puts aside a certain percentage of the total annual profits to be shared among his workers. The percentage of profits put aside for wages will depend on total profits made.

e) Bonus payment.

This is a payment to a worker which is over and above his fixed for exceptional contribution in production. It is always given when the employer is impressed with the good work done or when he wants to morale boost his workers in order to increase their productivity.

f) Market forces of demand and supply of labour.

Forces of demand and supply of labour interact and determine equilibrium wage.

g) Government policy of wage legislation.
The government sets either a minimum wage of a maximum wage.

h) Collective bargaining between trade unions and employers.
Representatives if trade unions and employers sit on around table through peaceful negotiation and determine the wage.

i) Individual bargaining between the employee and the employer.
The wage paid to a worker depends n his bargaining strength.

j) Employers setting the wage.
This is where a wage is effectively set by the employer especially without bargaining power on the basis of take it or leave it.

UNEB 2000

a) How are wages determined in your country?
(06 marks)

b) Account for wage differences in your country.
(14 marks)

HOW ARE WAGES DETERMINED/METHODS OF WAGE DETERMINATION IN UGANDA?

- Market forces of demand and supply of labour
- Collective bargaining through trade unions
- Employers fixing the wage
- Piece rate method of wage payment
- Time rate method of wage payment
- Individual bargaining between the employer and employee
- Government policy on salary structures.

UNEB 2001

(i) Distinguish between wage freeze and wage restraint. *(02 marks)*
(ii) Give any two causes of wage differentials in your country. *(02 marks)*

WAGE FREEZE.
This refers to legally backed holding of wages at their existing level for a specific period of time so as to control/check inflation.

WAGE RESTRAINT.
This is a voluntary restriction of wage increases where the government appeals and encourages trade unions and employers to moderate demand for wage increase in order to control / check inflation.

WAGE LEADERSHIP.

This is where employers set their wage level according to leadership provided by large employers who provide a standard wage and other employers simply follow. This is normally done in by employers dealing in production of similar or related products/in the same industry.

WAGE THEORIES.

1) **SUBSISTENCE WAGE THEORY OR IRON LAW OF WAGES.**

It states that workers should be paid a bare minimum/subsistence wage so that they can work harder after experiencing hardships such as hunger.

It emphasizes that the wage level should correspond with the subsistence level of living at which people could just maintain the existing population.

Any increase in the wage above the subsistence level to an increase in population which results into stiff competition for jobs which reduces wages back to the subsistence level.

On the other hand, a decrease in wages below the bare minimum would lead to malnutrition and increase death rates which eventually increases the wage rate back to the subsistence level.

2) **BARGAINING POWER THEORY OF WAGES.**

According to the theory, a wage is determined by the bargaining strength between workers through their trade unions and employers" associations.

According to the theory, labour markets are assumed to be competitive where the amount of wage paid to workers in an industry depends on the bargaining strength of the trade unions concerned or individual workers with employers.

This brings about wage differences on the strength of trade unions or individual workers to bargain successfully.

3) **MARKET THEORY OF WAGES/MODERN THEORY OF WAGES/MARKET FORCES OF DEMAND AND SUPPLY OF LABOUR.**

This is based on the fact that wages are determined by interaction of forces of demand and supply of labour in the labour market.

If there is excessive supply of labour than its demand, wages fall and if there is excessive demand for labour than its supply, wages increase

Equilibrium wage is attained where supply of labour is equal to demand for labour

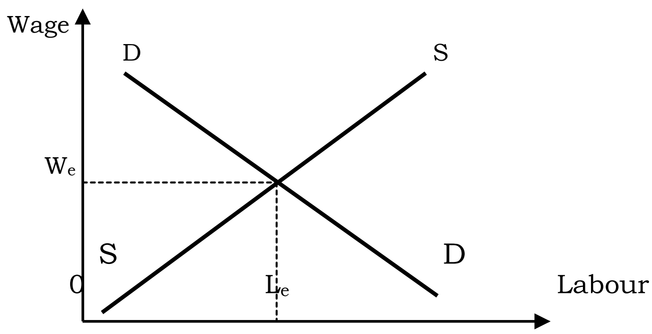


Figure 9.5: Interaction of market forces of demand and supply of labour.

- W_e is the equilibrium wage

Assumptions Of The Market Theory Of Wages.

- Demand for labour is determined by the demand for the product produced.
- No government intervention in wage determination.
- All units of labour are assured to be homogenous
- There is perfect competition among labour for jobs.
- There is perfect knowledge in the labour market
- Perfect mobility of labour.
- There is perfect competition among employers of labour.

UNEB 2010

a) Explain the factors that determine the level of wages in an economy. (06 marks)

b) What are the limitations of marginal productivity theory of wage determination. (14 marks)

UNEB 1998

a) Explain the marginal productivity theory of distribution as applied to labour. (06 marks)

b) What are the limitations of marginal productivity theory of distribution in the determination of wages? (14 marks)

4) MARGINAL PRODUCTIVITY THEORY OF WAGES/MARGINAL PRODUCTIVITY THEORY OF DISTRIBUTION.

It states that a worker should be paid a wage which is equal to the value his marginal product.

Wage = marginal Revenue product of labour (value of marginal product of labour)

Marginal revenue product = marginal product x price of each additional unity of output.

This means that when the marginal product of labour increases, the wage should also increase and when it reduces, the wage should also be reduced by the same amount.

The extra unit of labour employed should be able to produce additional unit of output and this output should be in position to fetch extra revenue which must be paid to workers.

The wage will be equal to the amount of extra value added to the total product by one additional worker. The worker has to keep on adjusting the level of employment until the value of the marginal product of labour is equal to the wage or cost of employing an extra worker.

NB.

Marginal revenue product of labour refers to additional revenue obtained as a result of employing an extra worker.

Marginal Revenue Product = Marginal Product x Price

Assumptions Of The Marginal Productivity Theory Of Wages.

- Employers and labour can calculate the value of marginal product of labour.
- All units of labour are assumed to be homogenous.
- Output is qualified in measurable units.
- There are no activities of trade unions in wage determination.
- No government intervention in wage determination.
- All factors of production are substitutable.
- Labour is assumed to be perfectly mobile.
- The law of diminishing returns operates at all times.

UNEB 2008, 2002

(i) State the marginal productivity theory of distribution. *(01 marks)*
(ii) Give any three limitations of this theory. *(03 marks)*

LIMITATIONS/CRITICISMS OF MARGINAL PRODUCTIVITY THEORY OFWAGES/MARGINAL PRODUCTIVITY THEORY OF DISTRIBUTION.

1. The theory assumes no government interference in wage determination, yet the government normally intervenes and fixes a minimum wage for different reasons.
2. The theory ignores the influence of historical factors in wage determination such as inherited salary structures in fixing wages. This is not related to marginal product of labour.
3. It wrongly assumes absence of trade union activities in wage determination yet they influence wages through collective bargaining.
4. Labour therefore may be paid a wage which is higher than the value of its marginal product.
5. The theory does not consider current exploitation of labour by capitalists and therefore wage paid to labour may be below the value of marginal product of labour so as to maximize profits.
6. Sometimes employers use the subsistence level as a measure of fixing wages and such wages may be above or below the value of marginal product of labour.
7. The theory does not apply when the marginal product of labour in some occupation such as teaching, legal services since output cannot be qualified.
8. Labour is not homogenous and workers' marginal productivity therefore varies. There are skilled, semi skilled and unskilled labour.
9. The law of diminishing returns does not apply at all times, with increase in technology there may be increasing returns.
10. Labour is not perfectly mobile as assumed by the theory, it is immobile to some extent since it is limited by factors such as old age and limited skills.

11. Labour cannot be wholly substituted for instance use of capital intensive technology requires labour to operate the machines, highly skilled labour cannot be wholly substituted.
12. Labourers and employers cannot determine the exact value of marginal product of labour because output is produced by many factors of production.
13. It ignores the possibility of paying wages according to level of education and training without relating to marginal product of labour.

UNEB 2010

a) *Explain the factors that determine the level of wages in economy. (06 marks)*

b) *What are the limitations of the marginal productivity theory of wage determination? (14 marks)*

UNEB 2005

(i) Distinguish between a minimum wage and a living wage. (02 marks)

(ii) State any two factors that influence the level of wages in your country. (02 marks)

FACTORS THAT INFLUENCE/AFFECT THE LEVEL OF WAGES IN UGANDA.

NB. Neutral points must be presented and each explained in two showing high wages and low wages for labour/workers.

1. **Market forces of demand and supply of labour.** High demand for labour than its supply leads to high wages while low demand for labour than its supply leads to low wages.
2. **Bargaining strength of individual worker.** Strong bargaining power for wages leads to high wages while low bargaining for wages leads to low wages.
3. **Level of experience/seniority.** High level of experience among workers leads to high wages while low level of experience among workers leads to low wages.
4. **Nature of the job/occupation.** Some jobs are highly paying such as risky jobs while others pay low wages especially non risky jobs.
5. **Level of natural talents.** Highly talented labour gets higher wages while low talented labour gets low wages.
6. **Employer's willingness and ability to pay workers.** High ability and willing to pay workers leads to high wages while low ability and willing to pay workers leads to low wages.
7. **Number of hours worked.** Long hours at work normally leads to high wages while limited hours at work leads to low depending on time rate method of wage payment.

8. **Discrimination in the labour market.** This is based on age, sex, religion, colour. Those who are favoured are paid higher wages while those who are not favoured are paid low wages.
9. **Cost of living.** High cost of living is normally associated with high wages especially in urban areas while low cost of living leads to low wages especially in rural areas.
10. **Level of education and training.** High level of education and skills leads to high wages while low level of education and skills leads to high wages.
11. **Strength of trade unions through collective bargaining.** Strong trade unions are able to agitate for high wages for members while weak trade unions are unable to agitate for high wages for members.
12. **Government legislation policy on wages.** Where a maximum wage is set, high wages are offered while where a maximum wage is offered, low wages are offered.
13. **Physical ability of workers to do work.** This applies to piece rate method of wage payment.

TRADE UNIONS.

Trade unions are labour organizations or associations of workers in a particular industry formed to pursue common objectives such as negotiating for increased wages and improved conditions of work for their members.

Or

Trade unions are organizations or associations formed by of workers in a particular industry with the primary objective of advocating for increased wages and imporved conditions of work for their members.

They are formed with the major aim of protecting and safe guarding interests of their members such as advocating for increased wages and improved conditions of work for their members.

Examples of trade unions in Uganda;

- Uganda National Teachers" Union.
- Uganda Manufacturers" Association.
- Uganda Law Society.
- Uganda Sports Press Association.
- Uganda Railway Workers Union.
- Makerere University Academic Staff Association.
- Uganda Medical Workers Association.

OBJECTIVES OF TRADE UNIONS.

- To bargain for better working conditions of their members such as attractive fringe benefits in form of better housing, welfare. This improves the welfare of workers.

- To increase wages for members to a desirable level. To increase bargaining power of workers in wage determination through collective bargaining.
- To protect rights of workers and maintain their human rights as laid down in the labour law such as social security benefits.
- To protect workers against unfair treatment such as dismissal by their employers hence ensuring job security for members.
- To imporce skills of members through training by use of seminars, workshops so as to increase workers" productivity and efficiency thus high wages.
- To advise the government on man power planning, employment policies and wage policies.
- To unite for a common cause and ensure that there is unity among members and this limits conflicts among members.
- To maintain consistent membership and ensure continuous supply of labour.

TYPES OF TRADE UNIONS.

1) **Craft trade unions/professional unions.** These are associations of workers organized according to their skills such as lawyers, Doctors and teachers.
2) **Industrial trade unions.** These are associations of workers that bring together all workers in a particular industry regardless of the type of work done by a particular worker such as workers in a bank.
3) **Company Trade unions.** These are associations of workers for one establishment. For instance workers in brick making industry.
4) **Closed shop trade unions.** These are associations of workers which agree with the employer to hire labour only registered with a particular trade union.
5) **Open shop trade unions.** These are associations of workers where all types of workers irrespective of their skills and occupations are free to join employment. Membership of the trade union is not a condition if getting employed by a certain firm. For instance National Union of workers.

TOOLS/METHODS USED BY TRADE UNIONS TO ACHIEVE THEIR OBJECTIVES.

- **Collective bargaining/round table discussion.** This is a peaceful round table negotiation between representatives of trade unions and employers regarding wages and better conditions of work.

Or

It refers to a process by which representatives of trade unions and employers reach and enforce agreements in regard to wages and conditions of work.

The terms agreed upon are contained in a document signed by both parties.

- ❖ **Use of court action/industrial court.** This is where workers report their grievances to the industrial court which is meant to settle disputes among workers and employers to have their wages increased.
- ❖ **Press or media role.** This is where trade union members contact journalists and write in media so that their demands are clearly spelt out to attract public sympathy and force employers to increase their wages. This include use of radios, televisions, newspapers where workers approach newsmen and clearly state their conditions of service and their demands to win public support.
- ❖ **Go slow tactic.** This is a situation where workers reduce on the amount of labour supplied by reducing on the number of hours worked per day and this reduces output and attract employers to increase their wages.
- ❖ **Sit down strike.** This is where workers report to their work place and so nothing in order for employers to respond to their demands and have their wages increased. This is a situation where workers withdraw their labour completely. All their operations come to a stand still and hence no output is produced.
- ❖ **Boycott/sabotage/decampaigning of the products.** This is where workers" representatives persuade or convince the public to stop the consumption of products of a particular firm until their demands are attended to and probably have their wages raised.
- ❖ **Picketing.** This involves trade union members positioning themselves at the entrance of their work places to prevent their fellow workers from proceeding to work until their demands are fulfilled such as increased wages. This is intended to make employers feel the impact of their absence.
- ❖ **Go on strike/destructive strike.** This is where workers strike violently after which property of the firm is destroyed so that employers are forced to address their problems until their wages are increased. This causes financial loss to the employer. This is the last resort when all other tools have failed.
- ❖ **Use of demonstrations.** This is where workers hold peaceful demonstrations to attract public sympathy so that employers can respond to their demands by increasing their wages.
- ❖ **Industrial arbitration or mediation.** An independent body is approached to mediate the workers and employers in a move to have workers" demands fulfilled such as increasing wages.

WHAT ARGUMENTS DO TRADE UNIONS PRESENT WHEN DEMANDING AN INCREASE IN WAGES? / REASONS WHY TRADE UNIONS DEMAND FOR HIGH WAGES.

1. **A rise in cost of living argument.** High prices for goods and services stimulate trade unions to demand for high wages so that members are able to meet their required lifestyle since their real wages reduce.

2. **Comparative wage rate argument.** Workers compare their wages with those of other workers doing the same job in different industries, therefore if others are paid more, then the trade unions demand for high wages.
3. **Increased profits argument.** When trade unions realize that profits made by the firms have increased abnormally, they demand for high wages.
4. **Increased marginal productivity of labour.** Workers demand for high wages after realizing that their contribution to the production process is high.
5. **Increase in demand for the product which workers produce.** An increase in demand for a firm"s products is used by workers as a basis for demanding high wages.
6. **Inelastic supply of labour/full employment argument.** So longer as workers realize that they are few in number and their services are vital and the employer cannot lay off some and replace them with others, they demand for high wages.
7. **Increased risky work argument/high risks involved in doing the job.** Workers doing risky jobs always demand for high wages as security for the life at the work place. For example in mining, heavy industrial operations and modern warfare.
8. **Failure by the employer to honour the earlier agreed upon periodical wage increases.** Workers keep demanding for high wages because they feel cheated by the employer.
9. **Failure by the employer to pay the minimum wage set by the government.** Where the current wage is lower than the government set minimum wage, wmployees demand for high wages to stop exploitation.
10. **High skills of offer by the workers.** Labour that had highly specialized skills to offer or is highly professional such workers demand for high wages.
11. **Increased work load/hours of work.** increase in activities done by workers forces them to demand for high wages so that the payment matches with the work done.

UNEB 2007

a) *What is meant by the term collective bargaining? (04 marks)*

b) *When are employees justified to demand for wage increase? (16 marks)*

UNEB 1998

a) *Under what circumstances may workers demand for higher wages? (08 marks)*

b) *Examine the problems facing trade unions in your country. (12 marks)*

CONDITIONS OR CIRCUMSTANCES UNDER WHICH TRADE UNIONS MAY DEMAND FOR INCREASED WAGES FOR THEIR MEMBERS/WHEN ARE TRADE UNIONS OR EMPLOYEES JUSTIFIED TO DEMAND FOR HIGHER WAGES OR WAGE INCREASES?

- **When** there is a rise in the cost of living, workers demand for higher wages s as to cope with the increased cost of living.
- **In case** the productivity of labour has increased which means an increase in output and revenue of the employer which justifies them to demand for higher wages.
- **When** the firm"s profits have increased abnormally which implies that it is as a result of sweat of workers and therefore are justified to demand for higher wages.
- **When** workers of a similar job/related firms are earning a higher wage, workers through their trade unions are justified to demand for higher wages.
- **In case** the wage paid to workers is less than the official minimum wage set by the government, trade unions are justified to demand for wage increases.
- **In case** there is an increase in risks related to the job such as industrial hazards, workers are justified to demand for wage increase as security for their life.
- **When** labour is producing commodities with inelastic demand, such workers are justified to demand for an increase in wages.
- **In case** there is an increase in skills of labour, trade unions for such labour are justified to demand for higher wages to match with wither skill.
- **When** the employer has failed to honour the previously agreed upon periodical wage increments, trade unions are justified to demand for wage increase to fulfill their premises.
- **When** the number of hours of work have been increased/increased work load implying high output which justifies trade unions to demand for high wages.
- **When** labour supply is inelastic/demand for services of labour is higher than supply (full payment) such labour tends to demand for increased wages since it is scarce.

UNEB 2004

a) *What is meant by collective bargaining? (04 marks)*
b) *To what extent have trade unions in your country achieved their objectives? (16 marks)*

To a smaller extent, trade unions have achieved their objectives in Uganda.

- ✓ They have tried to enable workers to participate in decision making at industrial level.

- ✓ They have tried to improve on working conditions of some workers. For example provision of houses for workers such as doctors.
- ✓ They have tried to improve on wages of some workers such as doctors, lawyers through collective bargaining.
- ✓ They have tried to seek, promote and maintain human rights of workers.
- ✓ They have tried to improve skills of members through training in seminars and workshops thus improvement in labour productivity.
- ✓ They have tried to persuade the government to pass legislations and better working conditions for all government workers in the country.

To a greater extent, trade unions have failed to achieve their objectives in Uganda.

- ✓ They have failed to unite all members for a common cause .i.e. they have failed to achieve unity among workers.
- ✓ They have failed to convince the government to support workers demands such as implementation of a minimum wage.
- ✓ They have failed to acquire and maintain substantial membership. They have faied to mobilize all rural workers to get actively involved in trade union activities.
- ✓ They have failed to improve working conditions for all workers such as medical, housing and transport allowances.
- ✓ They have failed to advise the government properly especially on proper man power planning and employment policy.
- ✓ They have failed to protect all workers against treatment and dismissed from the jobs i.e. there is limited job security.
- ✓ They have not adequately improved worker‟s skills through training in all organizations.
- ✓ They have failed to increase wages for all workers since most workers are still under paid.

UNEB 2009

a) *Explain the methods used by trade unions to obtain wage increase for their members.*
(08 marks)

b) *What factors that limit the ability of trade unions to raise wages for their members in your country?*
(12 marks)

UNEB 2013

State any four factors which limit the effective operation of trade unions in your country. *(04 marks)*

UNEB 2014

a) *What is meant by a Trade Union?* *(04 marks)*

b) *Explain the challenges faced by Tradw Unions in your country. (16 marks)*

PROBLEMS/CHALLENGES FACED BY TRADE UNIONS IN DEVELOPING COUNTRIES.

(Reasons why trade unions have failed to achieve their objectives in developing countries /Uganda).

NB. *These are responsible for making trade unions weak and thus failure to achieve their intended objectives of agitating for higher wages and improved conditions of work.*

1. **Shortage of adequate funds/financial difficulties.** Trade unions lack enough funds to finance their activities and maintain workers during periods of strikes because incomes of trade union members are very low.
2. **Weak and inefficient leaders/poor leadership skills.** Most leaders are incompetent and cannot give convincing reasons to justify demand for high wages on behalf of all members. Trade unions lack dedicated and professional leaders to push forward their objectives in a proper way.
3. **High level of unemployment in an economy.** It becomes easy for employers to replace workers who agitate for high wages since they fear to be replaced. There is open unemployment in LDCs and therefore trade unions fear to demand for high wages because of excessive labour ready to replace any striking workers.
4. **Increased government interference in trade union activities.** This is through influencing who their leaders should be and restricting trade unions from striking by demanding that they have to seek permission from state organs such as police, declaring their strikes illegal thus limiting their ability to agitate for higher wages.
5. **Disunity among trade union members.** This is due to tribal, religious, political and racial differences. This retards the performance of the trade unions since it makes them very weak which limits ability to demand for higher wages.
6. **High level of corruption and embezzlement of trade union funds.** Sometimes trade union leaders are bribed by employers and they end up betraying their fellow employees and resources meant for activities of the trade union are misused by few members thus limiting the amount of available to push their activities.
7. **Ignorance/apathy of workers about trade union activities/their rights.** In LDCs, most workers are less educated, unskilled and do not know their rights, therefore employers take advantage of this ignorance to exploit them and find it hard to accept trade union activities.
8. **Small size of membership/low level of unionization.** Most trade unions do not substantial numbers and this weakens their bargaining power for high wages. There are few salaried/wage earners to warrant the need for trade union activities.

   Rural workers do not mind about terms and conditions of service and many people are self employed in rural areas.

9. **Poor/weak economic performance/low profitable of firms.** This leads to low productivity of firms which makes it very hard for workers to justify demand for high wages. This keeps trade unions wreak.
10. **Poor transport and communication systems.** Limited infrastructure such as communication facilities make mobilization of members and coordination of trade union activities difficult thus limited ability to demand for higher wages and better conditions of work.
11. **Use of trade unions by leaders to achieve higher political positions.** Most leaders of the trade unions use them as a stepping stone to attain big posts in government which undermines trade union objectives.
12. **Low demand for labour due to weak industrial sector.** The industrial sector is still small thus few people are employed within the industrial sector thus a small percentage of working population which limits the ability of trade unions to expand and achieve their objectives.
13. **Low demand for products produced by members.** This implies that there is limited demand for services of some trade unions thus limiting their strength.
14. **Limited skills of members.** Trade union members do not have appropriate skills for employment and therefore cannot justify demand for increased wages.

FACTORS THAT INFLUENCE/DETERMINE THE STRENGTH OF TRADE UNIONS

NB. *Neutral points are presented and explained in two sides showing a favourable side that strengthens trade unions and unfavourable part that weakens trade unions.*

- **Amount of strike funds and financial strength of trade union.** Trade unions with a sound financial stand are able to finance their activities and therefore become strong compared to their counter parts with limited funds which remain weak.
- **Degree of organization of trade unions.** Highly organized trade unions are able to achieve their objectives, mobilize all members for a common cause and become strong while poorly organized trade unions remain weak. For instance Uganda law society is more organized than Uganda National Teachers Union.
- **Leadership skills/quality of management.** Competent and strong trade union leaders are able to agitate for given desired conditions of work on behalf of members which strengthens the trade union while weak trade union leaders are unable to agitate for given conditions on behalf of members which makes trade unions weak.
- **Level of unemployment and under employment.** High levels of unemployment and under employment weaken trade unions since trade union demands are likely not to be attained because unemployment may

react by firing those under strike and hire new labour while low levels of unemployment and under employment make trade unions strong.

- ❖ **Elasticity of supply of labour.** Where the supply of labour is elastic, trade unions become weak since demand for high wages is not easily achieved while inelastic supply of labour leads to strong trade unions since they are not easy to replace.
- ❖ **Size of membership/unionization.** Trade unions with limited members are unable to have high bargaining power and therefore become weak while trade unions with many members have high bargaining power and become strong.
- ❖ **Level of government interference.** High level of government interference in the affairs of the trade unions such as declaring strikes illegal weakens the trade unions while limited government intervention in activities of the trade unions is a basis of strong trade unions.
- ❖ **Prevailing economic performance.** Trade unions cannot succeed in demanding for higher wages during an economic depression due to low profitability of firms which makes the trade unions weak but it there is a boom, they are able to succeed in demanding for higher wages and therefore become strong.
- ❖ **Level of labour productivity of members.** Low level of labour productivity of trade union members makes trade unions weak while high level of labour productivity of trade members implies high profits to the employer which strengthens the trade unions.
- ❖ **Elasticity of demand for products produced by trade members.** Where trade union members produce commodities with inelastic demand, such unions become strong because employers get revenue but inelastic demand for products weakens the trade union since employers get revenue.

UNEB 2003

(i) What is meant by the term collective bargaining? (01 mark)

(ii) Give any three features of trade unions in developing countries. (03 marks)

Characteristics/features of trade unions in developing countries.

- ❖ They lack membership on permanent structure. High migrant and target workers.
- ❖ They attract a small number of members.
- ❖ They have weak leadership thus low bargaining power.
- ❖ Characterized by disunity among members based on age, sex, religion, sectarianism and tribal difference thus weak organization.
- ❖ They are often politically motivated.
- ❖ They are mainly urban based.
- ❖ They are financially weak and members fail to pay subscription fee.

POSITIVE EFFECTS OF TRADE UNIONS.

- **Trade unions encourage fair income distribution.** This helps to reduce income inequalities by increasing wages for low paid workers.
- **Help in designing government policies on employment.** For example wage policy thus proper man power planning.
- **They encourage increased savings.** This is because of social security benefits provided to workers.
- **They promote industrial peace** because disputes are settled peacefully. This promotes continuous production.
- **Increase labour productivity and efficiency.** This is due to increased training offered to members and high wages offered.
- **Reduce exploitation of workers by employers.** This increases morale at work.
- **They improve working conditions of workers.** Hence better welfare of workers.
- **Stabilize employment by increasing job security.** They protect members against unfair dismissal from their jobs.
- **Increase purchasing power of members through high wages.** This improves their standard of living.
- **Reduce entry of unqualified staff into given occupations.** For instance legal occupation, teaching, nursing. This leads to provision of better quality services.
- **They create unity among workers** in different regions and occupations.

NEGATIVE EFFECTS OF TRADE UNIONS.

- **Lead to unemployment.** This is due to frequent demand for high wages which limits demand for more labour by employers.
- **They increase income inequality.** This is between trade union members and non trade union members
- **Discourage investment** due to high wage demand by workers. This reduces demand for more labour to increase investment.
- **They cause wage push inflation.** High wage demands increase cost of production which is shifted to consumers in form f high prices for commodities.
- **Cause decline in production levels.** This is especially during periods of sit down strikes where output levels reduce.
- **Encourage political unrest/they are used by political opponents to cause instability politically.** This causes poor climate.
- **Cause destruction of property and loss of life in case of violent strikes.** This limits further production.
- **Increase rural urban migration by labour.** They are highly functional in urban areas which leads to congestion, development of slums.

Chapter 10: MONEY AND BANKING.

Money refers to an asset that is generally acceptable as a medium of exchange for goods and services/setting any financial obligation.
It is a legal meaning that everybody in the country concerned must accept it by law in the settlement of debts or other financial obligations.

FEATURES/QUALITIES OF GOOD MONEY.

1) **Universal acceptance.** Good money must be acceptable by everybody in the country for financial obligations.
2) **Portability.** Good money should be easy to carry in relation to its value or light to transfer from one place to another.
3) **Divisibility.** It should be divisible into smaller units to allow smaller transactions to take place without any difficulty.
4) **Durability.** Good money should last for longer periods without depreciating in its face value.
5) **Homogenity.** One piece of money should be as good as others meaning that it should be the same in all features of a particular currency to avoid easy forgery.
6) **Relative scarcity.** Good money should be relatively scarce / limited in supply, otherwise it would lose value if it is in plenty since it may cause inflation.
7) **Stability in value.** It should not frequently fluectuate in its value for purposes of smooth transactions to take place.
8) **Good money should be convenient and relatively cheap to print.**
9) **good money should be difficult to forge by counter fainters.**

FUNCTIONS OF MONEY.

- **Money is used as a medium of exchange.** It makes it possible to determine the value and quantities of commodities to be exchanged.
- **It is a unit of account.** Money is used when carrying out business transactions and accounting particularly through record keeping.
- **Money is a store of value/wealth.** It can be used to store wealth because it is not bulky and perishable, so having money is like having any other form of wealth.
- **It is used as a standard of deferred payments.** Money facilities payment of debts and transactions to some future time. One can effect transactions without immediate payments for them.
- **It is a measure of value.** It helps to measure the value of goods and services in terms of their prices in the market.

BARTER TRADE SYSTEM.

Barter trade refers to exchange of commodities directly for other commodities. This is the earliest form of exchange where commodities were exchanges directly for other commodities. This implies that it does not involve the use of money as a medium of exchange. The system requires double coincidence of wants between the seller and the buyer.

ADVANTAGES OF BARTER TRADE.

- Overcomes problems of currency difference and exchange rates between countries which are very costly.
- Encourages friendship and cooperation among traders.
- Avoids negative effects of price fluctuations in an economy.
- Eliminates the problem of black marketing.
- Reduces imported inflation.
- Makes transactions quicker compared to the use of money.
- Reduces balance of payment problems especially in LDCs.
- Encourages diversification of exports in order to meet foreign demand.

PROBLEMS/OBSTACLES OF BARTER TRADE.

1. **Lack of double coincidence of wants.** For instance if one has maize and wants rice, he must get somebody with rice who wants maize which is very difficult.
2. **Perishability problem.** Most commodities are perishable and difficult to store for exchange in near future.
3. **Difficulty in determining the relative value of goods being exchange.** There is no measure of value.
4. **Problem of bulkiness of some commodities.** Which affects transportation of such commodities from one market area to another.
5. **Indivisibility of commodities.** Some commodities are difficult to divide into smaller units to allow smaller transactions to take place.
6. **Lack of standard of deferred payments/credit transactions cannot be made.**

UNEB 2003

(i) Distinguish between fiduciary issue and fiat money. (02 marks)
(ii) State the Irving Fisher"s quantity theory of money (02 marks)

TYPES OF MONEY.

1) **Fiduciary issue.** This is money issued by the central bank on its discretion and it is not backed by gold or foreign reserves. The central bank may simply increase money supply into circulation to meet government obligations and this money is over and above gold reserves kept by the central bank. For instance if the central bank has gold worth 400 dollars but increases coins and bank notes equivalent to 500 dollars then 100 dollars will be fiduciary issue.
2) **Fiat money.** This is money printed by the central bank on the orders of government. It is issued irrespective of the level of economic activities and gold reserves.

3) **Deposit money.** This is the money held by the public in form of deposits in commercial banks that can be withdrawn on demand.
4) **Hard or convertible currency.** This is a currency a suitable value of the international recognition and can easily be exchanged for other currencies. It can easily be exchanged for other international currencies such as US dollars, Euro and British pounds.
5) **Token money.** This refers to coins whose intrinsic/material value is less than the face value. it is meant to discourage people from melting coins to sell the metals.
6) **Inconvertible currency.** This is the currency that cannot easily be exchanged for other currencies in international transactions and its value is unstable. For instance Uganda shillings.
7) **Quasi or near money.** These are basically assets that are held in form that can easily be converted into cash without loss of value. for instance cheques, bank drafts, bonds, treasury bills and shares.

MOTIVES FOR HOLDING MONEY.

There are generally the Keynesian motives of demand for money.

a) Transaction motive.

According to Keynes, money is demanded to facilitate the day today transactions of the business. For instance buying goods and services, paying wages, rent and interest. This is the most important motive of demand for money in the modern world. During the era where there was barter trade system, there was no transaction demand for money.

b) Precautionary motive.

People demand for money in order to prepare for unforeseen future uncertainties or problems in future. Money is demanded to meet unpredictable/unforeseen circumstances. For instance sickness, accidents, academics and death. It is a result of providing for contingencies or unplanned expenditure. People foresee uncertainties into the future and tend to save money to meet the unexpected expenses.

c) Finance/investment motive.

Money is needed to finance the ongoing projects where fixed capital has been invested. The desire to hold money is meant to finance the existing and on going investments.

d) Speculative motive

This is demand for money for the purpose of making gains in the near future through speculation. Money is kept in form of assets, bonds, treasury bills in order to make profits out of if in the near future in a financial market.

The demand for money for speculative reasons depends on the interest rate charged on bonds or *assets when the interest rate is high on assets, the*

demand for money is low but when the interest rate is low on assets, the demand for money is high.
When the rate of interest is expected to fall, speculators convert their bonds /securities into cash but when the rate of interest is expected to increase, speculators convert their cash into bonds/securities. This is illustrated by the liquidity.

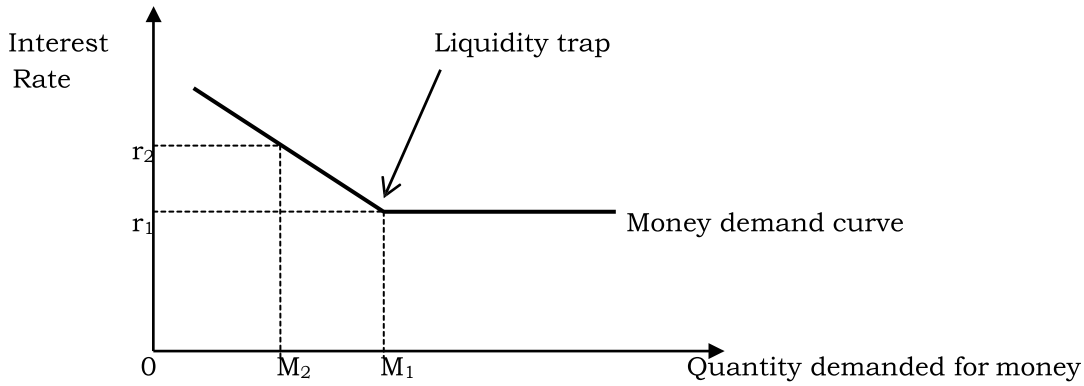


Figure 10.1: Liquidity trap

If the of rate of interest is high at r_2, speculators buy bonds and demand less money M_2.
If the interest rate is low at r_1, speculators convert bonds into cash and demand more money M_1 to avoid capital loss.
Liquidity trap is a point below which the interest rate is too low to encourage speculators to invest in bonds and hence people have an infinite desire to hold cash.
Or
it is a point below which the interest rate is too low such that speculators do not buy bonds and thus their wealth is trapped in liquid form.
It is a point below which speculators will no longer for assets for speculative purposes.
It is a low interest rate that forces speculators to prefer holding money in their hands other than converting it into assets.
At this point liquidity preference is high.

LIQUIDITY PREFERENCE/DEMAND FOR MONEY.
Liquidity preference refers to the desire by individuals to hold wealth/assets in cash or near form. Liquidity preference in many developing countries is very high because f high marginal propensity to consume, poor banking habits, underdeveloped financial institutions which leads to low level of investment.
UNEB 2014

(i) *Differentiate between liquidity ratio and liquidity preference (02 marks)*
(ii) *Mention any two reasons for the high liquidity preference in developing countries. (02 marks)*

UNEB 2006, 2000

(i) *What is meant by liquidity preferen (01 mark)*

(ii) *Mention three factors which determine liquidity preference in an economy. (03 marks)*

DETERMINANTS OF *LIQUIDITY* PREFERENCE.

- **Level of transactions in an economy.** High levels of transactions imply high level of liquidity preference while low levels of transactions imply low liquidity preference.
- **Interest rate on deposits.** Low interest rate on deposits implies high liquidity preference while high interest rate on deposited funds leads to low liquidity preference.
- **Level of income.** High level of income implies high liquidity preference since individuals require money to transact businesses while low level of income leads to low liquidity preference.
- **Level of prices of goods and services.** High price level leads to high liquidity preference while low price level leads to low liquidity preference.
- **Level of development of financial institutions.** Low level of development of financial institutions leads to high liquidity preference while well developed financial institutions help to mobilize deposits from the public hence low liquidity preference.
- **Knowledge of banking facilities.** Poor banking habits imply high liquidity preference while high level of use of commercial banks by the public implies low liquidity preference.
- **Degree of uncertainty.** High degree of uncertainty leads to high liquidity preference while low level of uncertainty in an economy leads low level of liquidity preference.
- **Investment climate.** Favourable investment climate leads to low liquidity preference while unfavourable investment climate leads to high liquidity preference.

Liquidity refers to ease with which an asset can be turned into cash/money as a medium of exchange.

MONEY SUPPLY.

Money supply refers to the quantity/amount of money which is in circulation in a particular country/economy at a given period of time.
It refers to the total cash in circulation outside banks plus bank deposits in a particular country at a given period of time.

It is the volume or stock of money circulating in an economy both in the hands of the public and on demand deposits in a given period of time.

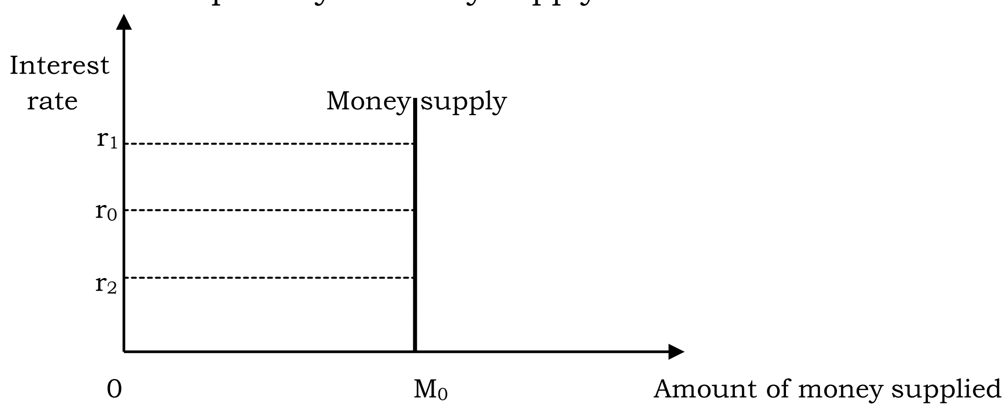
It excludes money in treasury, central bank, government and commercial bank deposits with the central bank. Money supply in Uganda has been increasing year because of frequent printing of new and more currency into circulation to finance government activities.

Demand deposits are deposits withdrawn by the customers form the banks any time on demand and do not earn interest.

Time deposits are deposits withdrawn by the customers on giving prior notice to the bank and they earn interest.

TYPES OF MONEY SUPPLY.

1) **Exogenous money supply.** This is money supply determined and fixed by the central monetary authority regardless of the level of interest rate and economic activity. This money supply is not influenced by the interest rate and it is determined by the minting authority. This means that changes in interest rates and economic activity do not have any influence on the quantity of money supply.



2) **Endogenous money supply.** This is money supply that is directly influenced by the interest rate and depends on the level of economic activity in an economy i.e. the level of output, interest rate and employment.

Aggregate money demand refers to total amount of money held in cash by all income earners for various motives.

UNEB 2005

(i) Distinguish between money supply and demand for money. (02 marks)

(ii) Mention any two determinants of money supply in an economy. (02 marks)

DETERMINANTS OF MONEY SUPPLY IN AN ECONOMY.

These factors are both endogenous and exogenous

1. **Level of financial accommodation.** The government may direct the central bank to print more money so as to finance government programmes, assist the declining key sectors of the economy. This is called financial accommodation. This influences the level of government expenditure.

2. **Level of liquidity preference.** High level of liquidity preference implies high money supply while low level of liquidity preference leads to low money supply.
3. **Level of monetization of the economy/size of subsistence sector.** A large size of monetary sector leads to high money supply while a subsistence sector dominated economy leads to low money supply.
4. **Volume of foreign exchange reserves.** When foreign exchange reserves are in abundance, money supply becomes high while foreign exchange reserves are in short supply money supply becomes low.
5. **Level of economic activity/level of investment.** High level of economic activity implies high output hence high money but low level of economic activity leads to low money supply.
6. **Level of capital inflow and outflow.** High level of capital outflow implies low money supply while high capital inflow exports, foreign investors increases money supply.
7. **Level of operation of monetary policy.** A contractionary monetary policy through increasing bank rate, selling securities to the public, selective credit control, high special deposits reduce money supply while expansionary monetary policy through reducing bank rate, buying securities from the public, reducing legal reserve requirements increase money supply.
8. **Interest rates.** High interest rates on borrowed money reduce money supply while low interest rate on borrowed money increases money supply.

NB. Financial accommodation refers to where government directs the central bank to print more money to finance its undertakings that run short of money.

CONSTITUENTS/COMPONENTS OF MONEY SUPPLY.

- Coins
- Foreign exchange reserves
- Bank notes
- Instruments of credit
- Bank deposits

UNEB 2009

(i) What is meant by the term value of money? (01 mark)

(ii) Mention any three factors that influence the value of money. (03 marks)

VALUE OF MONEY

Value of money is the purchasing power of a unit of money.

Or

It refers to the amount of goods and services a unit of money can purchase. The value of money is categorized into two;

a) **Nominal value of money.** This is the face value indicated on ban notes and coins irrespective of the quantity of goods and services that money can purchase.
b) **Real value of money.** This is the quantity of goods and services that can be purchases using a given amount of nominal value of money.

It is mainly determined by the price level and services and the size of nominal value of money itself.

DETERMINANTS OF VALUE OF MONEY

- General price level for goods and services
- Quantity of money in circulation/monetary policy of the country.
- Velocity of circulation of money. High velocity of money implies low value of money while low velocity of money in circulation leads to high value of money.
- Level of output/quantity of goods and services available in an economy.
- Government policy in relation to devaluation and revaluation. Devaluation reduces the value of money while revaluation increases the value of money.

Relationship Between Value Of Money And General Price Level.

An increase in money supply increases general price level and this reduces the value of money while a decrease in money supply reduces general price level which increases the value of money. This relationship between money supply and value of money is explained by **the quantity theory of money**

UNEB 2004, 2000, 1997

a) Explain the quantity theory of money (06 marks)
b) What are the limitations of quantity theory of money? (14 marks)

UNEB 2001

a) Given that the quantity of money in an economy is 1,000,000 dollars, its velocity of circulation is 20, and the numbers of transactions made are 250. Calculate the general price level in the economy.
(04 marks)
b) Explain the limitations on Irving Fisher''s quantity theory of money.
(16 marks)

UNEB 2013

a) Given that the volume of money in an economy is €20 billion, total level of transactions is €250 million and the transactions velocity of money is 20; calculate general price level in an economy.
(04 marks)

b) Explain the limitations of Irving Fisher"s quantity theory of money.
(16 marks)

THE QUANTITY THEORY OF MONEY BY IRVING FISHER.

The quantity theory of money was advanced by an economist Irving Fisher. It states that the general price level (P) of goods and services in an economy is determined by quantity of money in circulation (M) provided velocity of circulation of money (V) and number/ level of transactions (T) are held constant.

The theory is expressed by Irving Fisher"s equation of exchange

PT = MV or P = MV/T

Where;

P = general price level for goods and services
M= quantity/amount of money in circulation
T = volume/level of transactions
V = velocity of circulation of money.

NB. A *change in money supply (M) in an economy will lead to exact change in general price level (P) of goods and services provided the velocity of circulation of money (V) and number/level of transaction (T) remain constant.*

If the quantity of money in circulation doubles, the general price level will also double with V and T remaining constant.

Velocity of money refers to the number of times a unit of money is used in transactions. According to Irving Fisher, by holding V and t constant, an increase in M will lead to an increase in P and a decrease in M will lead to a decrease in P.

Velocity of circulation of money refers to the number of times on average a unit of money is used in transactions in a given time. It is the speed at which a unit of money changes hands.

Worked example.

(i) Given that the quantity of money in an economy is 1,000,000 dollars, its velocity of circulation is 20, and the number of transactions made are 250. Calculate the general price level in the economy

$$\text{General Price level} = \frac{\text{Quantity of money in circulation x velocity of circulation of money}}{\text{Level of transactions}}$$

$$P = MV/T$$

$$P = 1000{,}000 \text{ x } 20/250$$

General Price level = 80,000 dollars

(ii) Given that the volume of money in an economy is €20 billion, total level of transactions is €250 million and the transactions velocity of money is 20. Calculate the general price level in an economy

$$\text{General Price level} = \frac{\text{Quantity of money in circulation x Velocity of circulation of money}}{\text{Level of transactions}}$$

$$P = MV/T \text{ or } MV = PT$$

$$\frac{20{,}000{,}000{,}000 \times 20}{250{,}000{,}000}$$

General Price level = €1600

UNEB 2012

(i) *State Irving Fisher"s equation of exchange. (02 marks)*

(ii) *How is the value of money determined in Fisher"s equation of exchange? (02 marks)*

HOW IS THE VALUE OF MONEY DETERMINED IN FISHER'S EQUATION OF EXCHANGE.

- Quantity of money in circulation
- Velocity of circulation of money
- Level of transactions/volume of production
- General price level

Assumptions of the quantity of money.

- All businesses are affected by use of money as a medium of exchange. No barter trade transactions.
- Money is only demanded for transaction motive.
- V and T are assumed to be constant in the short run.
- General Price level is only affected by changes in money supply.
- Assumes no hoarding of money. All the money is spent on transactions.
- The theory is only operational in the long run.

CRITICISMS/LIMITATIONS OF THE QUANTITY THEORY OF MONEY.

1. The theory assumes that velocity of circulation of money (V) and level of transactions (T) are constant, but this is not the case because a change in one induces a change in the other.
2. The theory ignores a system of barter trade which does not involve the use of price and money supply and yet not all transactions are carried out through the use of money.
3. The theory attempts to attempt to explain changes in the value of money but does not clearly explain how it is determined since it only how changes in the value of money are brought about by a change in quantity of money in circulation.
4. This is not enough to explain the value of money.

5. It ignores the rate of interest on capital and yet this also influences supply of money, the theory cannot be complete without referring to interest rate.
6. Low interest rate implies high borrowing hence investment and high output hence low price level but this is ignored by the theory.
7. The theory ignores demand for money and only considers supply of money in its equation and yet demand for money is also very important and may either increase or reduce general price level.
8. There is nothing like the general price level which the theory talks about but rather a series of price levels for goods and services in an economy.
9. Price changes take place at different time periods due to changes in money supply.
10. The theory does not work in case there is high marginal propensity to save since high savings reduce velocity of circulation of money leading to a reduction in general price level.
11. The theory does not consider price control where minimum and maximum prices are fixed by the government; the theory becomes irrelevant since changes in money supply will not lead to changes in general price level.
12. The theory does not explain other causes of changes in general price level such as changes in cost of production, shortages in supply apart from money supply.
13. The theory ignores possibilities of haggling/bargaining between buyers and sellers which determines an aggregate price level. The price may reduce due to bargaining even if money supply increases.
14. The theory considers only the transaction motive of holding money and ignores other motives for holding money such as precautionary and speculative motives.
15. The theory is a truism, it merely says that M,V,P and T are related, but there is no clear explanation about how they change.
16. It ignores the fact that where a country has many unemployed resources, an increase in money supply increases output of goods and services which causes a fall in general price level or no change at all.

INTEREST RATE.

Interest rate is a reward/payment/price for the use of capital as a factor of production. It is therefore a change for securing capital i.e. cost of borrowing and price for lending. It is the price at which money is borrowed and it is usually expressed in percentage. In Uganda, commercial banks charge interest rate on loans of between 22-30% and less that 6% on deposits (September 2011).

There are two types of interest rate i.e.

- Interest rate on loans
- Interest rate on deposits.

UNEB 2004

(i) What is meant by interest? (01mark)

(ii) Mention any three determinants of interest rates. (03 marks)

UNEB 1999

(i) Different between interest and rent. (02 marks)

(ii) Mention any two determinants of interest rate in your country. (02 marks)

DETERMINANTS OF INTEREST RATE.

- Amount of money supply in an economy.
- Level of inflation/economic climate/general price level.
- Policy of individual lenders or commercial banks.
- Demand for loanable funds/investment capital.
- Period of loan repayment.
- Monetary policy of the central bank in relation to bank rate changed on commercial banks.
- Number of banking institutions/level of development of banking sector.
- Supply of loanable funds/investment capital.

FINANCIAL INTERMEDIARIES.

Financial intermediaries are financial institutions which bring borrowers and lenders together. A bank is an institution specialized in business of providing monetary services to the public. Banks trade in money as a commodity and charge a price called interest on loans and also give interest on deposits from customers.

TYPES OF FINANCIAL INTERMEDIARIES.

Banking financial intermediaries

These are financial institutions that receive deposits from the public, give out loans and create credit.

They are basically commercial banks which bring together deficit lending individuals and surplus lending individuals.

These are financial institutions that engage in provision of short term loans, receive short term deposit from the public and are involved in the process of credit creation.

Characteristics of Banking Financial intermediaries.

- They operate money markets
- They pay low interest rate on deposits from customers
- They lend on short-term basis
- They keep short-term deposits.
- They create credit through the process of credit creation.

UNEB 2004

(i) What are non banking financial intermediaries? (02 marks)

(ii) State any two functions of these intermediaries in your country. (02 marks)

NON BANKING FINANCIAL INTERMEDIARIES.
These are financial institutions which perform similar functions done by commercial banks but do not create credit.
Or
These are financial institutions which receive deposits, give out loans but do not create credit. They receive deposits from the public and give out long term loans but do not create credit.
Examples of non-banking financial intermediaries are;
- Development banks such as East African Development Bank, Africa Development bank
- Insurance companies
- Stock exchange markets/capital market Authority
- Post office savings Bank.

Characteristics of Non Banking Financial Intermediaries.
- ✓ They operate capital markets where long term securities are traded.
- ✓ They give long term loans mainly for development purposes
- ✓ They normally undertake risky and long term investments.
- ✓ They charge high interest rate on loans.
- ✓ They do not create credit through credit creation.
- ✓ They pay high interest on initial deposits
- ✓ They are mostly owned by government for instance development banks.

Functions of Non- Banking financial intermediaries.
- They finance long term investment
- They promote savings
- They provide compensation in case of insurance companies
- They encourage trade
- They ensure social security for instance NSSF, life assurance.

CAPITAL MARKET
A capital market is one where long term securities/financial assets are traded. It is market which deals in debentures of companies, bonds, stocks and long term government security shares. A capital market is operated by non-banking financial intermediaries.

UNEB 2009
(i) Distinguish between a money market and a capital market. (02 marks)
(ii) State any two functions of capital markets in your country. (02 marks)

Functions of capital markets.
- ❖ To mobilize savings
- ❖ To encourage investments
- ❖ To promote easy conversation of assets from near cash to cash form

- To regulate prices of traded securities/financial assets.

MONEY MARKET.

A money market is one where short term securities/financial assets are traded/exchanged. It is market for short term loans made up of borrowers and lenders. It is operated by banking intermediaries. Commercial banks operate such a market.

UNEB 2007

(i) Distinguish between a money market and a capital market. (02 marks)
(ii) State any two characteristics of money in developing countries. (02 marks)

Features of money markets in developing countries.

- They are mainly urban based.
- They charge mainly high interest rates.
- They mainly operate on a small scale.
- There are few participants in the market.
- Deal mainly in limited variety of financial assets.

UNEB 2012

a) Distinguish between banking financial institutions and non banking financial institutions. (04 marks)
b) Explain the functions of banking financial institutions in your country. (16 marks)

FUNCTIONS OF COMMERCIAL BANKS/BANKING FINANCIAL INTERMEDIARIES.

1. **They receive deposits from the public** and keep them in safe custody until they are required. With ATM commercial banks can receive huge deposits and make payments o a 24-hour basis. This helps to mobilize savings for future investment.
2. **They advance loans to individuals and companies.** For instance commercial banks advance over drafts to customers, cash credit and discounting bills of exchange. This helps to increase production.
3. **They issue various forms of instruments of credit/provide easy means of payment.** Travelers" cheques which can be cashed anywhere other than the country of origin, drafts, and credit cards are all offered. This minimizes risks of carrying large sums of money.
4. **They safe guard valuable items/assets for their clients.** For instance land titles, wills, certificates which are kept in strong rooms.
5. **They trade in foreign currency/exchange currencies of different countries.** They operate foreign exchange bureaus where they buy and sell different currencies of several countries. They provide facilities for foreign transfer of money. They make payments abroad on behalf of their

customers such as western money transfer offered by several commercial banks. This promotes international trade.

6. **They help to implement monetary policies.** They act as agents of the government in sale and purchase of securities. Such as treasury bills and bonds. Both expansionary and contractionary monetary policies such as selective credit control, moral suasion are implemented through commercial banks. This helps control money supply.
7. **They act as referees for potential investors/to their clients.** They act as credible referees for their customers in local and foreign trade because they issue letters of credit, financial cards. This makes possible to increase the level of investment.
8. **They offer advice to potential investors and customers on business and financial matters.** This helps to set up profitable projects. They provide advice and guidance to their customers on how to use the secured loans for profitable investment.
9. **They create credit through granting loans** from the initial received from the public. This is through the process of credit creation.
10. **They act as trustees and executors of property of their customers.** They are entrusted with the property of clients when they die. This is because they can guarantee continuous existence than any other organization.

CREDIT CREATION.

Credit creation is a process by which commercial banks create more deposits out of initial deposit by customers through repeated lending.

Money lent out by commercial banks out of initial deposit using the cheque facility expands to result into greater volume of credit than the amount originally lent out.

The process happens without receiving any new deposits which implies repeated lending. The credit created from the process is usually on current account and is in form of book entry.

ASSUMPTIONS OF CREDIT CREATION.

- ❖ Assumes many banks or one bank with branches in the banking system
- ❖ The public must be willing to deposit money to the bank/initial deposit must be made to the bank.
- ❖ A certain cash ration is known and fixed by the bank such as 0.2, 20%, 10%
- ❖ The borrowers must have accounts in different banks.
- ❖ There should be a low cash ratio and high initial deposits for credit creation to be effective.
- ❖ There should be use of cheque facility and never to withdraw cash.
- ❖ The public must be willing and able to demand for loans from the banks.
- ❖ Commercial banks should be willing to lend money to the public.

Total credit created = Initial deposit x Credit multiplier

Where Credit multiplier = $\frac{1}{cash\ \ ratio}$

For instance, If cash ratio is 20%, the credit multiplier $\frac{1}{20,000}$ / 100 = 5

Assuming the initial deposit was Ug shillings 10,000 and cash ratio of 20%.

Calculate the total deposit created.

Total deposit created = Initial deposit x Credit multiplier

10,000 x 5

Total deposit created = Ug Shs 50,000

UNEB 2004

a) Given that, the cash ratio is 0.1% and initial deposit is shillings 250,000. Determine the;

(i) Total credit created (02 marks)

(ii) Credit multiplier (02 marks)

Examinable questions

UNEB 2007

a) Given the cash ratio of 0.2 and total deposit created is Ug shillings 200,000,000, calculate the initial deposit that was available at the bank.

Initial deposit = Total deposits x cash ratio

200,000,000 x 0.2

Initial deposit = Ug. Shillings 40,000,000

Or

Initial deposit = Total deposit / credit multiplier

Where credit multiplier = $\frac{1}{cash\ ratio}$ = $\frac{1}{0.2}$

Initial deposit = Ug shillings 40,000,000.

b) Given that, the cash ratio is 0.1% and initial deposit is shillings 250,000. Determine

(i) Total credit created

(ii) Credit multiplier

Total credit created = Initial deposit/credit multiplier

Credit multiplier = $\frac{1}{cash\ ratio}$ = $\frac{1}{0.1\%}$ = $\frac{1}{0.001}$

= 1000 times

Total credit created = 250,000 x 1000

Shillings 250,000,000

Credit multiplier = $\frac{1}{cash\ ratio}$

c) Given that the cash ratio is 0.2% and initial deposit is shillings 500,000 Determine

- *Total credit created*
- *Credit multiplier*

Total credit created = Initial deposit / credit multiplier

Credit multiplier = $\frac{1}{cash\ ratio} = \frac{1}{0.2\%} = \frac{1}{0.002}$

Credit multiplier = 500 times

Total credit created = 500,000 x 500

Shillings 250,000,000

Credit multiplier = $\frac{1}{cash\ ratio} = \frac{1}{0.2\%} = \frac{1}{0.002}$

Credit multiplier = 500 times

d) Given that the initial deposit in a bank is shilling 10,000,000 and the cash ratio is 20%. Calculate the total amount of credit that will be created in a multi-bank system.

Total credit created = Initial deposit / credit multiplier

Credit multiplier = $\frac{1}{cash\ ratio} = \frac{1}{0.2} = 5$

Total credit created = 10,000,000 x 5

Total credit created = shillings 50,000,000

UNEB 2011

(i) What is meant by the term credit multiplier? (01 mark)

(ii) Given that the initial deposit in a bank is shillings 10,000,000 and the cash ratio is 20%. Calculate the total amount of credit that will be created in a multi bank system. (03 marks)

Credit multiplier or bank deposit multiplier

This is the number of times initial bank deposit multiplies itself to give/generate a final deposit/total credit created.

Credit multiplier has no units; it simply shows the number of units.

Assuming the initial deposit in a multi-banking system is Ug shillings 10,000 and cash ratio is 20%. Calculate total credit created when four banks are involved in the banking system.

Bank(s)	**Initial deposit new**	**Cash ratio (20%)**	**New loan advance**
L	10,000	2,000	8,000
M	8,000	1,600	6,400
N	6,400	1,280	5,120
P	5,120	1,024	4,096

Table 10.1: Credit creation

Total credit created after four banks = 10,000 + 8,000 + 6,400 + 5,120
Total credit created after infinity = 10,000 + 8,000 + 6,400 + 5,120 + ………………, if the process was to continue total deposit created will be much more.

From the above information, a given customer deposited shillings 10,000 to bank L
Cash ratio i.e. shillings 2,000 was kept for him
The remaining balances i.e. shillings 8,000 was lent out to another customer as a new loan who deposits it bank M.
Bank M keeps part of the deposit as cash ratio i.e. shillings 1,600 and lending out shillings 6,400 as new loan. The process continues for all banks until the deposit is defuses in the system.
NB. *At each stage, the amount lent out reduces because the cash ratio retained by the bank is constant.*

Worked example.
Given that the initial deposit among four commercial banks 1,2,3 and 4 is shillings 10,000 and the cash ratio is 5%. Determine the total deposit created

Banks	**Initial deposit/new deposit**	**Cash ratio (5%)**	**New loan advance**
1	10000	500	9500
2	9500	475	9025
3	9025	451.25	8573.75
4	8573.5	428.69	8145.06

Table 10.2: Credit creation

- Total deposit created = 10000 + 9500 + 9025 + 8573.75
- Total deposit created = shillings 37098.75

UNEB 2003

a) *How do commercial banks in your country create credit? (08 marks)*
b) *Explain the factors which influence the process of credit creation in your country. (12 marks)*

UNEB 2010

a) *How do commercial banks create credit? Illustrate your answer. (08 marks)*
b) *Explain the factors which limit credit creation by commercial banks in your country. (12 marks)*

UNEB 2015

a) *Describe the process of credit creation by Commercial banks. (10 marks)*
b) *What factors limit the ability of Commercial banks to create credit in an economy? (10 marks)*

HOW DO COMMERCIAL BANKS CREATE CREDIT?

- Commercial banks create credit by receiving initial cash deposit from customers by a given bank. For example bank K receives shillings 1,000,000 as initial deposit.
- Retaining/keeping a percentage of the deposit as cash ratio. For instance 20% (Shs 200,000).
- Lending out the remaining balance to another customer i.e. Shs 800,000 who deposits it to another bank.
- Accepting money lent out as new deposit in another bank such as bank L i.e. Shs 1,000,000 – 200,000 = shs 800,000 which becomes the new deposit in bank L.
- Keeping a percentage of deposit in form of cash ratio by bank L i.e. 20% of Shs 800,000 which is Shs 160,000 is kept as cash ratio.
- The process continues until the initial deposit defuses in the system.
- At the end of the process, total deposit created = initial deposit x credit multiplier

$$\text{Total deposit created} = \text{Shs } 1{,}000{,}000 \times \frac{1}{20\%} = \text{Shs } 5{,}000{,}000$$

UNEB 2007

a) *Given a cash ratio of 0.2 and the total deposit created is Ug shillings 200,000,000. Calculate the initial deposit that was available at the bank. (04 marks)*
b) *Explain the factors that influence the process of credit creation. (16 marks)*

DETERMINANTS OF CREDIT CREATION OF BANK DEPOSIT MULTIPLIER.
(Factors that influence/affect the process of credit creation in a multi-banking system)
NB. *Neutral points are presented showing high capacity to create more credit and limited capacity*
to create more credit by commercial banks.

- **Size of initial bank deposit/availability of funds for lending.** The bigger the size of initial deposit, the higher the credit creation and the smaller the size of initial deposit, the lower the process of credit creation.
- **Size of the cash ratio.** High cash ratio implies less credit creation while a low cash ratio increases the process of credit creation.
- **Level of central bank interference through monetary policy/government monetary policy.** Use of expansionary monetary policy by the central bank through reducing bank rate, reducing legal reserve requirements increases credit creation while use of a contractionary monetary policy lowers the process of credit creation.
- **Interest rate on loanable funds.** High interest rate on borrowed funds scares away potential borrowers thus low rate of credit creation while low interest on borrowed capital borrowers from the public which increases the capacity of commercial banks to create credit.
- **Availability of valuable collateral security**. Presence of valuable collateral securities such as stocks, bills and bonds. Commercial banks expand their lending activities thus high power of credit creation while limited valuable collateral security limits the level of lending by commercial banks thus low rate of credit creation.
- **Level of liquidity preference.** The higher the liquidity preference, the lower the rate of credit creation since money is not taken to banks and the lower the level of liquidity preference, the higher the rate of credit creation.
- **Number of banks in the system and their distribution/level of development of banking sector.** Presence of many banks in the system which are evenly distributed increases credit creation while limited commercial banks and which are urban based limit credit creation.
- **Level of liquidity preference.** The higher the liquidity preference, the lower rge rate of credit creation since money is not taken to banks and the lower the liquidity preference, the higher the rate of credit creation.
- **Number of banks in the system and their distribution/level of development of banking sector.** Presence of many banks in the system which are evenly distributed increases credit creation while limited commercial banks and which are urban based limit credit creation.
- **Economic climate/rate of inflation in an economy.** Mild inflation encourages people to undertake economic activities and banks lend out more money to facilitate such activities which leads to high power to

create more credit while hyper discourages investment and lending which lowers the rate of credit creation.

- **Level of investment/availability of investment opportunities.** The higher the level of profitable investments, the higher the rate of credit creation since individuals are encouraged to borrow while limited investments lower the capacity of commercial banks to create credit.
- **Level of awareness of people about the banking system.** High level of awareness of the public about banking system increases willingness to borrow and deposit money with commercial banks which increases credit creation while low level of awareness of the public about banking system limits credit creation.
- **Degree of accountability/corruption within the banking system.** Low level of corruption and embezzlement of funds among bank officials increases credit creation while high level of corruption and embezzlement of funds among bank officials limit the capacity to create more credit.
- **Level of monetization or size of subsistence sector of the economy.** If the use of money in an economy is high, credit creation increases but a large subsistence sector limits credit creation.
- **Level of demand for loanable funds/people's knowledge and popularity of loans.** High popularity of loans increases borrowing and credit creation while limited popularity of loans limits credit creation.

UNEB 2005

a) Given that a micro finance bank has initial deposit of shillings 1,000,000 and the required cash ratio of 25%. Calculate the;

(i) Credit multiplier (02 marks)

(ii) Total deposit that will be created in a multi bank system.(02 marks)

b) Explain the factors which limit credit creation in an economy. (16 marks)

FACTORS THAT LIMIT CREDIT CREATION AMONG COMMERCIAL BANKS IN AN ECONOMY

NB *These are given as unfavourable factors and one sided in nature that retard the capacity of commercial banks to create more credit.*

1. **Poor distribution of commercial banks.** Few and poor distribution of banks mainly concentrated in urban areas limit credit creation in rural areas since potential customers for loans are reduced.
2. **High cash ratio maintained by commercial banks.** A high cash ratio within commercial banks reduces the amount of loanable funds as well as the rate of credit creation.
3. **High interest rate on loanable funds.** High interest rate charged on loans by commercial banks discourages borrowers hence limiting credit creation process.

4. **Poor political climate.** This increase uncertainty which discourages potential investors leading to low demand for loanable funds which limits credit creation.
5. **High level of liquidity preference.** High desire by the public to hold cash limits the volume of deposits and savings to the bank hence less credit is created.
6. **Restrictive monetary policy by the central bank.** The use of restrictive monetary policy by the central bank reduces the capacity of commercial banks to create more credit. Power of the central bank through increasing bank rate, increasing legal reserve requirement which reduces amount of money for lending.
7. **Low demand for loans/unpopularity and limited knowledge of loans.** Limited demand for loans because of poor investment climate leads to low investment and limited use of commercial banks and credit creation reduces.
8. **Economic instability/uncertainty in form of inflation.** This leads to constant fluctuations in the value of the currency and discourages lending and credit creation as well.
9. **Limited valuable collateral security among the public.** This is because of wide spread poverty which limits the rate of borrowing and credit creation as well.
10. **Low level of monetization/large subsistence production.** Low level of monetization limits the rate of borrowing due to limited commercial transactions which limit credit creation.
11. **High rate of corruption and embezzlement of funds by bank officials.** Misuse of deposited funds in the banking sector and lending to only those who bribe them halts the process of credit creation.
12. **Small size of initial deposit.** Where the initial deposit is small, credit creation is lowered. This is due to low savings among the public.
13. **Limited credit worthy bank borrowers.** Bank customers who default on loans hinder successful credit creation in commercial banks.
14. **Low level of investment.** Limited investment levels reduce the ability of entrepreneurs to demand for loanable funds which limits the process of credit creation.

UNEB 2002

a) *What are the assets and liabilities of a commercial bank? (06 marks)*
b) *How are commercial banks able to achieve both liquidity and profitability? (14 marks)*

ASSETS AND LIABILITIES OF A C OMMERCIAL BANK.

1) **Assets of commercial bank.**

Assets of commercial bank are possessions of the bank plus its claims on other institutions. It refers to what the commercial bank owns.

Examples of assets of a commercial bank

- ❖ Cash at hand. This notes and coins within the bank
- ❖ Deposits with other banks and non banks
- ❖ Loans, advances and overdrafts to customers and other banks
- ❖ Special deposits with the central bank
- ❖ Reserves with the central bank
- ❖ Fixed assets such as buildings, land
- ❖ Long term investments in other institutions
- ❖ Profits and income from discounting bills of exchange.

2) Liabilities of a commercial bank

Liabilities of a commercial bank are claims against the assets of the bank by creditors and depositors. It is what the commercial bank owes.

Examples of liabilities of a commercial bank are

- ➢ Customers‟ deposits. Money on current, fixed and savings accounts which belong to bank customers, Government funds deposited in the bank.
- ➢ Deposits by other banks and non bans with the commercial bank
- ➢ Bills discounted with the central bank
- ➢ Dividends payable to share holders of the bank
- ➢ Reserves payable to the central bank
- ➢ Share capital.

A cheque is a written order by the drawer to his bank o pay on demand a specified sum of money to the person named on it.

A drawer is the person who writes out a cheque i.e. the account holder.

A drawee. This is the bank in which the cheque is drawn.

Payee is the person to whom the cheque is made payable.

CONFLICTING OBJECTIVES OF COMMERCIAL BANKS.

These objectives contradict each other when it comes to lending. For instance long term loans are profitable but risky; therefore commercial banks are faced with the problem of achieving these objectives. Commercial banks are basically aimed at achieving these objectives;

- ➢ Liquidity
- ➢ Profitability
- ➢ Security

How do commercial banks reconcile the three conflicting objectives?

1) **Liquidity objective.** The bank must reserve liquidity/cash/liquid assets to meet the daily demands of customers. This is necessary to gain public confidence. Commercial banks achieve liquidity objective.

- ❖ Through maintaining a cash ratio. Keeping part of deposits in cash form/ cash ratio to meet the daily demands of customers.
- ❖ By keeping some near liquid assets such as treasury bills and bonds which can easily be converted into cash.

- ❖ Through maintain a high minimum balance on deposits" accounts.
- ❖ By lending out short term loans so as to restore the lost liquidity / avoiding long term lending.
- ❖ By adopting a policy of credit squeeze.

Credit Squeeze refers to a deliberate policy adopted to limit lending by commercial banks to maintain enough liquidity for the bank.

2) **Profitability objective.** This is the ability of a bank to make enough profits. It is the responsibility of a bank to ensure enough liquidity because absence of cash disappoints customers and affects future profitability. This is the prime goal of any commercial bank. Commercial banks achieve profitability objective.

- ❖ By charging high interest rate on loans and overdrafts than what is offered on deposits.
- ❖ Through selling government securities. Taking short-term investments in treasury bills and bonds.
- ❖ Through charging fees on certain services rendered by the bank to customers such as keeping wills and storage of valuables.
- ❖ By discounting bills of exchange and promissory notes. These are bought at low prices before maturity and sold at higher prices at maturity time.
- ❖ By investing in other profitable ventures to generate income for instance construction project.

3) **Security objective/solvency.** This is the relative positions of assets and liabilities of a commercial bank. A commercial bank is considered solvent if its assets are more than its liabilities and insolvent if its liabilities are more than its assets. A bank should always be careful to avoid becoming insolvent. Commercial banks achieve security objective.
    - ❖ By avoiding lending out money to risky ventures.
    - ❖ By acquiring referees for any customer opening an account or getting a loan.
    - ❖ By demanding for collateral security in getting a loan by customers such as land, buildings, shares, bills and bonds.
    - ❖ By keeping fixed assets.

ROLE OF FOREIGN COMMERCIAL BANKS IN DEVELOPMENT OF UGANDA.

Foreign commercial banks are banks that are situated in the domestic economy but with their headquarters in other countries of origin.

For instance Stanbic bank, Barclays bank, Standard Chartered bank, Cairo International bank, Bank of Baroda, Kenya Commercial Bank, FINA bank, Equity bank.

Attractive investment incentives that have been given to foreign investors have attracted several foreign banks in the banking sector.

These commercial banks in Uganda are the majority and reap huge benefits from trade market and service industry and get a more than fair share of financing trade, imports and exports in Uganda. This has even increased the number of firms and entrepreneurs doing business in Uganda from their countries of origin such as Kenyans and South Africans.

POSITIVE ROLE OF FOREIGN COMMERCIAL BANKS IN UGANDA.

1. **Contribute to infrastructure development.** They finance long term projects such as power supply, road construction necessary for development.
2. **They are sources of government tax revenue.** They are among the top tax payers in Uganda thus enough government tax revenue realized.
3. **Encourage mobilization of savings and deposits from the public.** This increases future investment.
4. **Improve international relations and understandings.** This is necessary for increased trade and inflow of foreign aid.
5. **They create a competitive atmosphere in the local banking sector** thereby leading to improved efficiency and effectiveness and better service delivery. This stimulates the performance of the banking sector.
6. **They facilitate increased monetization of the country.** They encourage increased use of money because they provide loans for large scale investment thus breaking the large subsistence sector.
7. **They provide loans for investment.** They advance loans to local people necessary for increased investment.
8. **Provide employment opportunities to local people.** Many people are employed as tellers, bank managers, security guards. This enables people to earn income.
9. **Increase foreign exchange inflow for national development.** High foreign capital inflow which facilitates international trade.
10. **Promote private foreign investment.** Foreign investors usually prefer to keep their money in foreign banks. This increases capital inflow.
11. **They help in expanding the private sector.** The government is striving to expand and strengthen the private sector and such banks are helpful since most of them are large enough.
12. **Promote development of local skills in the banking sector**. Most of these banks are computerized and are helpful in equipping local Ugandans with modern skills in the banking sector.

NEGATIVE ROLE OF FOREIGN COMMERCIAL BANKS IN UGANDA.

1. **Increase profit repatriation.** They take profits to their home countries thus capital outflow which limits re-investment.
2. **They have discrimination employment policies.** They worsen unemployment situation due to employment of foreigners especially on top managerial posts and use of capital intensive technology.

3. **They out compete local banks.** They create unnecessary competition which results into domestic banks leaving the banking sector.
4. **Lead to regional imbalances in development.** This is because they mainly operate in urban areas with necessary infrastructure.
5. **They are difficult to control by the central bank.** This is because at times they work under the direction of large banks in their countries of origin. They interfere with government and central bank policies which limits effective operation of monetary policy.
6. **They have discriminative lending policies.** They discriminate against local business enterprises and charge them high interest rates. They show little concern to small-scale savers and are more interested in big depositors such as international firms, foreign embassies and government and mainly extend loans to foreign owned enterprises.
7. **Promote external economic dependence.** This exposes Uganda to dangers of external dependence such as unfavourable balance of payment position.
8. **They lead to low mobilization of domestic savings.** This is due to high minimum account balance requirements which local people may not easily manage.

PROBLEMS FACED BY COMMERCIAL BANKS.

Commercial banks in Uganda face various challenges which limit their capacity to mobilize enough deposits from the public and give out enough loans. This implies that they are unable to successfully achieve profitability and liquidity objectives.

- ❖ **Low savings among people.** Majority of bank customers have low incomes and this implies low deposits from the public hence poor performance of commercial banks.
- ❖ **Limited skilled manpower to manage and supervise the banks efficiently.** Limited supply of highly skilled bank managers, tellers, supervisors limit the performance of commercial banks since it reduces efficiency.
- ❖ **Poor distribution of commercial banks/commercial banks are mainly urban based.** Most commercial banks are located in urban areas which have access to supporting infrastructure such as power supply, roads and this makes it difficult to get large number of customers and mobilize rural savings.
- ❖ **Limited credit worthy bank customers or borrowers.** Some of the bank customers normally default on loans which negatively affects the liquidity of the banks.
- ❖ **Persistent inflation /economic instability.** Uganda normally experiences hyper inflation, this discourages lending and leads to loss of real value of money thus limited investment.
- ❖ **Poor political climate in some parts of the country.** Political instabilities curtail economic activities that would create savings in the

banking sector. This also leads to loss of money and people are uncertain to borrow for investment.

- **Government interference through the central bank.** For example increasing bank rate, increasing special deposits, regulations which limit the level of borrowing, increasing legal reserve requirement, selective credit control and through nationalization of commercial banks.
- **General ignorance of people about banking services.** Most people are ignorant about banking services provided by commercial banks due to low level of education thus poor banking habits and limited demand for loans.
- **High level of liquidity preference among people.** Many individuals prefer to hold wealth in cash form and they are unwilling to save it with commercial banks. This limits the level of deposits with commercial banks from the public.
- **Corruption and embezzlement of funds among bank employees.** This negatively affects liquidity of the bank and discourages potential borrowers and depositors of the bank.
- **Stiff competition in the banking sector/business.** This is between commercial banks themselves, competition from non -banking financial intermediaries and other money lending institutions such as credit schemes, SACCOs, micro finance, telecommunication companies which have assumed the role of handling money. This limits mobilization of savings by commercial banks, increased operational costs and reduces profitability.
- **Limited collateral security form customers for lending and borrowing purposes.** Many bank borrowers lack valuable securities such as land, shares, buildings, investments to guarantee accessibility to loans.
- **Existence of a large subsistence sector.** The level of economic transactions is still low since there is high production for own use thus limited borrowing for commercial activities. This limits deposits and demand for loans.
- **Poor infrastructure.** For instance roads and other communication facilities which reduces efficiency of the bank since it limits coordination of activities.

THE CENTRAL BANK.

A central bank is a government financial institution that helps to control amount and use of money in order to implement a certain monetary policy of the country.

It is a central monetary institution responsible for management of monetary system of the country. It is non-profit motivated and controls other banks and financial institutions operating in a country and it is responsible for ensuring economic stability in a country. In Uganda, the central bank is known as Bank of Uganda, It was formally established in Uganda on July 1st 1966.

UNEB 2010

a) Explain the functions of a central bank. (08 marks)

b) How does a central bank control credit in a multi bank system? (12 marks)

(Give tools of monetary policy and employ the phrase THROUGH at the beginning of every tool). This is mainly doe through manipulation of monetary policy tools.

FUNCTIONS OF THE CENTRAL BANK.

1. **Issues out the country's currency.** No ban other than the central bank is legally authorized print new currency notes and minting coins. The central bank enjoys the monopoly of the issue of country"s currency in accordance with the rate of economic activities.
2. **It is a banker to the government.** The central bank keeps the account, deposits of the government and it is charged with the custody of government foreign exchange reserves or gold reserves.
3. **It is fiscal agent and financial advisor to the government.** The central bank helps the government in devaluation and revaluation matters, advises the government during an economic depression, formulation of annual budgets and modes of expenditure.
4. **It is a banker to commercial banks.** The central bank accepts deposits from commercial banks such deposits are liabilities to the central bank.
5. **A lender of last resort to commercial banks.** Commercial banks always borrow from the central bank in case they are in financial difficulties to meet their obligations as the last resort.
6. **Manages country's monetary policy/controller of credit.** The central bank controls credit by use of various monetary tools such as ban rate, moral suasion, open market operation by regulating the buying and selling of government securities, legal services requirements to either increase or reduce money supply on behalf of the government.
7. **Manages the country's public debt.** Both internal and external public debts are managed by the central bank through various methods such as setting a sinking fund, selling government securities to the public deficit financing, debt conversion and debt rescheduling.
8. **Banker to all international institutions working in the country.** For instance international Monetary Fund, World Bank, DANIDA and Red cross. It provides banking services to such institutions.
9. **Controls and inspects all commercial banks operating in the country.** This is meant to ensure that they control with the monetary policy.

10. **It controls foreign exchange rates in the country.** The rate at which the local currency exchanges for foreign currencies is controlled by the central bank.
11. **It is a clearing house for all commercial banks.** Commercial banks settle all their indebtedness through the central bank.

UNEB 2010

(i) What is meant by monetary policy? (01 mark)

(ii) Give any three tools of monetary policy in tour country. (03 marks)

MONETARY POLICY.

Monetary policy is a deliberate government attempt through the central bank to regulate/control supply so as to achieve objectives of developments (such as price stability, stable economic growth rate, full employment and balance of payment of stability.)

Therefore concerned with either increasing or reducing money supply is an economy to achieve various objectives of development.

TYPES OF MONETARY POLICY.

1) **Expansionary monetary policy** refers to a deliberate government attempt through the central bank to employment, stable economic growth rate.
2) **Contractionary/restrictive monetary policy** is a deliberate attempt through the central bank to reduce money supply in an economy so as to achieve objectives of development such as price stability, full employment, and stable economic growth rate.

UNEB 2009, 2006

a) State the objectives of monetary policy in your country. (04 marks)

b) Explain the factors which limit the effective operation of monetary policy in your country. (16 marks)

UNEB 2013

a) Outline the objectives of the monetary policy in your country. (06 marks)

b) Examine the factors that limit the success of the monetary policy in your country . (14 marks)

OBJECTIVES OF MONETARY POLICY.

- To ensure price stability by controlling inflation through adopting restrictive monetary policy so that the value of money is stable over time.
- To influence the rate of economic growth in an economy by providing credit to private sector which helps to increase more investment.
- To influence the level of employment by stimulating investment through favourable interest rates which increases investment and job creation.

- To influence balance of payment position through maintaining a stable foreign exchange rate system. This is through devaluation of the local currency in order to encourage exports and increase foreign exchange earnings.
- To influence the level and nature of investment by controlling interest rates to attract more investors. This helps to attain balanced growth and development of the economy through selective credit control.
- To encourage the growth of financial sector. This increases the rate of borrowing for increased investment.
- To ensure stability of foreign exchange rates by strengthening the value of the currency in terms of other currencies.

UNEB 1999

a) *What is meant by tools of monetary policy? (08 marks)*
b) *What factors limit the application of monetary policy in your country? (12 marks)*

Tools of monetary policy are guidelines/weapons/instruments employed by the government through the central bank to regulate/control money supply so as to achieve objectives of development such as price stability, full employment, and stable economic growth rate.
Then give the tools of monetary policy and explain them.

UNEB 2015

a) *What are the objectives of the monetary policy in your country? (06 marks)*
b) *Explain the methods used by the central bank to regulate money supply in your country. (14 marks)*

UNEB 2008

a) *Define the term monetary policy. (04 marks)*
b) *Explain the tools of monetary policy used in your country. (16 marks)*

UNEB 1998

a) *Explain the term monetary policy. (04 marks)*
b) *Examine the tools used by the central bank to regulate money supply in your country.(16 marks)*

TOOLS/INSTRUMENTS OF MONETARY POLICY IN AN ECONOMY
(How does a central bank control credit in a multi-bank system?)

Tools of monetary policy are guidelines or weapons or instruments employed by the government through the central bank to increase or reduce money supply in circulation so as to achieve objectives of development such as stability, high levels of employment, stability in foreign exchange. These tools are basically methods of credit control.

The central bank uses a number of tools or instruments that can help to control credit (money supply) in an economy and achieve the intended objectives of monetary policy. These tools are basically methods of credit control. Each tool can either be contractionary / restrictive or expansionary monetary policy.

NB. ***State the tool, define it and clearly explain how it works both contractionary and expansionary***

1. **Bank rate.** This is the rate of interest that the central bank charges commercial banks when they borrow from it. An increase in bank rate reduces money supply since it increases interest rate on loans from commercial banks while a decrease in bank rate increases money supply it reduces interest rate on loans.
2. **Open market operation.** This involves buying and selling of government securities to the public such as treasury bills and bonds in an open market. Selling of government securities to the public withdraws excess money and reduces money supply while buying of securities from the public increases money supply.
3. **Legal reserve requirements (reserve ratio).** This is a compulsory deposit by commercial banks which by law must be kept with the central bank. Increase in legal reserve requirements reduces money supply and commercial banks with enough liquidity.
4. **Special deposits/supplementary legal reserve requirements.** This is where the central bank instructs commercial banks to make a special deposit which is over and above legal reserve requirements. Lowering of special deposits by the central bank increases money supply and increasing special deposits reduces money supply.
5. **Moral suasion.** This is the issuing of persuasive instructions by the central bank to commercial banks soliciting their cooperation in making its monetary policy effective. During inflation, the central bank advises commercial banks to increase lending thereby increasing money supply.
6. **Selective credit control.** This is where the central bank instructs commercial banks to favour or disfavour certain sectors when giving out loans. Credit is given to many sectors to increase money supply credit/ lending is restricted to few to reduce money supply.
7. **Margin requirement.** This refers to the monetary difference between the value of the collateral security mortgaged for a loan and the value of the loan advanced to the borrower. Margin requirement is raised to reduce money supply since it discourages borrowing while it is reduced to increase money supply since it encourages borrowing.
8. **Currency reforms/conversion.** This is where changes in the country's national currency are made especially during inflation. This helps to control money supply. It occurs when there is excess liquidity in an economy which lowers the value of currency and the central bank may be

in need to erode such liquidity from the public so as to reduce money supply and increase value of the currency.

9. **Rationing of credit.** This is where the government through the central bank portions the amount of money advanced to commercial banks. This is called credit/monetary squeeze. This helps to control money supply with either reduces or increases money supply.
10. **Direct intervention.** The central bank may intervene in the activities and management of commercial banks when they fail complement to comply with tools of monetary policy so as to control monetary policy.
11. **Cash ratio.** The central bank instructs commercial banks to increase cash ratio so as to reduce money supply and cash ratio is reduced in order to increase money supply.

NB. Government securities are debt obligations issued by government authority and agencies with promised repayment of the principal upon maturity as well as interest repayment periodically. They are usually used by the government to control money supply, to raise money to pay for various government expenses.

UNEB 2002

a) *Explain the objectives of monetary policy in an economy. (10 marks)*
b) *What factors limit the successful implementation of monetary policy in your country? (10 marks)*

LIMITATIONS OF MONETARY POLICY IN LDCs.

(Factors that limit effective/successful implementation of monetary policy in LDCs)

NB. *Mention the monetary tools that are limited where necessary in the process of explaining these limitations.*

1. **Limited effective use of commercial banks.** Commercial banks have limited number of borrowers due to limited collateral security, low incomes, few credit worthy bank customers, existence of alternative sources of income which makes implementation of some monetary policies such as bank rate difficult.
2. **Dominance of foreign owned commercial banks.** Foreign commercial banks dominate the banking sector in most developing countries and yet follow directives form their countries of origin and therefore are not under direct control of the central bank which makes it difficult to control their lending policies and this fails tools such as bank rate and rationing of credit.
3. **Excess liquidity held by commercial banks.** Most commercial banks posses enough liquidity and therefore they do not normally borrow from the central bank making bank rate system less effective.

4. **Poorly developed money markets.** Money markets in developing countries are less developed and this limits effectiveness of open market operation.
5. **Conflicting government objectives.** For instance increasing interest rate to control inflation while providing cheap loans to the poor to increase investment, increasing economic growth while limiting money supply. This makes it hard to control money supply thus limiting effective use of bank rate.
6. **Ignorance of the public about open market operation.** The largest percentage of the population is ignorant about the sale of government securities through commercial banks and therefore the public cannot but thus limiting operation of open market operation.
7. **Wide spread of corruption and embezzlement in banking sector.** This fails the operation of selective credit control system in its implementation and therefore credit would not go to priority sectors. Loan applicants bribe bank officials and get loans even when it is not necessary.
8. **High liquidity preference among the public.** People prefer to hold their assets in form of cash or near cash and this leads to limited use of commercial banks. This makes it very difficult to control credit through bank rate and selective credit control since people do not deposit and borrow money from the bank.
9. **Political/government interference in activities of the central bank.** The government interferes with the activities of the central bank by dictating expenditure as a result loans are given out to individuals on political grounds and economic considerations are ignored which fails selective credit control.
10. **Existence of a large subsistence sector.** There is limited money in economic activities and this fails tools such as bank rate since the rate of public borrowing is low.
11. **Uneven/poor distribution of commercial banks.** Commercial banks in LDCs are mainly urban based due to infrastructure viability hence limiting the applicability of monetary policy in rural areas and yet it is through these commercial banks that monetary policies such as bank rate executed.

TERMS TO NOTE.

1) Cash ration

This refers to a fraction/percentage of commercial bank‟s total deposits must be retained by the bank in cash form to meet the daily cash demands depositors.

2) Liquidity ratio

This is a fraction of total assets of the commercial bank which remains in form of cash, or near cash form. It is the measure of the commercial bank to pay its debts and remain operating.

3) Reserve ratio

This is a fraction/percentage of commercial bank"s total deposits which by law must be kept with the central bank.

4) Credit control

This refers to measures adopted by the central bank to regulate lending ability of commercial banks in order to achieve desired economic objectives.

UNEB 2010

(i) Differentiate between cash ratio and reserve ratio (02 marks)

(ii) Give any two reasons ratio may be increased. (02 marks)

REASONS WHY THE RESERVE RATIO MAY BE INCREASED BY THE CENTRAL BANK.

- To protect interests of depositors in times of crises and financial instability.
- To restrict credit creation by commercial banks
- To reduce liquidity level of the bank
- To control inflation
- To safe guard commercial banks against uncertainties such as periods of economic recession.

5) Instruments of credit.

These are written promises to settle payments at a future date. Examples of instruments of credit are; cheques, promissory notes, bills of exchange, bank drafts.

6) Treasury bills.

These are short term loan securities issued by the government treasury at a fixed interest rate for a given time.

They are documents issued by the central bank which represent debt obligations of the government. They are pieces of paper acknowledging government indebtedness of the stated sum of money to the holder and promise to repay it at a given date.

NB*: Credit* *means a system of borrowing and lending*

7) **A bill of exchange** is unconditional order in writing given by a creditor to a debtor to pay on demand a specific amount of money after a given period of time.
8) **A promissory note** is a document where a debtor promises to pay a specific sum of money to a named person at a given date.
9) **A treasury bill** is a short term loan security issued by the government treasury at a fixed rate for a given time. Its mainly period is less than a year and normally issued by the central bank to the public.
10) **A bond** refers to a long term government security whose maturity period is over one year and normally issued by the central bank.
11) **Security** refers to a document that gives a holder a right to have money or any property in possession in a specified period of time.

Factors that limit effective use of treasury bills in Uganda.

- Limited public awareness about government securities
- High level of liquidity preference
- Limited capital to buy securities
- Low interest rate that discourage potential buyers of treasury bills
- Underdeveloped money markets.

UNEB 2006

(i) Differentiate between a soft loan and a hard loan. (02 marks)

(ii) State any two reasons why your country continues to rely on loans. (02 marks)

What is a loan?

A loan is a transfer of funds from one economic activity to another which must be paid back with interest at an agreed period of time.

Soft loan

A soft loan is a loan given at a low or no interest rate yet it provided a long repayment period and other concessions to the borrower such as interest holidays, extended grace periods.

Hard loan

This is a loan given at a high interest rate and yet with a short repayment period. It is mainly paid in currency of a nation that has economic stability and a sound reputation abroad.

Why does your country continue to rely on loans?

- To finance long term development projects
- Due to low tax revenue
- To close budgetary deficits of government
- Due to low domestic savings
- Due to low export earnings yet there is rising need for imports.

CIRCUMSTANCES UNDER WHICH AN INCREASE IN MONEY SUPPLY MAY NOT NECESSARILY CAUSE AN INCREASE IN PRICES/INFLATION.

- When an increase in money supply is accomplished by an increase in direct taxes which reduce disposable income.
- When there is effective price control measures and therefore inflation is suppressed.
- In case an increase in money supply is accompanied by a corresponding increase in production of goods and services.
- When people"s marginal propensity to save is higher than marginal propensity to consume.
- When an increase in money supply is used to purchase capital goods and not consumer goods.

Chapter 11: PUBLIC FINANCE AND FISCAL POLICY.

Public finance is a science which studies the way in which government obtains/mobilizes revenue and how this revenue is spent in order to achieve major objectives of development.

Or

It is a science that is concerned with public revenue and public expenditure. It is about revenue and it deals with government revenue through taxation and other sources and public expenditure on various public utilities.

Public finance deals with the following

- **Public revenue.** Total income of the government from all sources such as deficit financing, taxation.
- **Public expenditure.** Total amount of money for government spending.
- **Public debt.** Total amount of money borrowed by the state, public authorities and corporations from both local and external sources.
- **Financial administration.** This involves studying how the national budget is prepared, implemented and audited.
- **Fiscal policy.** This is a deliberate policy under which government uses its expenditure and revenue (taxation) programmes to regulate the level of economic activities.

UNEB 2004

(i) What is meant by the term fiscal policy? (02 marks)
(ii) Mention any two sources of government revenue. (02 marks)

SOURCES OF PUBIC FINANCE.

Tax sources

This is the major source of government revenue which includes both direct and indirect taxes.

Non tax sources

a) Fees. These are payments made by individuals to the government for services rendered to them such as school fees in public schools and universities, valuating property, cost sharing in hospitals, stamp fees, postal services, land surveying fees.

b) Market dues. These are payments made by private individuals to the government to get permission to sell commodities in a given market place. These are paid on daily, monthly or weekly basis to the local government authorities.

c) Selling government securities to the public such as treasury bills which are sold to the public by the central bank through commercial banks.

d) ***Licenses.*** These are payments made by individuals who seek permission before operating a given business or any gainful economic activity. For instance trade license, driving permits.
e) ***Fines and penalties.*** These are imposed to punish law breakers. For example court fines and bails.
f) ***Compulsory saving schemes*** such as NSSF, insurance companies.
g) ***Gifts and donations.*** These are contributions made by individuals, international companies and friendly countries to the government for meeting costs of certain projects or events.
h) ***Privatization of public enterprises/disinvestment.*** The transfer of public enterprises to private ownership and control provide revenue to the government.
i) ***Loans/borrowing from internal and external sources.*** The government raises revenue by borrowing either internally or externally.
j) ***Deficit financing/printing more money.*** If there is shortage of funds, the government issues new notes and coins through the central bank and this money is used to complete new development projects.
k) ***Earnings a surplus from gambling.*** This happens especially where such activities are clearly liberalized. This is effective in developed countries such as national lottery.
l) ***Profits/proceeds from public commercial ventures.*** Government at times sets up commercial enterprises from which income is earned.
m) ***Rents on government owned property.*** This is obtained from government owned property such as buildings which may be rented to the public for commercial activities.

UNEB 1997

a) *Define the term public finance.* *(04 marks)*
b) *What is the role of public finance in your country?* *(16 marks)*

ROLE OF PUBLIC FINANCE IN DEVELOPMENT OF AN ECONOMY.

- **Achieving equitable distribution of income and resources/fighting income inequality.** This is through government expenditure to low income sections and tax systems such as progressive taxation to reduce income inequality.
- **Controls monopoly tendencies.** This is through high taxes on profits of monopolists and increased subsidization of weak firms.
- **Enables the government to mobilize public revenue.** This is through taxation, contracting internal and external debts and through other various sources. This revenue is important for public spending and national development.
- **Enables the government to promote economic stability.** Such as controlling demand pull inflation through increased direct taxation and reduced government public spending.

- **Influences proper use and allocation of resources.** Scarce resources are effectively utilized through proper budget allocations to cater for priority areas of development.
- **Important in stimulating economic growth.** It helps in increasing aggregate demand especially in periods of economic recession to promote recovery and economic growth.
- **Discourages the consumption and production of demerit goods.** Undesirable and harmful goods are controlled by the government through imposing high taxes to increase their prices e.g. sumptuary tax.
- **Improves Balance of payment position.** This is through the use of import and export duties to increase foreign exchange earnings and reduce foreign exchange expenditure. It helps to increase the volume of exports and reduce the volume of imports.
- **Protects and develops infant industries.** This is through subsidization policy to local industries and high import duties on goods similar to what is locally produced by such industries.
- **Promotes employment opportunities.** This is done by facilitating both private and public investments through fair taxes and increased government expenditure on projects and subsidies to producers to generate more employment.

TAXATION.

Taxation refers to legal and compulsory transfer of money from the public to the government mainly as a source of government revenue and other regulatory purposes for economic development.

A tax is a non-quid proquo payment payable made by the tax payer to the government as a source of government revenue.

This implies that the benefits received by the tax payer from the government do not necessarily correspond to the amount paid as a tax i.e. the benefits from the government to the tax payer can be equal, greater or less than the tax paid.

UNEB 1999

a) Explain the principles of taxation. (08 marks)

b) Why is it necessary to levy taxes in your country? (12 marks)

REASONS/RATIONALE FOR TAXATION/OBJECTIVES OF TAXATION / WHY IS IT NECESSARY TO LEVY OR IMPOSE TAXES IN AN ECONOMY

NB: *these are given as reasons for taxation but not as effects of taxation.*

- **To raise public revenue.** Taxation through both direct and indirect taxes is a source of revenue to the government so as to finance public activities such as schools, roads and other recurrent and development expenditure.
- **To achieve equitable distribution of income and wealth.** Through progressive tax system, income inequality is reduced.

- ❖ **To protect domestic infant industries form imported cheap items/ dumping.** This is done through imposing high duties on goods similar to what is produced locally by infant industries leading to industrial development.
- ❖ **To influence the level of economic growth.** Fair taxes are imposed to encourage increased production on investments to achieve economic growth.
- ❖ **To regulate/control monopoly powers.** Taxes are imposed on abnormal profits of monopolists so as to discourage their operations.
- ❖ **To discourage production and consumption of undesirable goods** such as alcohol, cigarettes by imposing high direct taxes on such commodities which increases their prices and reduces demand.
- ❖ **To control demand-pull inflation.** High taxes imposed on personal incomes disposable income leading to a fall in aggregate demand and general price level.
- ❖ **To improve balance of payment position.** High taxes on luxuries commodities from abroad reduce their demand thus reducing foreign exchange expenditure.
- ❖ **To regulate and influence allocation of resources.** In case the government wants to promote the use of a certain resources and increase production by attracting more investors in given sectors, low taxes are charged or removed on such economic activities.

UNEB 2014

a) Explain the importance of taxes in your country. (08 marks)

b) Discuss the demerits of imposing taxes in your country. (12 marks)

UNEB 2007

a) Distinguish between direct and indirect taxes. (04 marks)

b) Assess the impact of taxation on an economy. (16 marks)

UNEB 2006

a) Assess the role of taxation in your country. (08 marks)

b) How can the current tax system be improved in your country? (12 marks)

POSITIVE ROLE/IMPACT OF TAXATION IN AN ECONOMY.

- ❖ **It is a means of raising public revenue.** Direct and indirect taxation provide revenue to government which used to finance public activities such as schools, roads, defence or for recurrent and development expenditure.
- ❖ **Ensures equitable distribution of income and wealth.** This is attained through progressive tax system.
- ❖ **Protects domestic infant industries from imported cheap items/ dumping.** This done through imposing high import duties on goods similar to what is produced locally which discourages dumping.

- **Influences the rate of economic growth.** Taxation is done to obtain revenue to finance increased production of goods and services.
- **Regulates/controls monopoly powers.** Taxes are imposed on abnormal profits of monopolists so as to discourage their operations.
- **Discourages production and consumption of undesirable/harmful goods** such as alcohol and cigarettes. This is achieved by imposing high taxes on such commodities.
- **Controls inflation.** High taxation on incomes reduce disposable income leading to a fall in aggregate demand leading to reduced general price level.
- **Improves balance of payment position.** High taxation on luxurious commodities from abroad reduce their demand thus reducing foreign exchange expenditure.
- **Influences resource allocation.** In case the government wants to promote the use of certain resources and given sectors, low taxes are charged or removed on related activities.

NEGATIVE ROLE/IMPACT OF TAXATION IN AN ECONOMY.

- **Regressive taxation widens income inequality.** This is especially regressive tax systems and indirect taxes which treat buyers and the poor are therefore highly taxed.
- **Indirect taxes are inflationary/causes cost push inflation.** Heavy indirect taxation increases costs of production hence cost-push inflation and its negative effects.
- **Reduces consumer welfare/standard of living due to reduced consumption.** Taxation reduces disposable income leading to a reduction in welfare as consumption is lowered especially high income taxes such as progressive tax.
- **Discourages people's efforts and initiatives to work hard** especially progressive tax, high indirect taxes on producers and property. This leads to low investment and economic growth
- **Creates resentment which leads to unpopularity of government.** High and unfair taxes on incomes and commodities are normally criticized by the public which creates resentment hence eroding government popularity.
- **Taxation leads to misallocation/diversion of resources.** Resources are shifted from production of highly taxed commodities to production of less taxed goods and non productive ventures.
- **Encourages trade malpractices/illegal activities**. Black marketing results especially where customs duties are very high as importers and exporters attempt to dodge such taxes since they reduce their profits.
- **Discourages investment.** Heavy corporate taxes are a disincentive to investment and discourage undertaking of risky ventures by both local and foreign investors.

- ❖ **Reduces volume and benefits of trade**. High indirect taxation discourage trade locally, importation and exportation of commodities due to reduced profits hence lowering the benefits from local and foreign trade.
- ❖ **Discourages savings.** High taxation reduces ability to save because of reduced disposable income among tax payers" income.

UNEB 2015

a) *Describe the features of a good tax system.* *(08 marks)*

b) *Explain the role of taxation in the development of a country.(12 marks)*

UNEB 2008

a) *Explain the principles of taxation.* *(10 marks)*

b) *What are the problems faced by tax authorities in your country? (10 marks)*

PRINCIPLES/CANONS OF GOOD TAXATION.

These are rule and regulation which should be observed in tax assessment, tax collection and tax administration.

In 1977, Adam Smith in his writing (Wealth of Nations) laid down major four canons of taxation which should be followed when imposing a tax. Other economists later lone came up with other canons.

- ❖ **Equity or fairness.** This implies that tax should hear proportionately equal burden of the tax depending on their differences in income. It is divided into two;
  - ***a) Horizontal equity.*** This is where people in the same income bracket pay the same amount of a tax. Therefore, tax payers who are in equal income situations are treated equally.
  - ***b) Vertical equity.*** This is where people in different income levels pay different amount of a tax according to differences in their income. Therefore, tax payers who are in unequal income situations are treated differently where the rich should pay high taxes and the poor pay high taxes and the poor pay low taxes.
- ❖ **Certainty.** The nature of the tax, amount to pay, its assessment, mode of payment, place and time of payment must be clear and known to the tax payer and the tax collector. Therefore, the tax should be understood by the tax payer in terms of its of liability.
- ❖ **Convenience.** The places, periods and seasons when the tax is collected should be convenient to the tax payer. i.e. tax payers are taxed when they have money to pay. For instance farmers are taxed when they sell their crops, office workers are taxed when they receive their salaries and places of payment should be within a reasonable distance from the tax payer.
- ❖ **Economy or efficiency.** It should be economical to the government i.e. the cost of assessment administration and collection of the tax should

be small in relation to tax revenue collected. The cost of tax collection should not exceed 5% of the tax collected.

With changes in time and new thinking on taxation, other principles have been developed and added to the originally four stated by Adam Smith.

- ❖ **Simplicity.** It should be easy and simple to calculate and understand by both the tax payer and the tax collectors so as to raise enough tax revenue. It should be in a clearest language easily understood by the tax payers.
- ❖ **Elasticity or flexibility.** Tax system should be flexible according to the prevailing economic conditions, requirements of government and incomes of people. it should not be static.
- ❖ **Comprehensiveness or diversity.** A good tax system should have a wide coverage/base so as to spread the burden of the tax to different categories of people. it should cover all potential tax payers and all sectors of the economy.
- ❖ **Productivity or adequacy.** It should produce sufficient revenue to justify its imposition by covering a wider area to increase tax revenue. It should be able to encourage people"s efforts and initiatives and not to discourage investments. It should not be counter productive.
- ❖ **Neutrality or impartiality.** A good tax system should not discriminate among tax payers of the same category. All tax payers should be treated equally.
- ❖ **Consistency.** A good tax system should be in line with national economic objectives and most especially in resource allocation i.e. it should not contradict with national economic objectives.
- ❖ **Avoidance of double taxation.** A good tax system should not encourage double taxation to reduce negative effects of taxation on the tax payer.

TERMS USED IN TAXATION.

1. **Tax bases**

These refer to a range of economic units/activities on which taxes are imposed/levied.

It refers to an economic unit/activity on which a tax is imposed/levied. These economic entities may include individuals, firms, institutions, commodities among others.

UNEB 2013

a) *Differentiate between taxable capacity and tax base. (02 marks)*

b) *State any two reasons for the narrow tax base in your country.(02 marks)*

REASONS WHY THE TAX BASE IS NARROW IN LDCs.

- ❖ High level of unemployment and underemployment/limited employment opportunities.

- ❖ Political instabilities and insecurity which limit investment and makes if difficult to access tax bases.
- ❖ Poor identification of tax sources/inadequate information about sources of taxation.

Narrow definition of lawful activities worthy being taxed hence leaving out potential tax payers. For instance gambling, prostitution, footballing, music industry, religious activities.

- ❖ Provision of excessive tax exemptions and tax holidays to some potential investors.
- ❖ Poorly developed infrastructure
- ❖ Dominance of a large subsistence sector which are difficult to tax/ limited commercialization of the economy.
- ❖ A small industrial sector/low level of investment
- ❖ Low levels of income
- ❖ Large informal sector/small formal sector.

2. **Taxable capacity.**

This is the ability to which a tax payer is able to pay the tax assessed on him and yet remain with enough disposable income to maintain a standard of living which he is accustomed to.

Or

It refers to the ability of a tax payer to pay the tax levied on him and yet remain with enough disposable income to sustain/maintain usual standard of living/welfare.

Causes of low taxable capacity in LDCs.

- ➢ Wide spread poverty.
- ➢ Low level of industrialization.
- ➢ Poor political climate.
- ➢ Low tax awareness among tax payers.
- ➢ High income inequalities.
- ➢ Wide spread unemployment and under employment.
- ➢ Large subsistence sector.
- ➢ Low tax awareness among tax payers.

3. **Tax avoidance.**

This refers to a situation where a tax payer exploits loopholes or weakness in the tax system to pay less or no tax at all, it is legal. It is therefore not illegal and not punishable by law. For instance investing in tax free projects, investing in projects with tax holidays and tax exemptions.

4. **Tax evasion.**

This refers to a deliberate refusal by a tax payer to pay the tax imposed on him and it is illegal. It is illegal and punishable by law.

Reasons why people evade taxes in LDCs.

- ➢ Desire to retain all incomes earned

- Political sabotage where people may want to disown the ruling government
- Reluctance or awareness in the high tax rates
- Unfair tax assessment/high tax rates.
- Discontent of the tax payers about the provision of social services by the government.
- Low income/poverty among people
- Rampant corruption among tax collectors.

5. **Taxable income.**
This refers to the income among tax collectors.

- **Tax impact**

This refers to an individual or a firm on which a tax officially/initially imposed.
Or
It is the initial/first resting place of a tax when it is imposed.
It is where the burden of the tax initially falls. It is the first point of contact of a tax with the tax payer. It is upon tax payers who bear the first responsibility of paying a tax imposed by the fiscal authority.

UNEB 2005
a) Distinguish between incidence of a tax and impact of tax. (02 marks)
b) Give any two demerit of a regressive tax. (02 marks)

- **Tax burden.**

This refers to the loss incurred by the tax payer when the tax is imposed on him in terms of money or goods and services. It can real burden of the tax or money burden of the tax.
Real burden of the tax. This refers to opportunity cost in terms of goods and services forgone by the tax payer to pay the tax assessed on him. The tax payer becomes unable to purchase some goods and services as a result of paying the tax.
Money burden of the tax. It refers to the amount of money that must be given up by the tax payer to pay the tax assessed on him.

- **Tax incidence.**

This refers to the final resting position/place of a tax burden. It refers to a person who finally bears the burden of paying the tax. The incidence of an indirect tax is born by the seller or buyer or both in given proportions depending on price elasticity of demand for the commodity bought or sold.
Determinants of tax incidence.
- Price elasticity of demand for a product on which the tax is imposed.
- Price elasticity of supply of a product on which a tax is imposed.
- Size if income of the customer.

- Size of income of the consumer.
- Nature of the tax imposed.

UNEB 2007

(i) Distinguish between the impact and incidence of tax (02 marks)
(ii) Mention any two effects of taxation in your country. (02 marks)

- **Tax shifting.**

This refers to the ability of the tax payer to transfer part of the whole amount of the tax to another person either forwardly or backwardly. For instance if a tax is imposed on wheat flour, is it paid by the seller, the supply of wheat or the final consumer?

Forward tax shifting. This is where a producer extents or shifts the burden of paying the tax imposed on the product to consumers in form of charging high prices. It involves the producer raising the price of the commodity on which the fiscal authority has imposed a tax.

Backward tax shifting. This is where a producer transfers the burden of paying a tax imposed on product to the suppliers of raw materials/inputs by paying them lower prices for their inputs. It occurs when the producer is able to reduce the purchase price of iputs from suppliers.

- **Tax threshold.**

This is the minimum amount income that is not subject to taxation. It is the tax free income/any income below which it is not supposed to be taxed.

- **Tax holiday.**

This is a specified period of time during which the tax payer does not pay taxes.

- **Tax liability.**

This refers to amount of money which the tax payer is expected to pay in a given period of time.

- **Tax structure.**

This is the composition of tax system either according to mode of payment, nature of taxes and various areas on which taxes are imposed.

- **Taxable capacity of a nation.**

This refers to the ability of the government to realize revenue from tax payers which out causing harmful political, social and economic effects.

UNEB 2002

(i) Distinguish between taxable income and tax base. (02 marks)
(ii) Give any two reasons for the narrow tax base in your country. (02 marks)

CLASSIFICATION OF TAXES.

These are classified according to

- The tax income ratio
- The tax base

Classification of taxes according to tax income ratio.

This is according to ratio of paid tax to the amount of income of the tax payer.

a) Proportional tax.

This is a tax whose rate is uniform/same/constant for all tax payers regardless of the level of income.

This is a tax whose rate remains constant at all levels of income of tax payers. A uniform percentage of a tax is imposed on each tax payer"s income regardless of the size of income. Every tax payer is required to pay the same percentage/proportion of the tax regardless of his income. For example, if 15% is charged, then it means who earn shillings 100,000, shillings 200,000, Shillings 500,000, shillings 1,000,000 will pay the same percentage of the tax. It does not favour low income earners since it increases their tax burden. It is said to be unfair to the poor because they feel the tax burden more than the rich.

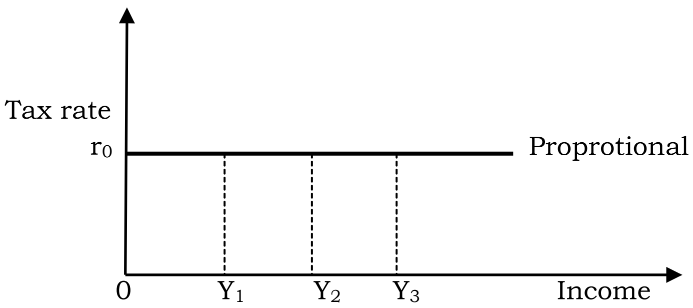


Figure 11.1: A proportional tax

The tax remains the constant regardless of charges in income of the tax payers.

Effects of a proportional tax.

- Easy to understand and calculate.
- Has less impact on work efforts, savings and investment.
- Adversely affects low income earners.
- Encourages income inequality.

b) Progressive tax.

A progressive tax is a tax whose rate increases as the tax payer"s income increases. The proportion of income paid as a tax by rich is higher than that of the poor.

It helps to redistribute income from the rich to the poor. The rich pay a high percentage of their income as a tax than the poor.

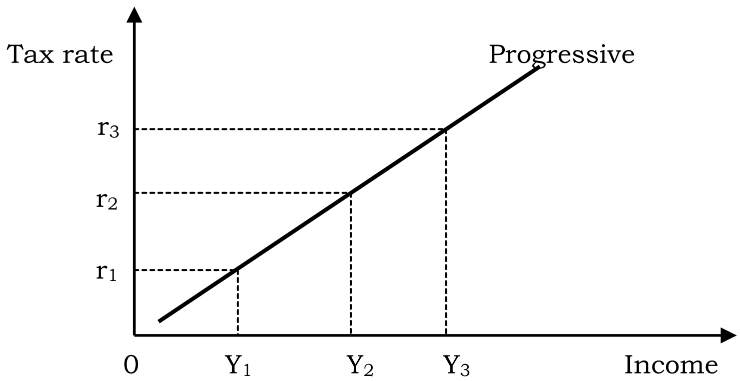


Figure 11.2: A progressive tax

An increase in income of the tax payer from Y_1 up to Y_3 leads to a corresponding increase in the tax rate from r_1 up to r_3

UNEB 2009, 2007, 2006, 2003

(i) Differentiate between a progressive tax and a regressive tax. (02 marks)

(ii) Give two reasons for imposing progressive tax in your country. (02 marks)

Advantages of a progressive tax.

- It aims at reducing income inequality/promotes equitable distribution of income and wealth.
- It yields more tax revenue to the government.
- It favours the poor/low income earners.
- It helps to fight demand –pull inflation.

Disadvantages of a progressive tax.

- It kills the initiatives to work hard.
- It discourages potential producers to produce more/investment is discouraged.
- It limits savings.
- It lowers aggregate demand.
- Causes political resistance.

UNEB 2012

a) Define the term regressive tax. (01 mark)

b) State any three effects of regressive taxes in an economy. (03 marks)

c) **Regressive tax system.**

A regressive tax is a tax whose rate reduces as income of the tax payer increase. It takes a high proportion of income of low income earners than high income earners. It is a tax that represents a small proportion of higher income paid groups than low income groups. Those who get more income suffer less from this tax. However, it hurts the poor more than the rich and those with low income.

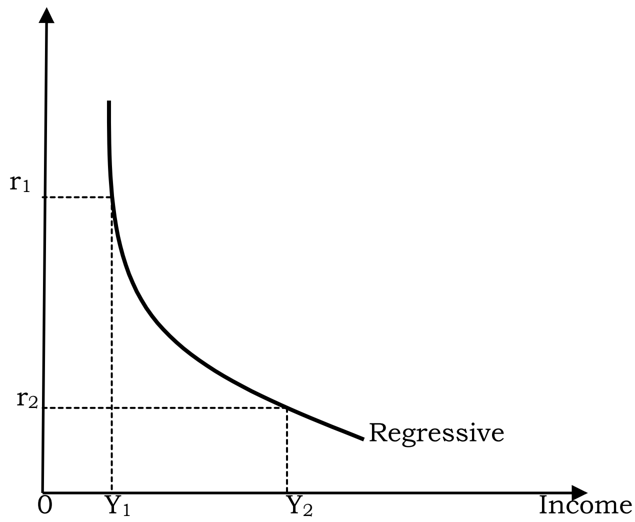


Figure 11.3: A regressive tax

As income of the tax payer increases from Y_1 to Y_2, the tax rate reduces from r_1 to r_2

Advantages/positive effects of a regressive tax.

- It encourages hard work among the poor to become rich and pay less tax.
- It encourages investment through promotion of savings among the rich.
- It attracts large savings from the rich.

Disadvantages/negative effects of a regressive tax.

- It widens income gap between the rich and the poor.
- It leads to social unrest/political discontent therefore it is socially and politically unpopular. This is especially among the poor.
- Low tax revenue is realized due to tax evasion. It increases tax avoidance and evasion among low income earners /the poor.
- Discourages savings and investment among low income earners.
- Leads to poor standard living among low income earners.

d) **Digressive tax.**

A digressive tax is a tax whose rate increase with an increase in income of the tax payer up to a certain level and then remains constant. This is a tax that has a progressive element at lower levels of income and a proportional element at higher levels of income.

It is a tax whose rate first increases with an increase in income of the tax payer and after a given point becomes constant as income of the tax payer increases.

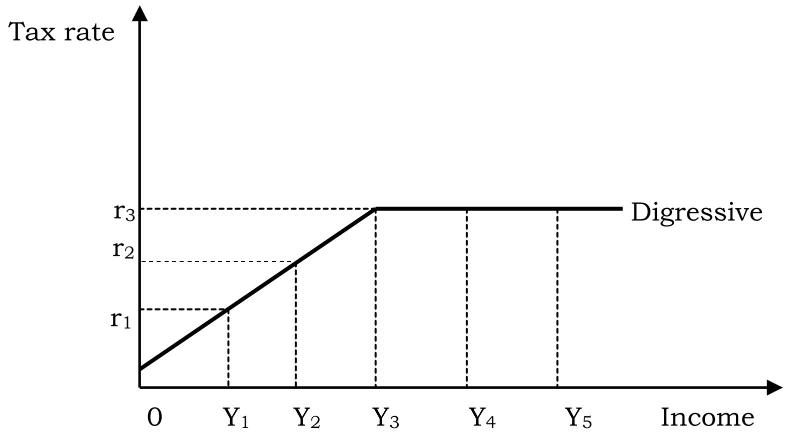


Figure 11.4: A digressive tax

The tax rate first increases with an increase in taxable income but later becomes constant at r_3 as income of the tax payer continues to increase.

CLASSIFICATION OF TAXES ACCORDING TO TAX BASES.

They are divided into two;

- Direct taxes
- Indirect taxes

DIRECT TAXES.

These are taxes levied directly on incomes and property of individuals such that the incidence of the tax rests on the tax payer concerned and cannot be shifted to another person. The tax impact, burden and incidence all fall on the individual or institution on which the tax is imposed. This implies that direct taxes are inescapable and cannot be shifted to the third party.

Examples of direct taxes.

a) ***Income tax.*** This is a tax imposed on individual"s income. For example on salary, wages and dividends.
b) ***Wealth tax.*** This is a tax imposed on individuals on individual"s wealth or property of an individual.
c) ***Corporate/corporation/company tax.*** This is a tax imposed on the profits of a company. It is usually charged as a percentage of profits.

Demerits of a corporation.

- Discourages investment.
- Encourages resentment and opposition to the ruling government.
- Limits ploughing back of capital in business.
- Encourages tax evasion.
- Discourages innovations in production.

UNEB 2006, 2011

(i) Distinguish between capital gains tax and corporation tax. (02 marks)
(ii) Give any two demerits of corporation tax in your country. (02 marks)

d) ***Inheritance or death duty tax.*** This is a tax imposed on who takes over the property of the deceased person. It is meant to redistribute income.

d) ***Income levy tax.*** This a tax imposed when there is a national emergency and there is a need for urgent revenue. For example during natural catastrophes such as earthquakes, floods and drought.

e) ***Graduated tax/head tax.*** This is a tax levied on every mature individual usually men above a certain age.

f) ***Capital gains tax.*** This is a tax levied on gains made by the seller of a certain capital/financial asset whose value has appreciated/increased greatly from the time of purchase to the time of sale.

g) ***Turn over tax.*** This is imposed on the total sales of the business.

h) ***With hold tax.*** This is a tax imposed on dividends and securities such as treasury bills and bonds.

UNEB 2009

a) Distinguish between direct taxes and indirect taxes. (04 marks)

b) Assess the impact of direct taxes on an economy. (16 marks)

POSITIVE IMPACT/EFFECTS OF DIRECT TAXES ON AN ECONOMY.

- ❖ **They increase government revenue.** This helps to finance various projects.
- ❖ **They control monopoly powers.** Direct taxes are sometimes used by the state to reduce profit margins of monopoly firms.
- ❖ **They encourage production/economic growth.** This is through reduced taxation which increases demand hence encouraging more production.
- ❖ **They promote hard work.** People work hard in order to mobilize enough money and be able to pay taxes.
- ❖ **They create awareness/civic responsibility among tax payers.** Direct taxes force the public to demand for service delivery form government as accountability for tax revenue.
- ❖ **They control inflation.** This is through charging progressive taxes which helps to reduce disposable income hence reducing demand pull inflation.
- ❖ **They promote equitable distribution of income.** This is through increasing such taxes on high income earners and low taxes on low income earners.
- ❖ **They influence resource allocation.** Direct taxes are normally increased on earnings from certain activities to direct resources such activities to others where such taxes are low such as the use of corporate taxes.

ADVANTAGES OF DIRECT TAXES IN AN ECONOMY.

- **They promote the principle of certainty.** This is because they are based on canon of certainty because the time of payment and the amount of pay are all known to the tax payer.
- **They are simple to understand by both the tax payer and tax collector.** This increases tax compliance because they are imposed on one"s income and property that can be seen and valued.
- **They are in most cases flexible.** They can be increased or reduced depending on one"s income and prevailing economic situation.
- **They are economical/cheap to collect.** They are easy to collect and administer since they are normally educated directly from people"s salaries and collected by employers on behalf of government.
- **They are convenient to the tax payers.** They are spread over a long period of time by paying in installments through monthly deductions from salaries/incomes and are paid after income has been received.
- **They do not shift the tax burden/incidence to another person.** The impact and the incidence of an indirect tax go to the person whom the tax has been imposed.

DISADVANTAGES/NEGATIVE IMPACT OR EFFECTS OF DIRECT TAXES.

- **They discourage savings.** They are progressive in nature and therefore people will become reluctant to save due to reduced disposable income especially pay as you earn taxes.
- **They discourage investment.** High direct taxes on people"s property reduce the level of profits hence discouraging investment.
- **They discourage people's efforts and incentives to work hard.** People"s willingness to work hard is negatively affected especially where extra earnings are taxed.
- **They are sometimes uneconomical/they involve high cost of collection.** This is especially in rural areas where the tax payers are dispersed which increases government expenditure on tax collection.
- **They reduce people's welfare.** This is because of reduced capacity to buy goods and services especially due to low disposable income.
- **They lead to resource diversion.** They force companies to divert resources from highly taxed activities to non taxed incomes / activities.
- **They cause wage push inflation.** They reduce disposable incomes of workers and force them to demand for high wages thus fuelling cost push inflation.
- **They erode government popularity because they create resentment among people.** high taxes on incomes and property tend to make the ruling government unpopular.
- **They tend to discriminate among tax payers.** High taxes are normally paid by high income earners and those who own a lot of property than the poor.

- ❖ **They widen income inequality.** This is especially where regressive taxes are imposed.

INDIRECT TAXES.

Indirect taxes are taxes levied on goods and services and a person who pays the tax can shift it to another person in form of high prices.
They are therefore taxes on consumption of goods and services and not income. They are paid indirectly as part of the price of the commodity.
The burden of the tax can be shifted to another person depending on the price elasticity of demand and price elasticity of supply.

Examples of indirect taxes.

a) **Excise duty.** This is a tax imposed on locally produced goods whether they are for export or local consumption.
b) **Sales tax.** This is a tax imposed on the sale of commodities. It is normally paid by the person who buys the commodity. In Uganda, it was replaced by VAT.
c) **Customs duty.** This is a tax imposed on either imports or exports. It can either be imports or exports. It can either be import duty or export duty.

UNEB 2000

(i) Define the term import duty. *(02 marks)*
(ii) State any three objectives of imposing import duties in your country. *(03 marks)*

Import duty.

This is a tax imposed on imported goods/commodities. It is imposed for the following reasons;

- ➢ To fight against imported inflation
- ➢ To discourage the importation of harmful and undesirable products
- ➢ To improve on balance of payment position of a country.
- ➢ To protect home infant industries form foreign trade competition.
- ➢ To raise revenue for the government.

Export duty.

This is a tax imposed in exported commodities. It is aimed at raising government revenue, encouraging stability of home prices, discourage exports and imports and satisfy home demand. Customs duty can be charged on either advalorem basis or specific basis.

d) **Advalorem tax.** This is a tax levied according to the value of a commodity. It is charged as the percentage of the value of the commodity.
e) **specific tax.** This is a tax imposed on each unit of output produced. It does not depend on the value of that unit of output produced.

f) **Sumptuary tax.** This is a prohibitive tax imposed on undesirable commodities so as to reduce their consumption. For instance taxes on given brands of alcohol, cigarettes.

g) **Octroi tax.** This is a tax imposed on goods in transit passing through the territory of a country to another. It is intended to pay for services which travelers / businessmen enjoy while crossing over to some territory of a country.

h) **Dead weight tax.** This is a tax which when imposed on import causes that tax payer to abandon the activity which forms the tax base.

i) **Lump sum tax.** This is a tax at a fixed amount irrespective of the level of output produced. It is normally used to control monopoly powers by increasing average cost of production and reducing profit.

j) **Value added tax (VAT).** This is a tax imposed on value added to the commodity as it passes through various stages of production.

Or

This is a tax imposed on net value added to the taxable product by the business enterprises at its various stages of production. The percentage of VAT is in most cases uniform. This tax in Uganda has replaced sales tax and expenditure tax.

UNEB 2002

(i) What is meant by the term value added tax? (01 mark)

(ii) Give any three advantages of value added tax in your country. (03 marks)

Advantages of value added tax.

- It is a more productive source of revenue/has a wider coverage because it is comprehensive and all factors are taxed equally.
- It is very difficult and evade since its distribution is at successive stages of production.
- It promotes efficiency in production especially in keeping books of accounts. This is because, it cannot be computed without proper business records.
- It avoids double taxation.
- It is economical in terms of administration and collection.
- Reduces corruption since its payment is through the bank.

Disadvantages of value added tax.

- The rate of VAT is uniform and it affects small business more adversely than big businesses.
- It is difficult to calculate because it requires proper book keeping among traders.
- It increases cost of production which eventually leads to high prices for final output.

- ❖ It has loopholes as tax payers try to undervalue their commodities.
- ❖ Exposes the secrets of the business
- ❖ Creates opposition from the public to the ruling government.

UNEB 2001

a) Distinguish between tax base and taxable capacity. (04 marks)

b) What are the advantages of relying on indirect taxes? (16 marks)

UNEB 2003

a) Explain the incidence of a tax when supply is elastic and demand is;

(i) Inelastic (04 marks)

(ii) Perfectly elastic (04 marks)

b) What are the advantages of levying indirect taxes? (12marks)

ADVANTAGES OF INDIRECT TAXES.

- ❖ **They are comprehensive enough.** Since every income group purchases, they have a wider coverage since they cover a variety of goods and services. They are therefore the major sources of government revenue since they cover a wider range of economic activities.
- ❖ **They are convenient to pay since they are paid when spending occurs.** They are paid when the commodity is bought or sold. One can only pay them if he wants to buy the commodity.
- ❖ **They have less tax evasion and avoidance.** They are included in the price and can only be evaded and avoided when consumers refuse to buy the taxable commodities. Buying a commodity on which a tax is imposed means paying a tax.
- ❖ **They are less felt and resented.** Individuals cannot easily feel their impact since they are not directly imposed.
- ❖ **They are impartial because they do not discriminate.** i.e. at least every category of people must purchase goods irrespective of how much they earn.
- ❖ **They are more economical in collection.** i.e. they are cheap and easy to collect since they are collected by business intermediaries.
- ❖ **They can redistribute income when selectively imposed.** High taxes on luxurious commodities and low taxes on essential commodities which the poor must purchase helps to redistribute income.
- ❖ **They are flexible or elastic.** They can be adjusted by the government depending on the country"s prevailing economic situation.

DISADVANTAGES/NEGATIVE IMPACT OR EFFECTS OF INDIRECT TAXES.

- ❖ **They widen income inequality.** They are regressive in nature since the poor and the rich have to pay the same amount of tax on commodities thus widened income gap.

- ❖ **They are inflationary in nature** because prices are bound to increase depending on price elasticity of demand or price elasticity of supply for a taxable commodity thus fueling cost inflation.
- ❖ **They have an adverse effect on investment and employment.** This is because they increase prices thus reducing aggregate demand which reduces production and employment.
- ❖ **They lead to misallocation of resources.** Producers shift from production of taxed commodities to non taxed commodities/less taxed commodities.
- ❖ **They undermine the volume and benefits of trade.** This is through high import and export duties which reduce benefits of international trade such as specialization.
- ❖ **They encourage trade malpractices.** Such as smuggling if they are high especially custom duties when importers and exporters try to dodge such taxes.
- ❖ **They lead to reduced consumption leading to reduced welfare.** They force consumers to resort on consumption of inferior goods. This lowers their consumption levels hence reducing their standard of living.
- ❖ **They breed inefficiency in protected firms.** Protected firms from foreign competition through high imported duties tend to remain infant in nature.
- ❖ **Lead to resentment of government/protest among traders and consumers.** They increase hatred to the ruling government form the public as a result of increased taxes especially on consumer goods.

UNEB 2010

a) *Distinguish between tax evasion and tax avoidance. (04 marks)*

b) *Assess the impact of indirect taxes on the economy of your country. (16 marks)*

Positive impact/effects of indirect taxes on the economy of Uganda

- ➢ They influence allocation of resources/level of investment
- ➢ Provide revenue to the government
- ➢ They improve balance of payment position
- ➢ Discourage consumption of demerit goods.
- ➢ Protect infant domestic industries from foreign competition
- ➢ Promote efforts and hard work among the people.

Negative impact/effects of indirect taxes on the economy of Uganda.

- ➢ They undermine reduce volume and benefits of trade
- ➢ Promote trade malpractices such as smuggling
- ➢ Lead to cost push inflation
- ➢ They promote income inequality since they are regressive
- ➢ Lead to reduced consumption hence decline in people‟s welfare
- ➢ They discourage investment
- ➢ Lead to resentment of government/protest among traders.

- Lead to misallocation of resources
- The breed inefficiency in protected firms. Protected firms tend to remain infant in nature.
- They lead to increased cost of production.

PROBLEMS/CHALLENGES FACED BY TAX AUTHORITIES IN LDCS/ UGANDA.

- **Existence of a narrow tax base.** There are limited entities on which taxes are levied due to low investment levels especially in the industrial sector.
- **Shortage of skilled man power to assess, administer and collect taxes.** There are limited qualified and experienced tax assessors and administers hence inability to impose fair taxes and collect them.
- **Low taxable capacity and income.** Majority of the tax payers cannot pay taxes on them and remain with enough income to live a decent standard of living. This is because of wide spread poverty which makes it difficult to determine how much each individual should pay as a tax.
- **Poor/underdeveloped infrastructure** such as poor roads, limited telecommunication facilities to coordinate the collection of taxes especially in rural areas. Tax officials cannot travel to various areas to assess and collect taxes.
- **Wide spread corruption and embezzlement among tax officials.** Tax revenue us misused by those on broad and bribes are offered in the process of assessing taxes. This lowers the tax revenue on the part of government.
- **Ignorance of masses/public about the importance of paying taxes.** Because of high rate of illiteracy, people do not know the role of taxation which reduces the amount of tax collected.
- **Wide spread tax evasion and avoidance.** Many people dodge and avoid taxes by using loop holes in the tax system, give false information about their income. This reduces tax revenue because of weak tax laws.
- **Conflicting government policies on taxation.** This leads to excessive tax holidays and exemptions (tax concessions) given to investors alongside increasing tax revenue. The government gives excessive concessions to investors and this reduces the amount of tax revenue collected and yet there increased need for more tax revenue.
- **Political instability in some areas.** This limits collection of taxes in such areas and besides it discourages investment leading to low tax revenue.
- **Difficulty in identifying taxable sources.** People earn income in different ways which is difficult to tax because of large subsistence sector, informal sector which makes it very hard for tax officials to identify entities on which to impose taxes.
- **Frequent changes in employment and residences.** There are several target workers who change places of work due to increased labour

mobility both geographically and occupationally. This raises costs of tax collection in trying to follow up the tax payers to get regular taxes.

- ❖ **Hostility and resistance from the public against tax payment.** Most tax payers are hostile to tax assessors and collectors especially with the introduction of new taxes thus less tax revenue is realized.
- ❖ **Existence of high level of inflation.** Inflation reduces the value of tax revenue collected overtime and at the same time makes it difficult to carry out fair tax assessment on different activities.

UNEB 2002

a) *Assess the role of taxation in an economy.* *(08 marks)*

b) *Suggest ways of how tax collection can be improved in your country.* *(12 marks)*

MEASURES THAT HAVE BEEN TAKEN TO INCREASE TAX REVENUE COLLECTION IN UGANDA/WAYS THROUGH WHICH THE CURRENT TAX SYSTEM HAS BEEN IMPROVED

- ❖ **Sensitization of masses on the role of taxation/intensive tax education to raise awareness of people about role of taxation.** Masses have been sensitized on the taxation through various channels such as seminars, mass media to increase tax payers‟ compliance thus reducing tax evasion and avoidance thus creating positive attitude towards paying taxes.
- ❖ **Improved infrastructure.** This has been done through upgrading rural roads, improving telecommunication systems to ease tax collection through increased accessibility to different areas which has increased tax collection.
- ❖ **Widened tax base by introducing new taxes.** This has been done by introducing more indirect taxes since they have low administrative costs in order to widen the tax base. For instance VAT introduced in 1996, income tax introduced in 1997.
- ❖ **Ensured proper and effective use of revenue from taxes.** The government has endeavored to provide necessary social and economic services to the public to motivate tax payers to pay taxes promptly since they will be seeing what the tax revenue has done.
- ❖ **Recruitment and training tax personnel/use of trained personnel to asses and collect taxes.** This has been done to enable manpower gain skills in tax administration and collection which increases tax revenue.
- ❖ **Reduced corruption in tax system/Disciplinary measures against corrupt tax officials have been adopted.** Code is adopted to guard against corruption and strengthening procedures for investigating allegations of corruption in tax collection and administration for government to increase tax revenue.
- ❖ **Improved political climate and security to promote economic activity.** This has been done through peace talks with rebels and good

governance to ensure stability of the country politically and encourage various investments, increase the tax base and tax collection.

- **Use f fair tax assessment/principle of equity.** Fair taxation depending on one"s ability to pay the tax has been emphasized. This motivates people to pay taxes and has been done to reduce on tax evasion and avoidance.
- **Improved implementation of tax laws/reforms.** Tax reforms have been implemented and this has helped to increase tax revenue collection.
- **Development of a tax payer friendly system of tax collection.** Tax collectors have been trained to use friendly methods of collecting taxes so as to encourage tax payers to pay taxes willingly. This increases tax payers" compliance.

NB: *there has been establishment of specialized institutions to deal with tax administration and collection such as URA in 1991.*

TAX INCIDENCE ON PRICE ELASTICITY OF DEMAND.

When indirect tax is imposed, supply reduces and therefore, the entire supply curve shifts to the left.

1. When demand is elastic

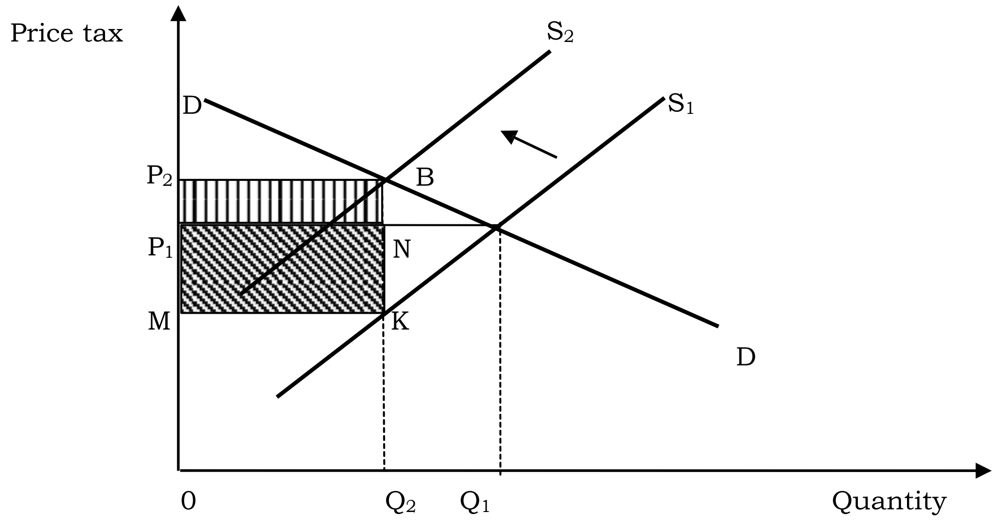


Figure 11.5; tax incidence on elastic demand.

- The vertical distance (KB) between the two supply curves is the total tax per unit of output
- Total tax is given by the area MP_2BK
- The biggest proportion of the tax is paid by the producer i.e. NK or (MP_1NK)
- The smaller burden of the tax is paid by the consumer (BN) or (P_1P_2BN)

UNEB 1999

(i) Distinguish between incidence of a tax and impact of a tax . (02 marks)

(ii) Determine the incidence of tax when demand is price inelastic (02 marks)

2. For inelastic demand.

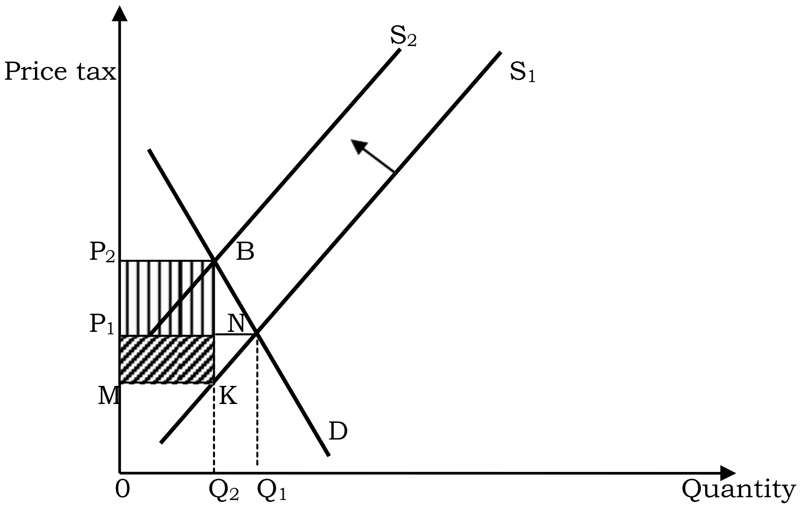


Figure 11.6: tax incidence on inelastic demand

- Total amount of the tax burden is given by the area MP_2BK
- The biggest proportion of the tax burden is paid by the consumer i.e. BN or P_1P_2BN
- The smaller burden of the tax is paid by the producer (NK or MP_1NK)

3. For perfectly elastic demand.

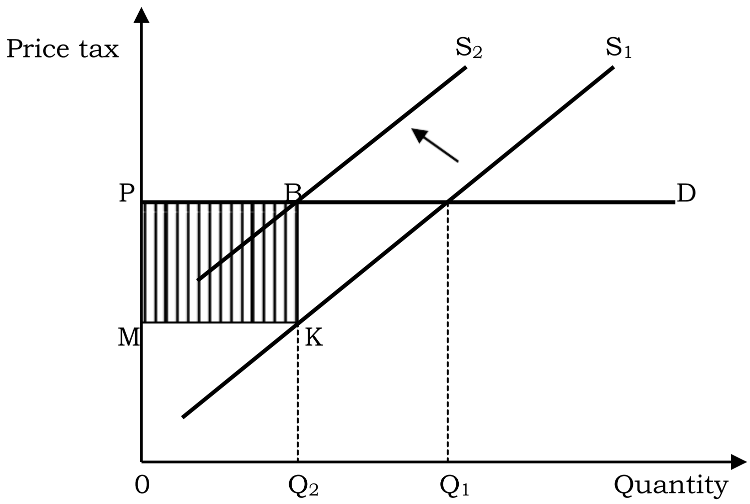


Figure 11.7: Tax incidence on perfectly elastic demand.

- The total tax burden is MPB or KB, which is paid by the producer only.

4. For perfectly inelastic demand.

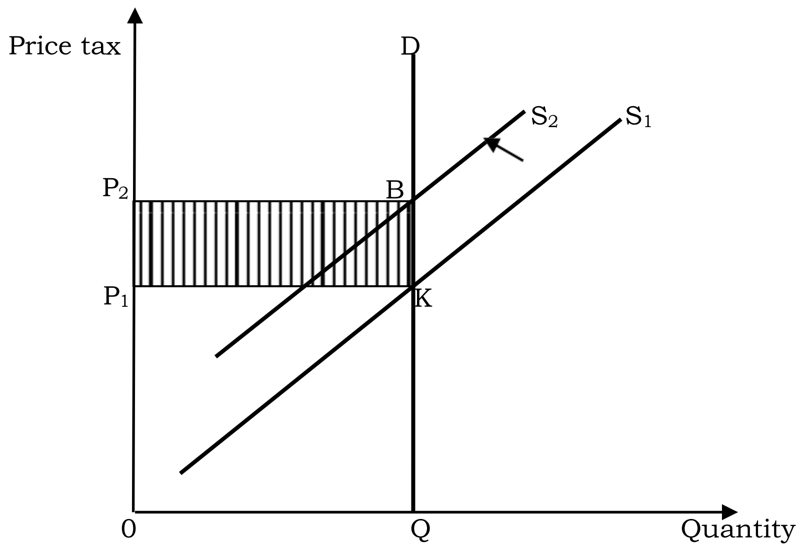


Figure 11.8: tax incidence on perfectly inelastic demand.

- Total tax burden is P_1P_2BK and it is paid by the consumer only

5. For unitary elasticity of demand.

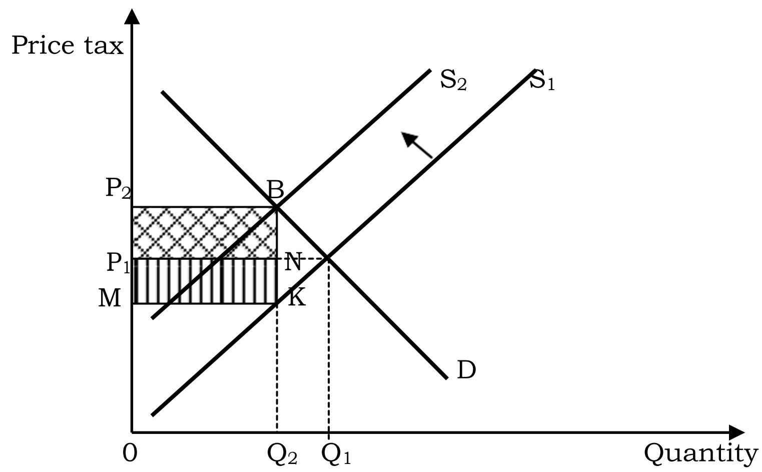


Figure 11.9: Tax incidence on unitary elasticity of demand

- Total tax is MP_2BK which if shared equally by the consumer and the producer i.e. MP1NK for the producer and P_1P_2BN for the consumer ($MP_1NK=P_1P_2BN$)

UNEB 2004

(i) What is meant by the term fiscal policy? *(01 mark)*

(ii) State any three sources of government revenue. *(03 marks)*

FISCAL POLICY.

Fiscal policy is a deliberate policy under which government uses its expenditure and revenue (taxation). It is a deliberate government policy involved in the direction and action through the instrument of taxation and public expenditure to influence the level of economic activities.

UNEB 2005

(i) Distinguish between fiscal policy and monetary policy. (02 marks)
(ii) State any two instruments of fiscal policy in your country. (02 marks)

TOOLS/INSTRUMENTS OF FISCAL POLICY.

- Taxation.
- Public/government expenditure.
- Licensing.
- Subsidization.
- Public borrowing.
- Fines.

UNEB 2011

a) What is meant by the term fiscal policy? (02 marks)
b) Explain the objectives of fiscal policy in an economy. (18 marks)

OBJECTIVES OF FISCAL POLICY IN AN ECONOMY.

- To maintain price stability in the country by controlling inflation through direct taxes to reduce disposable income and reducing government expenditure to reduce the amount of money in circulation thus reducing demand pull inflation.
- To harmonize and improve on investment climate /influence investment levels through favourable taxes and increased subsidies to producers from both local and foreign sources.
- To reduce balanced regional development i.e. increase expenditure on poor regions and fair taxes and reduced expenditure on already developed regions and tax such regions highly.
- To promote high level of employment opportunities through increased expenditure on economic activities such as agriculture, industries and social overheads to create job opportunities, reduced taxes to encourage increased investment to generate more job opportunities.
- To protect local infant industries from foreign competition through high import duties on finished imported products similar to what is produced by such infant industries thus encouraging consumption of locally produced commodities.
- To generate public revenue for both recurrent and capital budget sound taxation system where new taxes are introduced thus increasing government revenue.

- ❖ To ensure equitable distribution of income and resources through progressive taxation on high income earners and increased expenditure on projects that benefit the poor such as education and other social services.
- ❖ To improve Balance of payment position by discouraging given imports through high import duties and encouraging exports through subsidizing exporters.
- ❖ To discourage consumption of harmful / undesirable products through imposing taxes on such products to discourage their production and consumption since they are made very expensive.
- ❖ To influence the rate of economic growth through accelerating both private and public sector investments through tax holidays, tax exemptions to increase the productivity of the country.
- ❖ To control monopoly powers through increased taxation on profits of monopoly firms and subsidization of weak firms to compete with the already existing monopoly firms.
- ❖ To influence resource allocation through tax holidays and tax exemptions and increased government expenditure to investment areas which the government wants to favour.
- ❖ To achieve desirable political objectives through reduction in taxes and increased public expenditure especially on the disadvantaged which is indented to win political support.

PUBLIC BORROWING AND DEBT MANAGEMENT.

Public borrowing. This is a method of raising public revenue through contracting internal and external debts is classified into two;

1. **Internal borrowing.** This is a method raising public revenue by borrowing from citizens of the country and domestic financial institutions.

An internal debt is the total amount of money borrowed by the government from the country"s citizens and domestic financial institution. For instance from the central bank, from rich nationals and commercial banks within the country.

Or

It is the debt which the government owes to the country"s citizens and domestic financial institutions.

INTERNAL DEBTS ARE RAISED THROUGH THE FOLLOWING WAYS.

- ➢ Selling of government securities to the public in form of treasury bills and bonds.
- ➢ Borrowing from the central bank
- ➢ Borrowing from the rich nationals
- ➢ Borrowing from domestic institutions like commercial banks
- ➢ Borrowing from strong firms/companies in the domestic economy.

2. **External borrowing.** This is a method of raising public revenue by acquiring loans from other countries and from external financial and multi-national institutions.

An external debt is the amount of money the government owes to foreign countries and foreign institution /agencies.

Uganda has been with huge external debts since independence. For instance in January 1986 it was 1.4 billion US dollars and in June 2003, it had increased to 3.9 billion US dollars.

The major sources of external debts in Uganda are multi-lateral creditors such as African development Bank, IMF, European Investment Bank, European countries and commercial banks and non banks in foreign economies.

Sources of external borrowing.

- Borrowing from friendly outside countries.
- Borrowing from international financial institutions such as World Bank and IMF.
- Borrowing from multi-national corporations.
- Borrowing from regional cooperations such as EAC, EEU.

CLASSIFICATION OF DEBTS.

1. Public debts

This is a debt/money borrowed by central government, local authorities and public corporations either from internal or external sources.

Or

It refers to the total borrowing both internal and external by the central government, local authorities and public corporations in a country.

Or

It refers to a debt incurred by the central government, local government and public corporations as a result of borrowing from internal or external sources.

2. National debt.

This is a debt incurred by the central government on behalf of its nations either from external or internal sources. It excludes the debts of local authorities and public corporations.

Or

It is the debt that the central government owes its nationals and outsiders/foreigners.

3. Funded debt.

This is a long term debt where the date for repayment is not specified/fixed at the time of securing the debt but the borrower keeps on paying annual interest on the principal.

The borrower keep paying interest but the specific date for paying the principal is not known. The government is not obligated to repay the principal at a specific time but continues to pay interest until it is convenient for it to repay the principal.

4. Unfunded debt.

This is a short term debt where the time of repayment is specified/fixed and well known to both the lender and the borrower at the time of securing the debt. The date for repaying the interest and the principal is known.

5. Floating debt.

This refers to short-term debt by the government obtained from the sale of government securities of treasury bills and bonds.

6. A reproductive debt/self liquidating debt.

This is a debt used to finance productive projects that bring in returns used to pay back the loan i.e. it is a self liquidating debt.

It is a debt borrowed by the government and backed by real assets invested in productive activities which can easily pay back the debt. For example loans borrowed to construct development projects are usually self-liquidating such as power supply projects, purchase of industrial inputs. It represents the amount of money borrowed and spent on productive activities that generate revenue which can be used to repay the interest and the principal.

7. Dead weight debt/non – productive debt.

This is a debt used to finance unproductive activities that do not bring in returns i.e. it is not self liquidating. It is not backed by real assets (invested in non productive activities). For instance buying fire arms, financing elections, debts for organizing, swearing in ceremonies, debts to finance national celebrations, buying firearms.

Money has to be raised from other sources to pay the interest and the principal.

UNEB 2013

(i) Distinguish between a reproductive debt and a dead weight debt. (02marks)

(ii) State any two ways in which a public debt can be redeemed. (02marks)

UNEB 2004

(i) What is a public debt? (01mark)

(ii) Suggest three ways in which an external public debt may be cleared. (03marks)

Ways of clearing an external public debt.

- Creation and use of a sinking fund.
- Debt conversation/borrowing from cheaper sources.
- Use of foreign reserves.
- Disinvestment/sale of investments at home and abroad.
- Taxation.
- Negotiation for debt cancellation/debt relief/waiver.
- Utilizing grants, gifts from foreign sources.

TAXATION FINANCING AND DEBT FINANCING.

Taxation financing

This is where government meets her expenditure through use of revenue from taxation.

Or

It is where the government uses revenue from taxes to finance its expenditure.

Debt financing.

This is where government uses revenue from borrowing to meet her expenditure that may not be covered by tax revenue.

Or

It is where the government borrows to finance its expenditure that may not be covered by tax revenue. It is the government act of fulfilling its expenditure requirements through public borrowing either from internal or external sources.

UNEB 1997

a) Distinguish between dead weight debt and a funded debt. (04 marks)

b) What are the merits and demerits of government borrowing? (16 marks)

MERITS OF DEBT FINANCING/PUBLIC BORROWING AS A MEANS OF RAISING PUBLIC REVENUE

- **Bridges tax deficits/supplements tax revenue.** It helps the government to supplement tax revenue thus increasing funds available for government spending.
- **It is less costly on part of government to raise money.** it is cheap and convenient way of raising public revenue since borrowing does not required a lot of government expenditure.
- **Enables the government to raise quick revenue for national emergence** for instance during natural catastrophes such as floods, where urgent revenue is needed, debt financing becomes efficient.
- **It has less negative effects on consumption which improves people's standard of living.** It does not have direct burden attached and does not affect welfare of people in the short run since it does not reduce disposable income.

- ❖ **It facilitates large scale investments because enough revenue is raised.** Enables the government to finance long term projects and programmes which cannot be financed by taxation because it raises enough revenue by acquiring large sums of money.
- ❖ **Encourages international relationships and political cooperation** through external borrowing. This is between the borrowing country and the donor country thus increased international trade.
- ❖ **It is a tool used to check on demand pull inflation.** Internal borrowing by the government reduces amount of money supply thus reducing demand-pull inflation.
- ❖ **Has limited negative impact on government popularity/has limited opposition from the public.** It is politically popular as means of raising public revenue since it has less resentment from the public compared to taxation which creates resistance from the public against paying taxes.
- ❖ **It is a source of foreign exchange through borrowing from external sources** which helps a country to increase her foreign reserves for development purposes.
- ❖ **Helps to finance balance of payment deficits in the short run.** Borrowed funds are used by the government to clear debts that had accumulated in the past.

DISADVANTAGES OF DEBT FINANCING (BORROWING) AS A MEANS OF RAISING PUBLIC REVENUE.

- ❖ **Increased the problem of external debt servicing.** High capital flight results especially where there are external debts in the process of external debt servicing.
- ❖ **Encourages extravagancy and mismanagement of public resources.** Debt financing leads to increased extravagancy in the use of borrowed funds especially among top politicians who use such funds to live luxuries life since it does not encourage civic responsibility.
- ❖ **Worsens balance of payment problem.** This is especially where there is excessive external borrowing when it comes to repaying thus high foreign exchange expenditure.
- ❖ **Lowers the level of consumption among future generation.** The future generation suffers through paying high taxes to raise enough revenue to clear the debts thus reducing their consumption levels.
- ❖ **Encourages laziness among citizens thus increased external dependence.** This is because nationals remain lazy since they are subjected to high taxes to encourage them work harder.
- ❖ **Borrowed funds are sometimes tied.** Such funds cannot be used to meet the interest of the borrowing country leading to resource misallocation.
- ❖ **Reduces capital accumulation.** This is because the amount of funds that would be used for increased investment is used to clear the debts accumulated in the past.

- **Shifts the burden of repaying the public debt to future generation.** This is because some debts especially due to external borrowing can be contracted for a very long period of over 25 years. This becomes worse especially where the borrowed funds are spent on unproductive ventures such as fighting wars.

UNEB 2004

a) *Distinguish between debt financing and taxation financing..*
(04 marks)

b) *Present the advantages of debt financing over taxation financing.*
(16 marks)

UNEB 2013

a) *Differentiate between taxation financing and debt financing*
(04 marks)

b) *Why may a government rely more on debt financing that taxation financing*
(16 marks)

ADVANTAGES OF DEBT FINANCING OVER TAXATION FINANCING.

- Debt financing does not involve costly methods of collection (it is easier to borrow) compared to taxation financing which is in most cases uneconomical since high costs are incurred in the process.
- Debt financing enables a country to use both local and foreign sources of revenue compared to taxation financing which is only internal and resources raised may not be enough.
- Debt financing helps the government to realize a lump sum of money (large amount of revenue) compared to taxation where revenue comes in slowly and fluctuates.
- Debts financing has limited negative political effects to the government from the public compared to taxation financing which costs the government political popularity.
- Debt financing involves shifting of debt burden to future generation compared to taxation financing where the tax burden is felt by the present generation.
- Debt financing does not discourage production by raising production costs compared to taxation especially high indirect taxes which lead to high production costs and finally inflation.
- Debt financing does not have adverse effects on consumption in the short run since it does not reduce disposable income but taxation financing reduces disposable income and hence low consumption.
- Debt financing increases foreign reserves of the country and encourages foreign investment compared to taxation financing which discourages potential foreign investors.

- Debt financing can be used to fight inflation especially internal borrowing compared to taxation financing which causes cost push inflation.
- Borrowing is a quicker method of raising money than taxation financing.

UNEB 2006

a) Why do countries incur public debts? (06 marks)

b) Explain the methods used to reduce the burden of public debts in your country. (14 marks)

UNEB 2008

(i) Differentiate between a national debt and a public debt. (02 marks)

(ii) Mention any two reasons for incurring a public debt in an economy. (02 marks)

UNEB 2011

(i) What is meant by a public debt? (01 mark)

(ii) Mention any three reasons for raising money through a public debt. (03 marks)

WHY DO COUNTRIES INCUR PUBLIC DEBTS/REASONS FOR RAISING MONEY THROUGH PUBLIC DEBTS

- To repay mature public debts/meet debt repayment obligations (interest rate and the principal).
- To raise more funds currently needed for recurrent expenditure such as paying salaries of civil servants.
- To handle the effects of natural calamities such as floods, earthquakes and land slides.
- To ease the burden of taxation on nationals in the short run
- To fill savings investment gap/to raise more revenue for investment. This helps to finance budgetary deficits which would in turn speed up economic growth.
- To supplement tax revenue especially where the majority are poor.
- To finance short run balance of payment deficits.
- To sustain markets by leaving citizens with enough disposable income.
- To control inflation by reducing amount of money in people"s hands.
- To achieve and maintain a given level of employment.

PROBLEMS ASSOCIATED WITH AN EXTERNAL DEBT/NEGATIVE IMPLICATIONS OF A LARGE PUBLIC DEBT.

- Worsens balance of payment position of a country.
- Encourages wasteful use of resources extravagancy.
- It is a burden to future generation due to increased taxation to pay back.
- It encourages over dependence of country on others.

- Creates a problem of debt servicing.
- It may be inflationary.
- It has high administrative costs.

PUBLIC DEBT MANAGEMENT.

Public debt management refers to the process of acquiring, utilizing, servicing and repaying debts by the central authority, local authority or public corporations.

Or

This refers to the ways and means of how a public debt is administered **i.e.** how it is obtained, controlled, serviced and later on repaid.

It refers to the means undertaken by the government to raise public loans, ways of using the borrowed funds and how to repay the borrowed funds.

- It involves the ways and means of how public debts are administered.
- It involves when to borrow, how to use the borrowed money, where to borrow from and when to pay back.

UNEB 2002, 2010

a) What is meant by public debt management? (01 mark)

b) Mention any three objectives of public debt management. (03 marks)

OBJECTIVES OF PUBLIC DEBT MANAGEMENT.

- To influence the prevailing rate interest.
- To mobilize financial resources.
- To reduce on the debt burden/minimize the cost of public debt.
- To maintain price stability.
- To influence income distribution.
- To ensure proper utilization of funds minimize corruption.

UNEB 2009

(i) Differentiate between a reproductive debt and a dead weight debt. (02 marks)

(ii) Mention any two ways of managing a public debt. (02 marks)

UNEB 2006

a) Why do countries incur public debts? (06 marks)

b) Explain the methods used to reduce the burden of public debt in your country. (14 marks)

WAYS OF PUBLIC DEBT MANAGEMENT/METHODS USED TO REDUCE THE BURDEN OF PUBLIC DEBTS IN AN ECONOMY/WAYS IN WHICH A PUBLIC DEBT CAN BE REDEEMED.

Clearing huge public debts and proper public debt management especially in developing countries had been a major challenge since it involves painful measures.

- **Negotiation for debt cancellation/waiving/relief.** This where the borrower pleads to the lender to cancel part of the whole debt due to inability to pay back. Uganda has had some of her external debts cancelled.
- **Debt rescheduling.** It involves a request from the borrowing country to the lending country to postpone the date for paying back the borrowed money.
- **Disinvestment/privatization of public enterprises.** Government sells state owned enterprises both within and abroad to private individuals to raise money and clear public debts.
- **Debt conversion.** It is a policy of the by borrowing from low interest sources and uses such loans to pay mature debts borrowed from high interest sources.
- **Use of donations, gifts and grants** from other states and multi-national corporations. These help to clear the outstanding public debt.
- **Debt repudiation/outright refusal to pay back the debt.** It is a deliberate government refusal to pay back the debts it owes to creditors. However, this is not a good measure of public debt management because it damages the credit worthiness of the country.
- **Setting up a sinking fund.** It is a policy of the government where it establishes a resource pool per year for clearing the mature public debts. The government successively puts aside a given amount of money year after year to accumulate and pay back the debt.
- **Sale of government securities to the public** such as treasury bills and bonds to accumulate revenue for paying back public debts.
- **Increased taxation/capital levy.** This is where nationals especially the rich are made to pay high taxes so as to raise money to clear the public debt.
- **Use of deficit financing/financial accommodation/borrowing from the central bank.** Government prints more money through the central bank in what we call financial accommodation to clear the public debt.
- **Use of accumulated foreign reserves.** The government uses foreign exchange reserves and gold reserves held by the central bank to repay the borrowed funds.
- **Use of accumulated profits from state owned enterprises.** State owned enterprises at times accumulate some profits which are used to clear the outstanding public debts.
- **Operation of a surplus budget.** The government uses money in excess of its expenditure at the end of a given year to pay back the debt.

NB: public debt burden refers to the cost of contracting public debt on the present or future generation. It may be real public debt burden or money public debt burden.

GOVERNMENT/PUBLIC EXPENDITURE.

This refers to the total amount of money spent by the government on different activities and projects on behalf of the state. It is divided into two;

Recurrent expenditure.

This refers to the day today spending of government aimed at maintaining the existing capacities/projects. For instance expenditure on salaries of civil servants, defence and maintenance of existing infrastructure, periodic contributions to international organizations, paying interest on the national debt, pensions, general public administration.

Or

This is the daily expenditure by the government on the day today running of the state to maintain and finance the already existing projects.

NB: *Over most of the years since 1998, recurrent expenditure in Uganda has been increasing because of increasing number of public servants, increasing size of parliament and cabinet, increasing size of public debt. This expenditure has been in form of servicing vehicles, repaying national debts, paying pensions and salaries of civil servants.*

Development/capital expenditure.

This refers to spending by the government on capital goods/investment projects for the purpose of both expanding the existing capacities and creating new ones to generate more goods and services. For instance expenditure on establishment of infrastructure such as (roads, railways, setting up hospitals and schools) energy projects, mining projects.

It is all about expenditure by the government on short term and long term development projects which will lead to future production of goods and services. It is concerned with increasing the productive capacity of the economy.

Government spends on capital goods, investment projects for the purpose of expanding capacities.

UNEB 2012

a) *Distinguish between government recurrent expenditure and development expenditure. (04 marks)*

b) *Account for the increase in public expenditure in your country. (16marks)*

CAUSES OF INCREASE IN PUBLIC EXPENDITURE IN UGANDA OVER THE YEARS.

- **Increasing public administrative costs.** This is due to increase in public service, creation of new districts, frequent by-elections, large cabinets and size of parliament. All these have led to high government spending.
- **Rising levels of corruption and embezzlement of public funds/rising costs of fighting corruption.** Public officials misuse large sums of public revenue which has been forcing the government to make new

expenditure. There are rising costs of fighting corruption and embezzlement, several corruption scandals have increased the cost corruption through increased expenditure on public accounts committee, office of the inspector general of government and the police.

- **Increasing costs of infrastructure development.** There has been increasing demand for tarmac roads, power supply projects and extension in different parts of the country thus high government expenditure.
- **Rising emergency expenditure due to frequent occurrence of natural calamities.** There has been frequent occurrence of natural calamities such as floods, landslides, epidemic diseases which have led to frequent emergency expenditure.
- **Rising expenditure on defence due to increasing social political unrest in the country.** Defence takes large section of government expenditure and the government has been trying to create political stability country wide and in neighbouring countries thus spending more money.
- **Increasing expenditure on servicing the public debt.** The government has been spending a lot of money on servicing external debts due to increased external borrowing and most of them are non productive.
- **Continuous over ambitious planning.** The government norms drafts over ambitious plans for instance prosperity for all, universal secondary education, vision 2040 which require excessive government expenditure.
- **Rising expenditure on international commitments/engagements.** These include contributions made to various international organizations, peace keeping missions in other countries which increases government spending.
- **Persistent high rate of inflation.** This leads to high costs of project implementation. Inflation in Uganda has been a major macro economic problems which increases the cost of implementing projects since the real value of planned revenue is reduced and requires supplementary expenditure.
- **High population growth rates.** The population has been growing at a high rate per year which increases government expenditure on social services such as education, health facilities , provision of clean water which require high government expenditure.
- **Rising government expenditure on programmes intended to create more income and employment.** for instance youth fund, prosperity for all programmes which require increased government spending.

GOVERNMENT/NATIONAL BUDGET.

A national budget refers to an estimate of expected/planned government revenue and planned government expenditure of a given financial year.

Or

It refers to an estimate of revenue the government expects to raise and how it plans to spend that revenue in a given financial year.

In Uganda, the budget is read to the nation by the finance minister at the beginning of every fiscal year in June. It deals with the policy techniques both fiscal and monetary that are aimed at directing the economy for the coming fiscal year

It is through the national budget that the government highlights the general performance of the economy in the previous fiscal year and the intended course of action in the next fiscal year.

TYPES OF NATIONAL BUDGETS.

a) Balanced/neutral budget.

This is a budget (one) whose planned/expected government revenue is equal to planned government expenditure of a financial year. Such a budget is very rare in most LDCs and may simply be put in place to avoid external borrowing and foreign dependence.

b) Unbalanced budget.

This is a budget (one) which is either surplus where planned government revenue is greater than planned government expenditure of a financial year or a deficit where planned government expenditure is greater than planned government revenue of a financial year.

Or

It is one where there is either a deficit budget or a surplus budget.

Unbalanced budget can be;

a) ***A deficit budget.*** This is a budget (one) whose expected/planned government revenue is less than planned government expenditure of a financial year. It should be noted that many governments use deficit budgets and resort deficit financing.
b) ***A surplus budget.*** This is a budget whose expected/planned government revenue is greater than planned government expenditure of a financial year.
c) ***Recurrent budget.*** This is one which involves estimated daily revenue and estimated daily expenditure of the government.
d) ***Development/capital budget.*** This is one where government planned revenue and planned expenditure is meant for the purpose of development projects. For instance construction of roads.

UNEB 2001, 2007

(i) What is meant by a government budget? *(01 mark)*
(ii) Mention any three objectives f a government. *(03 marks)*

UNEB 2015

(i) What is a national budget? (01 marks)
(ii) Mention any three objectives of a budget in your country.(03 marks)

OBJECTIVES OF GOVERNMENT/NATIONAL BUDGET.

- To raise government revenue for providing social services/infrastructure development.
- To correct Balance of Payment deficits.
- To protect infant domestic industries from foreign competition.
- To reduce income inequalities/Redistribute income.
- Used as a collecting tool during both inflationary and slum periods.
- To increase the rate of economic growth through forces savings which are re-invested.
- To ensure proper allocation of resources.
- To increase employment opportunities and reduce unemployment.
- To discourage production and consumption of undesirable goods.

Advantages of a deficit budget.

- **It helps to reduce unemployment.** Since it stimulated demand which increases investment opportunities thus more job creation.
- **It helps to remove an economy from a depression.** Since it helps to stimulate demand in an economy. This through increased borrowing.
- **Borrowing may be cheaper and quicker.** Therefore, a deficit budget is able to help the government raise money in the shortest possible time through increased borrowing.
- **It is politically acceptable.** This is because through this budget, the citizens are not normally subjected to heavy taxation since it normally implemented through borrowing.
- **It helps to promote large scale investments.** It enables the government to mobilize enough revenue for large scale investments through borrowing.
- **It encourages private savings.** A deficit budget reduces the burden of taxation on tax payers which enables them to save money that would have been used to pay taxes.

UNEB 1998

a) What is meant by unbalanced budget? (04 marks)

b) Why may government deliberately plan for unbalanced budget? (16 marks)

REASONS WHY THE GOVERNMENT MAY OPERATE/PLAN FOR DEFICIT BUDGET.

- To encourage borrowing which may be quicker and cheaper. This attracts foreign aid.
- To win political support of the masses especially towards general elections.
- To avoid negative effects of taxation and increase their disposable income.

- To increase consumption by raising disposable income.
- To raise more funds to encourage investment and growth by increasing government expenditure.
- To stimulate aggregate demand for goods and services.

REASONS WHY THE GOVERNMENT MAY PLAN FOR A SURPLUS BUDGET.

- To enable the government accumulate reserved for future investment especially where there are long term investment plans to be undertaken in future.
- To provide foreign aid to other countries which increases international cooperation and understanding.
- To improve on balance of payment position through reduced importation.
- To gain on government popularity since resources to improve social welfare are available through the budget.
- To prepare for any unexpected problems such as landslides, floods and earthquakes.
- To regulate aggregate demand so that pull inflation is controlled by increasing taxes and reduce money supply.
- To raise more revenue that the required expenditure so as to clear the already contracted public debts.

UNEB 2006, 2003

a) *Distinguish between a surplus and a deficit budget.* *(04 marks)*
b) *How does government finance a deficit budget?* *(16 marks)*

HOW DOES THE GOVERNMENT FINANCE A DEFICIT BUDGET.
(Ways/measures used by the government to finance/close deficits in its budget)

NB: *the government finances a deficit in the budget through / by;*

- **Soliciting for donations and grants.** The government seeks for donations from friendly countries, companies to mobilize revenue and close budgetary deficits.
- **Selling government securities to the public such as treasury bills and bonds.** These securities are said to the public through the central bank which helps the government to raise revenue to finance the budget deficit.
- **Use of a country's foreign reserves/running down foreign reserves.** The government uses all its held foreign currency such as dollars to finance a budget deficit.
- **Printing of more money/borrowing from the central bank.** The central government directs the central bank to print more money into circulation which raises revenue to finance the budget deficit.

- **Levying special taxes such as capital levy.** The government over taxes individuals especially the rich and obtain revenue to close the budget deficit.
- **Borrowing from external sources such as world bank.** The government contracts external loans from friendly countries, international aid agencies and foreign financial institutions to finance a deficit budget.
- **Use of profit/revenue from government commercial ventures.** Government owned businesses make some profits and such revenue is used close a budget deficit.
- **Introducing compulsory saving schemes such as NSSF.** Through government, the public is forced to save part of their income and such savings are used by the government to finance its deficits in the budget.
- **Disinvestment/sale of government enterprises to raise revenue.** The government privatizes its enterprises so as to raise revenue necessary for financing a deficit budget.
- **National lottery/earning a surplus from gambling.** This is effective where the related activities are legalized.

UNEB 2005, 1999

a) Distinguish between a budget surplus and a budget deficit. (04 marks)

b) Explain the significance of a national budget in an economy. (16 marks)

UNEB 2014

(i) Distinguish between a deficit budget and a surplus budget. (02 marks)

(ii) State any two reasons why a country may prepare a deficit budget. (02 marks)

UNEB 2002

a) Why may the government plan for a deficit budget? (04 marks)

b) Explain the role of government budget in an economy. (16 marks)

UNEB 2011

a) Explain the role of the national budget in your country. (08 marks)

b) Account for persistent budget deficits in your country. (12 marks)

ROLE/SIGNIFICANCE OF THE NATIONAL/GOVERNMENT BUDGET.

- **It helps to reduce balance of payment deficit/improve balance of payment position.** Through introducing high import duties especially on expensive imports to reduce foreign exchange expenditure and reducing taxes on exports, increased expenditure on exports to increase foreign exchange earnings.
- **It helps to protect local infant industries from foreign competition.** This is through introducing high taxes on imports competing with locally manufactured goods and increased government expenditure on such industries to increase demand for locally produced goods.
- **It influences proper resource allocation/investment.** This is done by introducing favourable taxes on given activities which the government

wants to promote and allocating more resources to such activities/ according to priority.

- **Helps to mobilize public revenue for providing social services/ essential goods.** Public revenue is mobilized through taxation, forced savings outlined in the budget to establish different forms of infrastructure, provide goods at affordable prices.

  Several forms of infrastructure are outlined in the budget and resources are allocated to develop them.

- **It discourages consumption of harmful/undesirable/demerit goods.** Through the national budget the government introduces high taxes on harmful products which makes them expensive thus reducing their demand.
- **It is used as a correcting tool during inflationary periods/controls inflation.** It controls inflation by introducing high direct taxes on incomes in the budget to reduce aggregate demand and deliberately reducing government expenditure to reduce money supply and attain price stability.
- **Helps in achieving equitable distribution of income.** This is achieved by introducing progressive taxation on the rich, subsidization of the poor on commodities, planning for distribution of projects in different parts of the country and introducing a minimum wage.
- **It helps to create and maintain high level of employment/helps to reduce unemployment.** This is through the use of a deficit budget which leaves people with enough disposable income to consume which increases investment and job creation. In addition, through the budget, high government expenditure is made on infrastructure and economic activities that lead to job creation.
- **It accelerates the rate of economic growth.** this is achieved through increased taxation to encourage forced savings, government expenditure on subsidization of firms and other economic activities that lead to production of more goods and services thus achieving economic growth.
- **It helps to mobilize external resources/foreign aid.** Donor countries and agencies are interested in a well laid down budget for revenue and expenditure. It highlights the rate of economic growth and performance of the economy which gives confidence to donors to finance certain projects.
- **It helps in mobilization of the masses.** Through the budget, the government is able to win political support where certain positive policies are put in the budget to win political support.
- **Helps in management of the public debt.** it is through the budget that various methods of acquiring, utilizing and repaying public debts are outlined.
- **Helps to reduce economic dependence.** Through the budget, various appropriate measures are outlined in the budget to increase domestic production and reduce expenditure on imports and other requirements.

UNEB 2000

a) *Distinguish between recurrent expenditure and capital expenditure in the budget.* *(04 marks)*

b) *Account for persistent budgetary deficits in your country. (16 marks)*

CAUSES OF PERSEISTENT GOVERNMENT BUDGETARY DEFICITIS IN UGANDA.

- **Low taxable capacity.** The ability to pay taxes in Uganda is limited due to poverty thus low taxable income implying limited tax revenue to balance the budget.
- **High corruption and embezzlement of public funds/low levels of accountability.** Increased misuse of funds by government officials leads to loss of funds that would have been used to off budget deficits.
- **Narrow tax base/few tax bases.** There are limited activities and low incomes on which taxes are imposed hence limited tax revenue.
- **Increased cost of infrastructure development.** Such as roads, power supply projects, hospitals, schools which have to be financed. These take a large percentage of government revenue thus budgetary deficits increasing population size increases demand for social services such as education through UPE, USE and university scholarship thus high government expenditure.
- **High military expenditure due to political instability.** This is not productive and does not bring in returns, increases government expenditure on maintenance of security organs, buying military hardware.
- **Persistent debt servicing and repayment of the principal.** Huge external debts normally take part of revenue that would have been used to finance domestic activities which reduces to be used for public expenditure thus budgetary deficits.
- **Limited non-tax sources of public revenue.** There are very few non-tax sources of government revenue such as fees, licenses and fines thus low government revenue.
- **High cost of public administration/civil servants and politicians.** There is high expenditure on politicians, civil servants due to creation of many districts, large cabinet thus high recurrent expenditure. Uganda has one of the biggest cabinets and many parliamentarians in Africa thus budgetary deficits.
- **Weak tax administration.** This leads to low government tax revenue due to high rates of tax evasion, tax avoidance leading to budgetary deficits.
- **Increased importation of expensive goods especially capital machinery.** This leads to high government expenditure abroad compared to revenue from abroad.

- **Frequent occurrence of natural disasters.** This is due to increased occurrence of floods, drought, landslides which normally calls for heavy emergence funding leading to increased government expenditure thus budgetary deficits.
- **Over ambitious planning.** Over generalized plans required a lot of money of implement leading to high government expenditure.
- **Heavy expenditure on international/external commitments.** For instance contributions to international organizations leading to high government expenditure.

Chapter 12: INTERNATIONAL TRADE.

International trade refers to the exchange of goods and services between different countries. International trade is divided into two;

- **Bi-lateral trade.** This is the exchange of goods and services between only two countries.
- **Multi-lateral trade.** This is the exchange of goods and services among more than two countries. Modern economies carry out international trade on multi-lateral basis.

Visible trade; This refers to trade transactions carried out in intangible items/services. For instance trade in coffee, cotton, rice, clothes, drugs, fish and cattle hides.

Invisible trade; this refers to trade transactions carried out in intangible items/services. For instance trade in insurance services, hotel and lodging services , banking services, legal services and security services, consultancy services.

NEED FOR INTERNATIONAL TRADE/FACTORS GIVING RISE TO INTERNATIONAL TRADE.

- **Differences in natural resource endowments.** Different countries have different natural resources such as minerals, forests, water bodies and they are not transferable from one country to another unless international trade takes place.
- **Need to acquire necessary technology.** A country can acquire machinery in agriculture, machinery in industries through international trade.
- **Need to acquire skills and experienced man power.** LDCs are able to acquire expatriates to run their key sectors through international trade.
- **Need to dispose of surplus output.** Production of excess output which cannot be absorbed by the domestic market is disposed off to other economies through international trade. For instance Uganda produces excess coffee which finds market in other countries.
- **Need to acquire revenue for national development.** This is through charging export and import duties.
- **Need to minimize production costs/comparative advantage argument.** A country may find it cheaper to consume imported commodities than producing them domestically. Production of one commodity in one country may be at a low cost than in another country.
- **Need to acquire foreign exchange.** Some countries trade with others because they want to acquire foreign currency essential for economic development.
- **Need to acquire cooperant factors of production.** A country may get involved in international trade in order to acquire vital missing cooperant factors of production to exploit the existing natural resources such as attracting foreign entrepreneurs.

UNEB 2010

a) *What is meant by "vent for surplus theory" as used in international trade? (04 marks)*

b) *Assess the role of international trade in the development of your country. (16 marks)*

ADVANTAGES OF INTERNATIONAL TRADE.

- **Enables a country to get what it does not produce.** Due to limited technology, man power and other essential resources, a country cannot produce all its requirements which are obtained through international trade and this improves general welfare of nationals.
- **Enables a country to dispose off surplus output.** Output which could have been wasted due to limited market at home is disposed off to other countries.
- **Provides a variety of goods.** A variety of both consumer and non consumer goods are obtained through international trade thus increasing consumers" choice.
- **Promotes efficiency of domestic firms due to competition.** Importation of foreign goods forces home industries to become more efficient thus improved quality output on the market and exportation involves adding value to exports to meet standards of foreign market.
- **Promotes infrastructural development.** Infrastructure such as roads, pipeline, railways and airports are improved to coordinate international trade.
- **Leads to increased utilization of resources.** This is through the vent for surplus advantage of international trade because of widened market for output.
- **Promotes international friendship and cooperation.** It strengthens political and economic ties between participating countries and this opens room for diplomatic missions between countries and increased trade.
- **Increases employment opportunities.** This arises from the expansion of import and export sectors.
- **Generates government tax revenue.** Government obtains revenue through imposing import and export duties which is necessary for public expenditure.
- **Promotes international specialization and its benefits.** Countries have different abilities in performing different activities and a country specializes in operations where output is maximized and where costs are minimized on the basis of comparative advantage.
- **Enables a country to acquire skilled labour from countries.** It facilitates movement of highly skilled labour from one country to another to engage in trade opportunities and working in key sectors as expatriates.

- **Enables a country to acquire new ideas and values.** This is a foundation of social change since it disseminates new ideas worldwide.
- **Promotes technological transfer/development.** This increases the level of production.
- **Increases output hence economic growth.** This results from a need to produce for a wide foreign market.
- **Increased quality of output due to competition.** This improves standard of living among the population.
- **Enables a country to get supplies in times of emergences/supplements domestic output.** During emergencies in the domestic economy, commodities are imported to supplement the available limited output.
- **Promotes capital inflow.** This is important for increased domestic production due to very many foreigners attracted in trade and foreign exchange acquired from export.

VENT FOR SURPLUS.

Vent for surplus refers to a situation where international trade provides an opportunity for countries to utilize the formerly idle resources to produce surplus output for export markets.

NB. vent for surplus theory as *used in international trade states that international trade provides an opportunity for countries to utilize the formerly idle resources to produce surplus output for export markets.*

DISADVANTAGES OF INTERNATIONAL TRADE.

- **Leads to imported inflation.** There are chances of importing commodities from inflation prone economics thus negative effects if inflation in an economy.
- **Leads to importation of harmful/undesirable goods.** Undesirable commodities such as expired drugs, expired food stuffs, pornographic magazines and films which are socially undesirable are likely to be imported especially where there are weak trade restrictions thus reducing welfare.
- **Leads to over exploitation of domestic resources.** This happens especially where exports are highly demanded and marketable thus quick depletion of non renewable resources.
- **Worsens balance of payment problems in LDCs.** Developing countries get less foreign exchange earnings on exports and yet there is increased foreign exchange expenditure on imports.
- **Leads to collapse of domestic infant industries due to foreign competition.** International trade leads to increased importation of gods similar to what infant industries produce thus out competing such firms.

- **Leads to dumping and its negative effects.** International trade opens up a ground for dumping and this usually suffocates the growth of domestic infant industries where goods are dumped.
- **Retards the development of local skills.** International trade avails a country with most is its requirements, thus limited domestic production and skill acquisition. This kills the country"s local creativity and innovativeness.
- **Increases external economic dependence/reduces self sufficiency.** This reduces the level of self reliance due to increased dependence on imports.
- **Leads to poor terms of trade.** This is due to low prices of exports of LDCs compared to highly priced imports form developed countries.
- **Leads to cultural erosion.** This results from importation of socially undesirable commodities such as pornographic magazines, copying eating and dressing styles from foreigners which are socially undesirable.

BEGGAR MY NEIGHBOUR POLICY.

Beggar my neighbor policy is a government measure adopted by a country to benefit her own economy but which negatively affects her trading partners that adopt counter to retaliate.

Or

It refers to an economic measure adopted by a country to improve its economic situation but has negative effects on her trading partners and trading partners adopt counter policies to retaliate.

THE PRINCIPLE OF ABSOLUTE ADVANTAGE (BY ADAM SMITH).

The principle of absolute advantages states that given two countries and two commodities, one country can produce both commodities more cheaply than another country using the same amount of resources.

Absolute advantage is the ability of a country to produce a commodity more efficiently than another country. Given two countries and the same amount of resources (labour), a country which produces more output or quantity than another at less input costs is said to have absolute advantage in production of those commodities.

For example, given equal units of labour and two countries producing coffee and rice, state the country with absolute advantage in production of both commodities.

Country	Coffee (Tonnes)	Rice (Tonnes)
Uganda	20	30
Kenya	15	25

Table 12.1: Principle of absolute advantage

Using the same units of labour, Uganda produces 20 tonnes of coffee and 30 tonnes of rice which means that it has an absolute advantage over Kenya in the production of both commodities.
Therefore, Uganda produces both coffee and rice more efficiently (at less input costs) than Kenya.

UNEB 2003

a) *Differentiate between trade creation and trade diversion.* *(04 marks)*
b) *To what extent is the comparative cost theory applicable to developing countries?* *(16 marks)*

UNEB 1999

a) *Distinguish between the principle of comparative advantage and absolute advantage in international trade. (04 marks)*
b) *What are the limitations of the principle of comparative advantage? (16marks)*

LAW OF COMPARATIVE COST ADVANTAGE (BY RICARDO DAVID).

The law of comparative advantage states that given two countries, two commodities and same amount of resources, a country should specialize in producing a commodity where it has/incurs the least opportunity cost than the other country.

$$\text{Opportunity cost} = \frac{\textit{Alternative foregone}}{\textit{Actual output (alternative undertaken)}}$$

A country has a comparative advantage in that product for which it has a lower domestic opportunity cost ratio than its competitor.
Even if a country is better off in the production of two commodities, it pays more than if that country specializes in the production of a commodity in which it incurs the least opportunity cost.
That"s why a country may decide to import a commodity than producing it locally because it may be cheaper to import such a commodity than producing it locally.

Country	**Coffee (Tonnes)**	**Rice (Tonnes)**
Tanzania	40	10
Kenya	20	8

Table 12.2: Law of comparative cost advantage.

Tanzania has absolute advantage in the production of both commodities over Kenya. However it may not have comparative advantage in production of both commodities over Kenya. This implies that there is a need to calculate opportunity cost rations to find out in which commodity should each country specialize.

For Tanzania to produce 40 tonnes of coffee, it forgoes 10 tonnes of rice, therefore to produce one tone of coffee, Tanzania foregoes $\frac{10}{40}$ = 0.25 tonnes of rice

For Kenya to produce 20 tonnes of coffee, it forgoes 8 tonnes of rice, therefore to produce one tone of coffee, it forgoes $\frac{8}{20}$ = 0.4 tonnes of rice.

Therefore, Tanzania has comparative advantage in production of coffee over Kenya because it foregoes less tones of rice (0.25) compared to Kenya which foregoes 0.4 foregoes 0.4 tonnes of rice.

For Tanzania to produce 10 tonnes of rice, it has to forego 40 tonnes of coffee, therefore to produce one tone of rice it foregoes $\frac{40}{10}$ = 4 tonnes of coffee

For Kenya to produce 8 tonnes of rice, it has to forego 20 tonnes of coffee, therefore to produce one tonne of rice, it foregoes $\frac{20}{8}$ = 2.5 tonnes of coffee.

Therefore, Kenya should specialize in the production of rice because it has the least opportunity cost of 2.5 tonnes of coffee compared to Tanzania with 4 tonnes of coffee.

Examinable question

Given same units of labour and two countries, study the table below and answer the questions that follow.

Country	**Commodities**	
	Generators	**Coffee**
A	400	600
B	100	300

Table 12.3: law of comparative cost advantage.

a) State the country with absolute advantage in production of both commodities.

Country A has absolute advantage in the production of both commodities because it produced more output than country B.

b) Calculate the opportunity cost of producing each commodity in each country.

Opportunity cost for commodity A

400 generators = 600 coffee

Therefore, 1 generator = $\frac{600}{400}$ = 1.5 coffee i.e. 1 generator = 1.5 coffee

600 coffee = 400

Therefore, 1 coffee = $\frac{400}{600}$ = 0.67 generators i.e. 1 coffee = 0.67 generators

Opportunity cost for commodity B

100 generators = 300 coffee

Therefore, 1 generator = $\frac{300}{100}$ = 3 coffee i.e. 1 generator = 3 coffee

300 coffee = 100

Therefore, 1 coffee = $\frac{100}{300}$ = 0.33 generators i.e. 1 coffee = 0.33 generators

c) ***In which commodity should each country should each country specialize?***

Country A should specialize in production of generators while country B should specialize in production of coffee

UNEB 2009, 2002, 2011

a) *Distinguish between comparative advantage and absolute advantage as used in international trade.* *(02 marks)*

b) *State any two assumptions underlying the principle of comparative advantage.* *(02marks)*

ASSUMPTION OF THE LAW OF COMPARATIVE ADVANTAGE.

- Assumes only two countries. For instance Uganda and Kenya
- Assumes only two commodities produced and exchanged between two countries.
- Factors of production/units of labour are assumed to be homogenous and perfectly efficient.
- There are no transport costs incurred in the exchange of commodities between countries.
- There is perfect mobility of factors of production (labour) within a country/internally and perfect immobility of factors of production (labour) externally.
- Assumes the existence of barter trade system.
- Assumes full employment level of resources in both countries.
- Technology is assumed constant in both countries.
- Assumes similar and constant tastes and preferences among the two countries.
- Assumes constant returns to scale/the law of diminishing returns does not operate.
- Demand is assumed to be elastic.

RELEVANCE/APPLICABILITY OF THE PRINCIPLE OF COMPARATIVE ADVANTAGE IN DEVELOPING COUNTRIES.

To a smaller extent the principle of comparative advantage is relevant to developing countries.

- Developing countries import manufactured goods such as machinery, drugs, vehicles, computers, phones where they have a lesser comparative advantage which makes the law applicable.
- There are some cases of mobility of factors production internally (within individual countries) in developing countries which makes the law applicable.
- There are some areas of free trade especially where there is economic integration in developing countries. This is normally used for various reasons such as expanding market.
- In many developing countries, labour intensive techniques of production are used because of abundance of cheap labour and the theory talks about labour as the major input in production implying that to some extent technology has remained constant.
- There exists some areas of barter trade arrangements in some developing countries and the theory talks about trade to be carried out in barter trade.
- Most developing countries have tended to specialize/concentrate on agricultural products such as cotton, coffee, cocoa and tea where they have the lowest opportunity cost which makes the law applicable.

IRRELEVANCE/LIMITATIONS/CRITCISMS OF THE COMPARATIVE ADVANTAGE IN LDCs.

To a larger extent, the principle of comparative advantage is irrelevant to developing countries.

- The theory assumes only two countries yet modern international trade involves many countries, therefore it is based on what does not exist in real life.
- The theory assumes conditions of full employment yet such conditions do not exist in developing countries because it is difficult to achieve full employment in LDCs.
- It does not favour developing countries because it makes them more poorer since they specialize in primary products that attract low prices and yet MDCs specialize in manufactured products with high prices.
- It is unrealistic to assume only two commodities produced and exchanged between countries, yet there are various commodities exchanged between countries.
- The theory assumes of free trade which is unrealistic yet in actual sense there are various trade restrictions such as quotas, total ban in international trade, therefore free world trade does not exist in reality.
- It does not take into account changes in technology implying that the role of technological improvement in decreasing the cost of goods and

increasing their supply in the long run. This occurs in developing countries.

- ❖ It does not take in account transport costs between two countries yet long distances are involved in which cause differences in costs of transport.
- ❖ It wrongly assumes that all factors of production/labour are equally homogenous and efficient and yet it is very difficult to find such a situation. Labour differs in skills and experience.
- ❖ Assumes perfect mobility of factors of production within a country which is not possible, because they tend to be immobile for some reasons and even of factors of production can be international.
- ❖ It assumes barter trade and yet barter trade has become out dated since exchange of goods is monetary.
- ❖ It does not take into account the need for self reliance and diversification by countries which tend to disagree with specialization yet modern countries aim at self reliance to reduce dangers of economic dependence.
- ❖ Ignores existence of diminishing returns since it assumes constant returns which is unrealistic because diminishing returns cannot be avoided in production and this is likely to reduce output.
- ❖ Assumes that demand is elastic and yet demand for agricultural products in developing countries is inelastic.
- ❖ It ignores the possibility of absolute cost advantage (comparative advantage in production of both commodities) which limits specialization and exchange between countries.

UNEB 2004

a) *Given same units of labour, two countries, study the table below and answer the questions that follow.*

Country	*Commodities*	
	Generators	*Coffee*
A	*400*	*600*
B	*100*	*300*

a) *(i) State the country with absolute advantage in production of both commodities. (01 mark)*

(iii) Calculate the opportunity cost of producing commodity in each country (04 marks)

b) *In which commodity should each country specialize? (01 marks)*

c) *What are the limitations of comparative cost advantage theory in international trade? (14 marks)*

UNEB 2000

(i) What is meant by terms of trade? (01mark)

(ii) State any three reasons why the terms of trade of developing countries are deteriorating. (03 marks)

TERMS OF TRADE.

Terms of trade refers to the ratio of price index of exports to the price index of imports of a country.

Or

It is the relationship between the price index of a country"s exports and the price index of her imports.

Or

It refers to the rate at which a country"s exports are exchanged for imports. Both imports and exports should be valued in the same currency whose value does not fluctuate frequently.

$$\text{Terms of Trade} = \frac{\textit{Index of export prices}}{\textit{Index of import prices}} \times 100$$

- If the ratio is equal to 100, then the price index of exports = price index of imports.
- If the ratio is greater than 100, it means favourable terms of trade.
- If the ratio is less than 100, it means unfavourable terms of trade.
- When terms of trade are increasing i.e. 100, 120, 130, 140, 150, 160, 170, ………. The country is said to be enjoying improving terms of trade.
- If terms of trade are declining i.e. 90, 80, 75, 60, 55, 45 ………then such a country will be experiencing deteriorating terms of trade. This is when terms of trade become unfavourable year after year.

Unfavourable terms of trade.

This is a situation where price index of exports is relatively lower than the price index of imports of a country.

Favourable terms of trade.

This is a situation where the price index of exports is relatively higher than the price index of imports of a country.

Examinable question

Given 85 as a country's export unit value index and 120 as its import unit value index

(i) Calculate the terms of trade of such a country.

$$\text{TOT} = \frac{\text{Price of exports}}{\text{Price of imports}} \times 100$$

$$\text{TOT} = \frac{85}{120} \times 100$$

$$= 70.8$$

(ii) Comment on the state of terms of trade of such a country.

The terms of trade are unfavourable because it if less than 100

UNEB 2001

(i) Distinguish between barter terms of trade and income terms of trade. (02 marks)

(ii) State any two cause of unfavourable terms of trade in your country. (02 marks)

Terms of trade are two forms i.e.

- **Barter/commodity terms of trade;** this refers to the rate at which a country‟s exports are exchanged for imports. This shows the actual quantity of imports a country can purchase using a given volume of exports.

It measures the purchasing power of a unit of exports in terms of imports of a country. For instance how many sacks of Ugandan coffee in order to acquire one tractor from USA.

$$\text{Barter Terms of Trade} = \frac{\text{Price of a unit of exports } (\text{price index of exports})/ PX}{\text{Price of a unit of imports } (\text{Price Index of imports}) / PM}$$

If the ratio is greater than one, it means that one unit of exports buy more than one unit of imports hence favourable terms of trade
If the ratio is less than one, it means that one unit of exports cannot but one unit of imports hence unfavourable terms of trade.

- **Income terms of trade;** this is defined as the ratio of the value of exports to the price index of imports of a country. It shows the capacity of a county to import out of export earnings/income. It shows how much a country can import using from exports.

$$\textbf{Income terms of trade} = \frac{\text{Value of exports } (PXQX)}{\text{Price Index of Imports } (PM)}$$

Where;
PX = price of exports, QX = Quantity of exports, PM = Price of imports

UNEB 2007

a) Account for the existence of unfavourable terms of trade in your country. (10 marks)

b) Suggest measures that should be taken to correct unfavourable terms of trade in your country. (10 marks)

REASONS WHY TERMS OF TRADE ARE DETERIORATING IN LDCs/CAUSES OF UNFAVOURABLE TERMS OF TRADE IN DEVELOING COUNTRIES.

The causes of unfavourable terms of trade in developing countries originate form factors that lead to low export prices and high import prices. Many developing countries experience such economic problem.

NB: *explanation should show the element of falling / low price of exports and rising / high prices of imports.*

- **Exportation of semi-processed/primary products.** Which are agricultural and mineral products such as coffee, cotton and minerals which do not command high prices on the world market implying low export prices compared to highly priced from developed countries.
- **Importation of expensive manufactured capital and consumer goods.** These include machinery, vehicles, equipment, drugs which command high import prices yet prices of exports remain low.
- **Increased competition of exports with synthetic fibres/artificial substitutes by MDCs.** There is stiff competition with synthetic fibres on the world market/substitution of LDCs products with artificial fibres such as nylon, silk, plastic by developed countries. This reduces demand for natural fibres such as sisal, raw wool and natural rubber thus low export prices compared to high prices of imports.
- **Market flooding of raw material products on the international markets.** Almost all LDCs produce similar agricultural primary products which leads to competition and high supply on the world market thus low export prices yet prices of imports remain high.
- **Protectionist policies of developed countries against LDCs' products.** Developed countries use trade barriers such as tariffs, sanitary ad hygiene requirements, total ban, and import quotas thus low export prices export prices yet compared to high prices of imports.
- **Weak bargaining power on the world market.** Because of weak agricultural commodity agreements and weak regional groupings, LDCs cannot bargain effectively for higher export prices yet prices of their imports remain high.
- **Discovery of raw material saving techniques by developed countries.** High technology by MDCs enables them to discover raw material saving innovations in production (using little raw material as possible to increase output) thus less demand for primary products and low export prices yet import prices remain high.
- **Low quality exports.** These exports cannot compete favourably on the world market and attract low prices compared to highly priced products from developed countries.
- **Low income elasticity of demand for exports.** Most of the exports of developing countries are agricultural products especially food items, even if world income, demand for primary products does not increase as fast instead the increasing proportion of income is spent on

manufactured goods thus low price for exports yet prices of imports remain high.

- **Falling prices of exports.** This is due to their low demand abroad which leads to their low prices compared to highly priced imports.
- **Unfavourable exchange rates between LDCs and MDCs.** There is depreciation of currencies of LDCs and this makes developing countries to be in a poor position to negotiate for a high return from their exports leading to low export prices but makes imports relatively expensive leading to high import prices.
- **Increasing prices of imports.** i.e. increasing prices of oil petroleum products leading to reduce production and volume of exports thus low export prices and high import prices.

MEASURES TO IMPROVE TERMS OF TRADE IN DEVELOPING COUNTRIES/UGANDA

NB: *These measures should aim of either increasing export prices or reducing import prices.*

- **Establish import substitution industries** to produce the formerly imported expensive commodities. This helps to reduce reliance on imports which are highly priced hence reduced import prices.
- **Strengthen commodity agreements.** This is meant to increase bargaining power through formation of price fixing agreements so as to help in coordinating supply and marketing of products to increase export prices.
- **Processing primary exports to add value on exports.** Value addition on exports increase export prices and reduces dependence on primary products.
- **Imposition of trade restrictions on imports.** LDCs should impose trade barriers such as import quotas, total ban on the importation of expensive capital and luxuries commodities to reduce import prices.
- **Negotiating for removal of trade barriers in export markets.** This is done in order to avoid high tariffs and quotas imposed by MDCs which increases demand and export prices. For instance USA opened her market for Africa through Africa growth Opportunity Act, this increases export prices.
- **Diversifying products for export.** This can be done through producing a variety of manufactured products and diversifying agriculture instead of depending on a few export crops so as to increase export prices.
- **Diversifying of export markets.** Through strengthening economic integration so as expand export market leading to high export prices.
- **Encourage use of barter trade arrangements** which does not involve the use of currencies as a medium of exchange.
- **Encourage importation of goods from cheaper sources.** This leads to low import prices for instance from newly industrialization economies.

- **Improving the quality of exports.** This should be done through improving methods of production in order to increase export prices.

UNEB 2001

Mention any four effects of deteriorating terms of trade in your country. (04 marks)

EFFECTS OF DETERIORATING/UNFAVOURABLE TERMS OF TRADE IN LDCs.

- Leads to scarcity of basic inputs into the manufacturing sector because of limited foreign exchange to import.
- Contributes to debt crisis because LDCs earn less from exports hence heavy dependence on foreign aid.
- Leads to low incomes for peasant farmers.
- Hampers economic growth.
- Makes government planning difficult.
- Reduces the level of importation.
- Increases the level of dependence on developed countries.
- Reduces investment levels.
- Worsens balance of payment deficit.
- Leads to foreign exchange shortages.
- Results into currency depreciation as prices of exports continue to be low.
- Increases unemployment since the export sector cannot be expanded.

BALANCE OF PAYMENTS.

Balance of payments is a relationship between the country‟s transactions with the rest of the world in export and import of goods and services as well as capital flows for a given period.

Or

It is the difference between a country‟s receipts/earnings from abroad and its expenditure abroad during a given time.

Or

It is a difference between receipts from both visible and invisible exports and payments for both visible and invisible imports of a country, it includes capital inflows and outflows for a given period of time. Balance of payments is a difference between the country‟s foreign exchange earnings and her foreign exchange expenditure in a given period of time.

If a country‟s foreign exchange expenditure exceeds foreign exchange earnings, such a country is a said to be experiencing unfavourbale balance of payment/BOP deficit.

However, it a country"s foreign exchange earnings are greater than foreign exchange expenditure, then such a country is said to be experiencing favourable balance of payment / BOP surplus.

UNEB 2010

a) *Differentiate between balance of trade and terms of trade (02 marks)*

b) *Suggest any two ways of improving terms of trade in your country. (02 marks)*

COMPONENTS OF BALANCE OF PAYMENT ACCOUNT/STRUCTURE OF BALANCE OF PAYMENT ACCOUNT.

1. **Current account**

This is a summary of all transaction of a country involving the exchange of goods and services with other countries (both visible and invisible trade). It is of two forms i.e.

a) ***Visible trade account;*** this shows the record all receipts from abroad on export of goods and all expenditure abroad on import of goods. When these are compared, this is called balance of trade

Balance of trade refers to the difference between the value of visible exports and value of visible of imports of a country.

When the value of visible exports exceeds the value of visible imports, it is called
favourable balance of trade.

When the value of visible imports exceeds the value of visible exports, it is called unfavourable balance of trade.

When the value of visible exports is equal to the value of visible imports, it is called balance of trade equilibrium.

b) ***Invisble trade account;*** this shows the record of all earnings from intangible exports rendered abroad and expenditure on intangible imports. These services may include banking, insurance, hotel and lodging , travel and shipping, tourism.

2. **Capital account**

This is a record of all transactions arising from capital inflows and outflows. For instance purchase of stock, bonds, treasury bills in another country, repayment of foreign loans, direct foreign investment, creation of real physical assets in another country, borrowing from abroad, investing in industrial production in another country. It records capital inflows and outflows.

Uganda liberalized its capital account in 1997. This has seen increased inflow of capital by Ugandans abroad and foreign private investments.

3. **Monetary/cash account.**
This is called official financing account. This records all transactions related to the change in country"s foreign exchange reserves in cash. It shows the official resrves in response to urrent and capital accounts.

It has items that help to Balance of Payment Surplus (autonomous items) such as lending to other cournties, investing abroad and items that help toreduce short term Balance of Payment deficit. (accommodating items) such as borrowing from abroad, selling state enterprises. Foreign exchange reserves may be held in foreign commercial banks, the central bank may hold gold and special drawing rights with IMF.

4. **Errors and omissions account.**
This caters for unavoidable shortages or surplus on balance of payment account to ensure that there is a balance in BOP. if the balance of payment records are completed both sides of balance payment statement would balance, but in reality the two sides may not balance because imperfect data collection in relation to imports and exports.
It ensures that the credits and total debits of the three accounts are balancing, therefore in accounting sense the three must always balance.

UNEB 2005

a) *Distinguish between balance of trade and balance of payments. (04 marks)*
b) *Explain the causes of balance of payment disequilibrium in your country. (16 marks)*

UNEB 2001, 1999

a) *Account for balance of payment problems in developing countries. (10 marks)*
b) *What reasons should be taken to solve the problem of balance of payment deficit in an economy? (10 marks)*

UNEB 2012

a) *What is meant by the balance of payments? (04 marks)*
b) *Account for the persistent balance of payments deficit in your country. (16 marks)*

CAUSES OF BALANCE OF PAYMENT DEFICIT/DISEQUILIBRIUM OR CAUSES OF UNFAVOURABLEBALANCE OF PAYMENT POSITION IN LDCs.

This occurs where foreign exchange expenditure exceeds foreign exchange earnings. Causes of balance of payment deficit/disequilibrium originate from factors that lead to high foreign exchange expenditure and low foreign exchange earnings.

NB: *Explanation should be connected to the element of either rising/ high foreign exchange expenditure or decreasing/ low foreign exchange earnings.*

- **Unfavourable natural factors which reduce agricultural output for export.** This leads to fluctuations in the volume of exports. Export volume tends to reduce due to natural calamities such as drought which affect agricultural output for export hence low foreign exchange earnings.
- **Excessive profit and income repatriation.** High capital outflow in form of profit, dividends and income repatriation by foreign investors and expatriates hence storage of foreign exchange and increased expenditure abroad.
- **Protectionist policies of developed countries/trade restrictions on exports.** Developed countries tend protect their economies by use of tariff and non tariff barriers. This reduces LDCs export volume hence low foreign exchange earnings.
- **Persistent political instabilities leading to increased imports of military hardware.** Political unrest characterizing most LDCs leads to excessive government expenditure on imported military hardware defence equipment leading to high foreign exchange expenditure and limited investment to expand export volume.
- **Excessive government expenditure on diplomatic missions and travels abroad.** Excessive expenditure on bureaucrats and big delegations that travel abroad and foreign missions waste the scarce foreign exchange leading to increased foreign exchange expenditure.
- **Increased debt servicing problems due to constant borrowing.** LDCs are ever suffering with high external debt burden and its servicing leads to high capital outflow which leads to high foreign exchange expenditure.
- **Heavy dependence on exportation of primary products.** Due to low prices that such exports attract such as coffee and cotton because of low value added, there is limited foreign exchange earnings from such exports.
- **Limited markets for exports leading to flooding of international markets.** This is because LDC produce similar primary school products, they sell in similar world markets thus flowing of international markets with agricultural products which leads to low export prices and limited foreign exchange earnings.
- **Increased importation of expensive capital and consumer goods.** Heavy importation of machinery drugs and vehicles against low priced exports due to limited import substitution industries increases foreign exchange expenditure.
- **Weak bargaining power of LDCs on the world market.** Prices of LDCs' exports are dictated by major external buyers who fix them at a lower level leading to low foreign exchange earnings.

- ❖ **Low quality exports.** Exports are of low quality due to poor methods of production and are less competitive on the world mark thus low prices and low foreign exchange earnings.
- ❖ **Limited variety of exports/dependence on a few export products.** LDCs rely on a few export crops such as coffee, tea which experience price fluctuations on the world market, limited exports of manufactured goods hence low foreign exchange earnings.
- ❖ **Heavy reliance on expatriate manpower.** This is through excessive use of expatiates who are highly paid using the foreign currency hence high foreign exchange expenditure.

UNEB 2008, 2005

Mention any four effects of balance of payment deficit in an economy.
(04 marks)

EFFECTS OF BALANCE OF PAYMENT DEFICIT IN AN ECONOMY.

- Reduces volume of imports.
- Results into disinvestment.
- Leads to high taxation on the citizens.
- Limited prospects of employment opportunities.
- Leads to currency depreciation.
- Increases shortage of foreign exchange/leads to depletion of a [illegible]scarce foreign exchange reserves.
- Leads to limited level of savings and investment.
- Retards economic growth.
- Inflationary tendencies may result.

UNEB 2014

a) *Account for the persistent balance of payments deficits in your country. (10 marks)*
b) *Suggest measures that should be taken to reduce balance of payments deficits in your country. (10 marks)*

MEASURES TO REDUCE BALANCE OF PAYMENT DEFICITS IN LDCs.

NB. *These measures should aim at either increasing exchange earnings or reducing foreign exchange expenditure and this should be brought out in explanation.*

- ❖ **Establishment of export promotion industries.** LDCs should try to establish industries to increase production for export and import only what they cannot produce. This will in the long run increase the volume of exports hence high foreign exchange earnings.
- ❖ **Devaluation of domestic currency.** This makes exports cheaper and makes imports expensive which increases foreign exchange earnings and reduces foreign exchange expenditure.

- **Diversity export markets.** This should be done through economic integration so as to increase the bargaining power on the world market, expand market for exports which increases foreign exchange earnings.
- **Set up import substitution industries.** Industries to produce the formerly imported goods should be established which reduces the volume of imports in the long run and encourage consumption of locally produced goods hence reducing expenditure abroad.
- **Proper manpower development/training.** This helps to reduce heavy expenditure on expatriates which reduces foreign exchange expenditure.
- **Promote political stability/create a conducive political climate.** Emphasis should be put on creation of a peaceful, stable and conducive political climate to reduce the huge expenditure on military hardware and encourage domestic investments to reduce importation hence low foreign exchange expenditure.
- **Use of trade restrictions on imports.** Tariff and non-tariff barriers should be imposed by LDCs to restrict imports such as high import duties on imported luxurious commodities. This will help to discourages some imports hence reduction in foreign exchange expenditure.
- **Strengthen international commodity agreements.** These help to set and fix favourable prices for LDCs" exports which increasing bargaining power leading to high export prices hence increasing foreign exchange earnings.
- **Reduce external borrowing and use of proper debt servicing methods.** External public debt burden should be reduced through debt rescheduling, debt negotiation for debt relief and debt cancellation leading to reduced foreign exchange expenditure.
- **Encourage use of barter trade arrangements.** This involves absence of money hence reduced expenditure abroad thus stabilizing balance of payment position by minimizing the use of foreign exchange.
- **Restructure foreign missions and diplomatic travels/limit expenditure on diplomatic travels and foreign missions.** Excessive expenditure by government bureaucrats on foreign travels and diplomatic missions should be limited so as to reduce capital outflow and save the scarce foreign exchange thus reduced foreign exchange expenditure.
- **Diversify products for export**. This involves production of a variety of exports and reduce over reliance on a few exports which expands export base thus increase in foreign exchange earnings.
- **Encourage liberalization of the economy**. This favourable trade policy increases production which leads to supply for exports which helps to increase foreign exchange earnings.

UNEB 2000

a) Explain the different forms of protectionism. (10 marks)

b) What are the implications of protectionism in an economy? (10 marks)

PROTECTIONISM IN INTERNATIONAL TRADE.

Protectionism refers to a commercial policy of restricting trade between countries through methods such as total ban, tariffs, quotas and foreign exchange control.

It is aimed at reducing dangers of international trade on an economy. It involves trade restrictions used by economies in international trade. The country imposes trade barriers to the free movement of goods and services across its borders.

TOOLS OF PROTECTIONSIM.

(Methods/ways of trade restrictions).

Tools of protectionism are instruments that are used to control foreign trade in an economy. They are of two categories;

- **Tariffs**

These are taxes imposed on either imports of exports. High import tariffs discourage importation and low tariffs encourage importation.

High export tariffs discourage exportation intended satisfy local demand and low export tariffs encourage exportation.

A tariff barrier; is an international restriction involving the use of taxes.

Objectives of tariff barriers in an economy.

- To generate government tax revenue.
- To discourage dumping.
- To improve Balance of Payment position.
- To act as a beggar my neighbor policy.
- To protect domestic infant industries form foreign competition.
- To discourage importation of harmful and undesirable commodities.
- To reduce imported inflation.

- **NON TARIFF BARRIERS.**

These are restrictions employed in international trade which don"t involve the use of taxes.

These may include;

a) ***Import quotas.*** This is the physical amount of goods that are permitted to be imported into a country in a given period of time. For instance a country may decide to import only 200 tonnes of sugar in a particular period. This is intended to control the volume of imports.

b) ***Total ban / trade embargo.*** This is where a country completely stops the importation of certain commodities for given reasons. For instance importation of marijuana was completely banned for health reasons.

c) ***Import licenses.*** This is where the government requires every importer to have a license. The government becomes selective and gives licenses to importers of essential commodities. This is intended to control the nature of imports.

d) ***Devaluation of the local currency.*** This is used as a measure to reduce on importation since it makes imports very expensive and increase exportation since it makes exports relatively cheaper.

e) ***Direct intervention.*** This is where the government takes over importation of certain commodities and prohibits importers to easily control the volume of imports and encourage local production.

f) ***Direct administrative controls/regulations.*** These are long administrative formalities aimed at discouraging given importers for instance filling several forms, delay to clear items out of a bonded ware house. This is intended to control the volume of imports.

g) ***Subsidization of domestic industries.*** this is done so as to enable infant industries grow, produce at a low cost internally and therefore charge low prices and out compete imported commodities and export cheaply.

h) ***Quality control requirements***. Commodities to be imported are required to satisfy a certain quality standard. The government through bureau of standards recommends certain sanitary and health requirements to be met by the imported commodities and once they are not met the product cannot be traded.

i) ***Special import deposits.*** Importers are asked to deposit a certain amount of forex with the central bank before they are allowed to import certain commodities. This limits their ability to import and helps volume imports.

j) ***Rationing of foreign exchange among importers.*** The government reduces foreign exchange that is allocated to some importers or provide foreign exchange cheaply to some importers. The government through the central bank controls or allocates foreign exchange to be used in importation of particular commodities. This makes the government to have control over which commodities should be imported.

UNEB 2006, 2011

(i) What is meant by the term a tariff? (01 mark)

(ii) Mention any three non tariff barriers in your country. (03 marks)

FORMS OF NON TARIFF BARRIERS THAT UGANDA HAS IMPLEMENTED.

- Total ban.
- Subsidies to local industries.
- Use of Quotas.
- Administrative controls such as tight bureaucratic procedures.
- Manipulation of exchange rates.
- Qualify control measures.
- Licensing.

UNEB 1997, 2003

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

ADVANTAGES OF PROTECTIONISM IN AN ECONOMY.

- **Protects domestic infant industries from unfair competition of foreign goods.** Infant industries need to be protected from competition of foreign imported cheap commodities until they reach a stage where they are large enough to enjoy economies of scale through high import duties and import quotas.
- **Discourages dumping.** High import duties are imposed on goods for dumping because such cheap commodities discourage growth of industries in countries where they are dumped and create instability in prices and supply since they are not constant thus enabling domestic industries to expand.
- **Creates and maintains employment opportunities in the domestic economy.** Domestic jobs are created and maintained since domestic industries are subsidized and protected from foreign competition that can lead to closure of some industries leading to increased investment and employment creation.
- **A source of government tax revenue.** Tariffs imposed on imports are a major source of revenue to the government for national spending.
- **Reduces foreign dependence on imports and ensure self reliance.** It leads to attainment of self reliance where import substitution industries are developed and imports are reduced through high import duties, total ban thus promoting self reliance.
- **Guards against imported inflation.** This is done by limiting the volume of imports from countries suffering from inflation through charging high import duties and total ban on goods from such countries.
- **Improves the country's Terms of Trade.** Restriction such as import quotas, total ban and high special import deposits on highly priced imports reduce their demand hence improving terms of trade of a country.
- **Improves on Balance of Payment position.** Trade restrictions help to reduce the volume of imports hence reducing foreign exchange expenditure which results into improvement in BOP position.
- **Discourages importation and consumption of harmful commodities.** It prevents the importation of expired drugs and foodstuffs by imposing high import duties, total ban hence protecting the country"s standard of living.
- **Encourages the use of domestic/local resources.** Restrictions on imported raw materials increase demand for local resources leading to their increased utilization.
- **Acts as a retaliation measure towards trading partners.** It helps to retaliate against tariffs imposed by other countries. It is done by

countries as a way of retaliation/a beggar my neighbor policy in international trade.

- **Promotes innovations and creativity in the domestic economy.** Because commodities from abroad are restricted, entrepreneurs in the country devise means to modernize production to satisfy domestic demand which leads to technological development.
- **Reduces political domination and influence from abroad.** Protectionism reduces the influence of foreigners in the politics of the domestic economy thus encouraging independence while making political decisions.

UNEB 2008

(i) *What is meant the term protectionism?* *(01 marks)*

(ii) *Give any three reasons why there is need for protectionism in your country. (03 marks)*

WHY IS THERE A NEED FOR PROTECTIONISM IN AN ECONOMY/REASONS FOR PROTECTIONISM IN AN ECONOMY/WHY IS IT NECESSARY TO ADOPT PROTECTIONISM IN AN ECONOMY.

NB: *These are given as reasons but not as effects of protectionism*

- To improve the country"s Balance of Payment.
- To guard against imported inflation.
- To promote employment opportunities at home.
- To minimize political influence from abroad.
- For retaliation purposes.
- To promote innovations and creativity at home.
- To provide government revenue through tariffs.
- To guard against importation and consumption of undesirable commodities.
- To encourage dependence on foreign goods and attain self sufficiency.
- To protect local infant industries form foreign competition.
- To discourage dumping.
- To improve on terms of trade.

DISADVANTAGES/NEGATIVE IMPACT OF PROTECTIONISM IN AN ECONOMY.

- **Leads to creation of monopoly in the domestic economy.** Local producers become monopolists due to limited competition, thus negative effects of monopoly on an economy such as consumer exploitation.
- **Increases government expenditure/costly for government to implement.** It increases supervisory costs, subsidizing domestic industries and other enforcement agencies thus budgetary deficits.
- **Leads to retaliation/beggar of neighbor policy form trading partners.** Other countries can also impose tariff and non tariff barriers

on exports of the country and this retards trade between countries thus reducing benefits of international trade.

- ❖ **Encourages trade malpractices.** Increases smuggling/illegal trade and corruption especially at border posts. This occurs as people try to avoid high tariffs imposed on imports.
- ❖ **Some tools of protectionism reduce government tax revenue.** Various non tariff barriers such as import quotas, total ban and preferential treatment reduce tax revenue since they do not involve the use of taxes.
- ❖ **Reduces foreign exchange earnings.** This results from limited volume of exports which limit the level of development. The country may not enjoy all the benefits of international trade, therefore loss of vent for surplus and reduced earnings from abroad.
- ❖ **Leads to persistent infancy of protected local firms.** Firms protected from foreign competition may not grow so as to benefit continuously form government support through subsidies thus limited industrial expansion which is very costly and dangerous to the economy.
- ❖ **Subjects nationals to highly priced goods.** Creates shortage of commodities at home hence consumption of highly priced commodities due to increase in costs of production in running domestic industries, in case of structural break down at home and due to limited imports, shortages are likely to occur hence inflation.
- ❖ **Subjects nationals to poor quality goods.** Low quality products are produced because domestic industries are protected from foreign competition thus poor standard of living.
- ❖ **Encourages international specialization and its advantages.** It becomes difficult for a country to get involved in what it can produce better and leave other commodities to be produced by other countries since countries may use tools such as total ban and export quotas thus limited benefits of comparative cost advantage.
- ❖ **Limits variety of goods.** Protectionism limits importation of various commodities which reduces consumers which reduces consumer"s choice.

FREE TRADE.

Free trade refers to unrestricted exchange of goods and services between countries through absence of any form of government interference such as of tariffs, import quotas, total ban and foreign exchange control.

Or

It is a situation where there is absence of any form of government interference in form trade barriers such as quotas, import licenses, total ban in the flow of international trade. Free trade implies no intervention of the government in the flow of international trade which implies that importing and exporting of commodities is free.

ADVANTAGES OF FREE TRADE IN AN ECONOMY.

- **Stimulates fair utilization of resources/promotes a vent for surplus.** Domestic resources are put to use to benefit from the expanded world market.
- **Relieves the government of high expenditure on protectionism.** Protectionism is not necessary in free trade thus reduced expenditure on subsidies to local firms.
- **Encourages international specialization and its benefits.** This reduces costs of production because a country can easily acquire what it does not produce efficiency.
- **Encourages more inflow of foreign exchange and resources.** This is because of limited control in acquiring foreign exchange and transferring of resources from one country to another.
- **Eliminates trade malpractices.** Since trade is free between countries, there are no chances of spending on anti smuggling activities.
- **Widens market for a country's output.** The entire world becomes a market place for all produced commodities.
- **Encourages stiff competition in production hence high quality products are produced.** Competition is created between domestic industries and foreign products thus efficiency of local firms.
- **Discourages local monopoly tendencies.** Free trade leads to increase inflow of substitutes which limits growth of monopoly powers thus reduced dangers of monopoly.
- **Facilitates easy technology and development.** New and efficient methods of production are transferred from developed economies to developing economies due to absence of barriers in their transfer.
- **Increases international cooperation and mutual understanding between countries.** Trading countries enjoy international relationships and understanding which promotes more trade and inflow of foreign aid.
- **Eliminates possibility of beggar my neighbor policy/retaliation.** Free trade means no protectionist policies implying that chances of retaliation among countries in trade are reduced.
- **Expands employment opportunities.** Increased production to enjoy the opportunities of expanded market helps to create more job opportunities.

DISADVANTAGES OF FREE TRADE IN AN ECONOMY.

- **Promotes external dependence.** This results from high level of specialization and a country will be importing from other countries.
- **Results into damping.** Free importation leads to damping which retards the development of local industries.
- **Leads to consumption of harmful and undesirable imported products.** This is because there are no taxes to discourage their importation.

- **Encourages high capital outflow.** This occurs in form of profit repatriation, desire to invest abroad by rich nationals.
- **Leads to collapse of domestic infant industries due to foreign competition.** Local firms are out competed by foreign firms that produce at low costs and charge low prices.
- **Results into imported inflation.** Since there are no controls on goods from inflation prone economies, there are possibilities of importing from such economies.
- **Leads to over underutilization of domestic resources.** Domestic natural resources are over utilized to enjoy benefits of free trade which leads to their quick depletion.
- **Reduces government tax revenue.** Free trade does not involve taxes on imports and exports leading to loss of customs duty.
- **Worsens unfavourable balance payment position in LDCs.** Total expenditure abroad in most developing countries exceeds totals foreign exchange earnings due to limited volume of exports and high volume of imports.
- **Leads to political and economic domination by foreigners.** Free trade leads to increased dependence on MDCs by LDCs thus political domination which undermines political sovereignty of LDCs.

UNEB 2010

(i) What is meant by dumping? (01 mark)

(ii) State any three effects of dumping in the recipient country. (03 marks)

DUMPING.

Dumping is the selling of commodities in foreign markets at lower prices than those charged in the local market.

Positive Effects Of Dumping In The Recipient Country.

- Cheap goods are availed to consumers.
- A variety of goods are availed to consumers.
- Increases government tax revenue when dumped goods are taxed.

Disadvantages Of Dumping In The Recipient Country.

- Local producers are out competed thus collapse of infant industries.
- Inferior goods are sold to consumers.
- Promotes external dependence.
- Leads to underutilization of local resources where goods are dumped.
- Discourages local initiatives/investment.
- Leads to employment.

DEVALUATION.

Devaluation is a legal/official reduction of the exchange value of a country's currency in terms of value of other currencies. It is mainly intended to reduce Balance Payment deficit. It can be carried out successively under a fixed exchange rate system with the purpose of increasing exports and

reducing imports. When a currency is devalued, it becomes cheaper in terms of other currencies.
Devaluation increases the domestic currency price and reduces the foreign currency price.

Devaluation increases the value of exports by making them cheaper and discourages the volume of imports by making them more expensive which reduces Balance of Payments deficit of a country. Between 1981 and 1988, the government repeatedly devalued the Uganda shilling in an effort to stabilize the economy.
For instance in order to make national exports cheaper and more competitive on the world market, the Uganda shilling was devalued in 1987 after frequent minot devaluations in the previous years.
In May 1987, Uganda devalued the currency by 77% and in July 1988, it was devalued by 60%. With current linearization of foreign exchange mark, this tool is no longer used in Uganda.

UNEB 1999

(i) What is meant by devaluation? *(01mark)*

(ii) Given that the exchange rate is 1€ = 1000 shillings. Calculate the new exchange rate after devaluation of the shilling by 20%. *(03marks)*

New exchange rate = 1,000 + (20,000 x 1,000)
1000 + 200
New exchange rate = 1€ = 1,200 Ug shillings

This implies that after devaluation, a shilling becomes cheaper compared to a pound and a Ugandan importer finds it difficult to import from countries where pounds are used but it becomes easy for those countries using pounds to import from Uganda.
Devaluation therefore makes exports of the devaluing country cheaper and imports expensive. This helps to increase foreign exchange earnings form exports and reduces foreign exchange expenditure on imports which helps to reduce balance of payment problems.

Worked example

If the country's current exchange rate is US$ 1 = 1800 Ug shillings, and if there is a 40% devaluation of the shilling. Calculate the new exchange rate.

New exchange rate = 1800 + (40/100 x 1800)
New exchange rate = $1 = 2520 Ug shillings

After devaluation, with a few dollars, foreigners can buy more quantity of exports of the devalued currency but with the same amount of the devalued currency, people can import less quantity from where dollars are used.

Reasons/Objectives Of Devaluation.

- To reduce imports since they become expensive.
- To reduce BOP problems in the long run increasing foreign exchange earnings and recuing foreign expenditure.
- To encourage domestic production by attracting both local and foreign investments.
- To increase foreign capital inflow.
- To increase government revenue by expanding tax base.

CONDITIONS/REQUIREMENTS NECESSARY FOR SUCCESSFUL DEVALUATION IN AN ECONOMY.

- **Demand for exports should be price elastic in order to increase foreign exchange earnings.** This implies that a small decrease in the price of exports resulting from devaluation should lead to a very big increase in quantity demanded for exports and increase the volume of foreign exchange earnings.

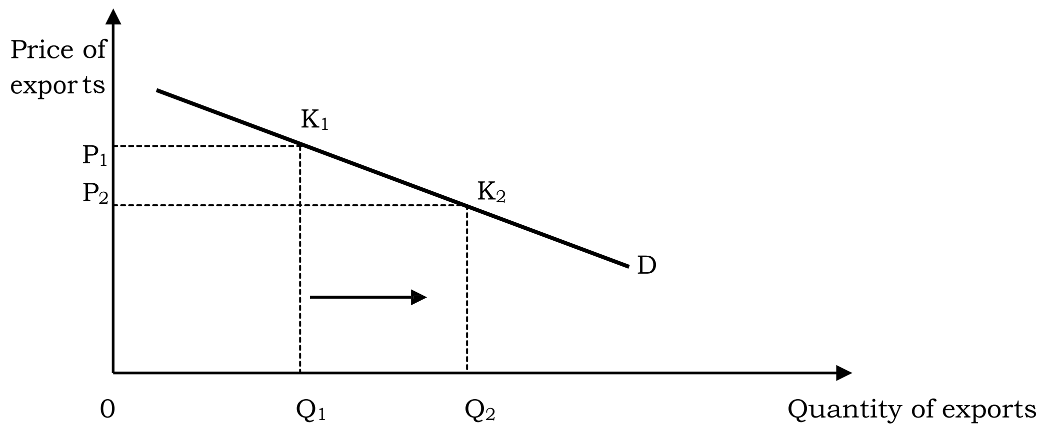


Figure 12.1: effect of devaluation on exports and foreign exchange earnings

Before devaluation, the country"s foreign exchange earnings from exports are $OP_1K_1O_1$. After devaluation that caused the fall in price of exports from OP_1 to OP_2, more exports are demanded thus generating more foreign exchange income to $OP_2K_2Q_2$

After devaluation, price of exports reduces from OP_1 to OP_2 implying that quantity demanded for exports increases from OQ_1 to OQ_2 leading to increased foreign exchange earnings from $OP_1K_1Q_1$ to $OP_2K_2Q_2$.

- **Demand for imports in the devaluing country must be price elastic in order to reduce foreign exchange expenditure.** In this case, a small increase in the price for imports resulting from devaluation leads to a big decrease in the quantity demanded for imports.

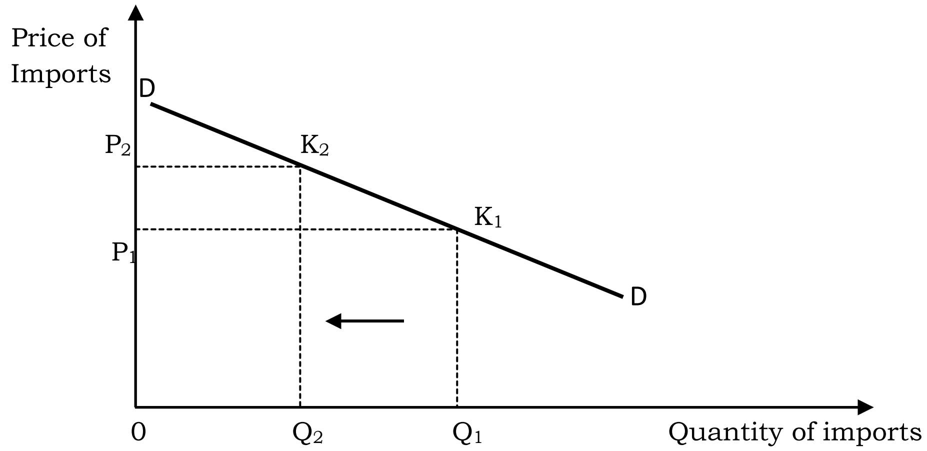


Figure 12.2: effect of devaluation on imports and foreign exchange expenditure

Before devaluation, a country was spending foreign exchange on imports equivalent to $OP_1K_1Q_1$ which is a large expenditure.
After devaluation, foreign exchange expenditure on imports reduces because of a rise in price of imports from OP_1 to Op_2 and so a country only spends $OP_2K_2Q_2$ which is a less expenditure.

- ❖ **Supply of exports in the devaluing country should be price elastic.** This implies that as demand for exports increases, the country must have the capacity to respond very quickly and increase supply of exports to increase foreign exchange earnings.
- ❖ **There should be absence of competitive devaluation.** Other countries in the same region producing the same commodities should not devalue at the same time because this does not make exports cheaper than those of competitions. There should be retaliation by other trade partners in devaluing their currencies.
- ❖ **The country devaluing should be free from inflation.** This is because inflation makes exports expensive and hence less attractive in the foreign market. This is intended to increase foreign exchange earnings.
- ❖ **The exchange rate in the devaluing country should be a fixed exchange rate.** This is because it is stable and predictable and hence encourages long term transactions to take place and it does not encourage speculation in the exchange rate system so as to increase supply of exports.
- ❖ **The devaluing country should be producing at excess capacity.** It should be producing at excess capacity so that production and supply of exports increase when demand increases thus increased foreign exchange earnings.
- ❖ **There should be absence of trade restrictions on exports of devaluing country** to increase export volume. In other words there should be no trade barriers between trading partners so as to increase the volume of exports and foreign exchange earnings.

REASONS WHY DEVALUATION FAILS TO ACHIEVE ITS OBJECTIVES IN LDCs (Why does the use of devaluation policy fail to solve balance of payment problem in developing countries.)

Devaluation in most developing countries has failed to achieve the intended objectives. This is due to the following reasons.

- **Exports of LDCs have inelastic demand.** Even if the prices of exports reduce by a very big percentage, the demand for exports does not increase by the same percentage because of primary products of poor quality which does not increase foreign exchange earnings.
- **Supply of exports of LDCs is price inelastic.** This is because of supply of exports whenever demand increases which limits foreign exchange earnings.
- **Demand for imports of most LDCs is price inelastic.** Therefore, even if prices for imports increase by a very big margin for imports does not reduce by the same margin because of high prices for propensity to import which may not reduce foreign exchange expenditure.
- **Persistent inflation in most LDCs.** This increases costs of production which leads to high prices for exports and reduces foreign exchange earnings.
- **Competitive devaluation.** Where competing countries retaliate and devalue at the same rate makes evaluation unsuccessful.
- **There are various trade restriction on exports of LDCs** such as import quotas, total ban and this limits the volume of developing countries" exports and reduces foreign exchange earnings.
- **Exportation of same poor quality primary products.** Most developing countries export the same poor quality products and such commodities cannot compete favourably on the international market even if their prices reduce.
- **High marginal propensity to import in most LDCs.** This is especially for the essential commodities and capital goods because they cannot produce them locally. This increases foreign exchange expenditure and fails devaluation policy.
- **Most developing countries have liberalized the foreign exchange rate/system** and yet devaluation works successfully under a fixed exchange rate system. Unstable exchange rate in LDCs discourages long term planning.
- **Weak administrative machinery to coordinate and implement devaluation policy** i.e. incompetence of policy makers in LDCs thus failure to effectively implement devaluation and increase production for export.

UNEB 1998

a) *Distinguish between devaluation and currency depreciation. (04 marks)*

b) *Why may devaluation fail to achieve the objectives it is intended in an economy? (16 marks)*

REASONS WHY THE USE OF DEVALUATION MAY FAIL TO SOLVE BALANCE OF PAYMENT PROBLEM IN AN ECONOMY.

- There may be weak administrative machinery in the devaluing country to coordinate and implement devaluation policy.
- Consumers in the devaluing country may be having high marginal propensity to import.
- Exports of the devaluing country maybe of poor quality and cannot get enough market abroad.
- Exchange rate in the devaluing country may be unstable.
- The devaluing country may have reached full payment level of resources which may limit supply of exports to meet high demand in external markets.
- Demand for exports of the devaluing country may be price inelastic.
- Demand for imports of the devaluing country may be inelastic.
- There may be existence of competitive devaluation between competing countries.
- Supply of exports in the devaluing country may be price inelastic.
- The devaluing country may be affected by inflation which increases cost of production.
- There may be use of trade restrictions on exports of the devaluing country.

UNEB 2000

(i) Distinguish between devaluation of a currency and depreciation of a currency. (02 marks)

(ii) State any two merits of currency devaluation in an economy. (02 marks)

UNEB 2001

(i) Distinguish between deflation and devaluation. (02 marks)

(ii) Mention any two effects of devaluation in an economy. (02 marks)

EFFECTS OF DEVALUATION IN AN ECONOMY

- **Increases volume of exports.** It is an instrument of commercial policy which expands on the demand for a country‟s exports and creates alarge market.
- **Increases foreign capital inflow/foreign investors.** Foreign investors undertake greater investments because of a large market created for exports.
- **Increases foreign exchange earnings.** It earns greater exchange to the country which is used to import the required capital equipments and facilitate the overall development programmes.
- **Improves on balance of payment position.** This is affected by increasing foreign exchange earnings from exports and reducing foreign exchange expenditure on imports.

- ❖ **Reduces the volume of imports.** There is reduced importation due to increases prices of imports.
- ❖ **Increases domestic production.** Export promotion industries are expanded to produce high output for export.
- ❖ **Leads to retaliation by trading partners.**
- ❖ **Causes inflation in the domestic economy.**

EXCHANGE RATE SYSTEM

Exchange rate system is the rate at which a country"s currency is exchanged for other currencies in a foreign exchange market. This is the price of a country"s currency in relation to other currencies in a foreign exchange market.

Some currencies are easily converted into other currencies and are readily acceptable for use in international translations such as US dollars, British pound sterling, Japanese yen and such currencies are called **hard currencies/convertible currencies.**

Other currencies are not easily convertible into other currencies because they are not accepted in many countries in international transactions for instance Uganda shilling.

Countries involved in international trade use currencies other than their own and therefore exchange rate is necessary because countries must be paid in their own currency when trading together.

International trade makes it necessary for one country to demand for foreign currency. For instance the Ugandan importer of vehicles form United States of America would need dollars.

UNEB 2007

(i) Distinguish between a managed exchange rate and a floating exchange rate. (02 marks)

(ii) State any two advantages of adopting a floating exchange rate in your country. (02 marks)

TYPES OF EXCHANGE RATE SYSTEM

1. Floating/flexible/free exchange rate system

This is one where the rate at which the local currency exchanges for other currencies is determined by market forces of demand and supply in foreign exchange market.

It is the one in which the price of the domestic currency in terms of other currencies is determined by the interaction of the forces of demand and supply in foreign exchange market. There is no intervention form monetary authorities.

The value of the currency in terms of other currencies is determined by the operation of market forces in the foreign exchange market.

Usually a flexible exchange rate system results into an equilibrium exchange rate by forces of demand and supply.
An equilibrium exchange rate is where the demand for a currency is equal to its supply.

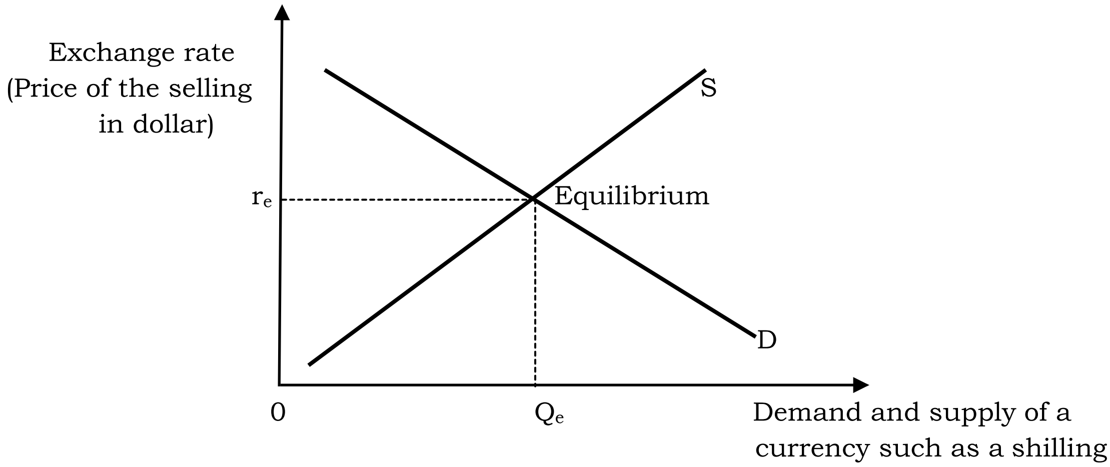


Figure 12.3. A flexible exchange rate system

r_e is the equilibrium exchange rate
forces of supply of a shilling interact with forces of demand for a shilling to determine the equilibrium exchange rate r_e
Q_e is the equilibrium quantity demanded and supplied of a currency

Advantages Of A Flexible Exchange Rate.

- ❖ Enables a country to generate adequate amount of foreign exchange from transactions, grants and loans.
- ❖ Enables a country to pursue an independent monetary policy which is not influenced by external forces.
- ❖ Provides an automatic mechanism for reducing balance of payment problems and does not require official administration.
- ❖ It is cheaper to administer. Does not required the country to maintain a large foreign exchange reserve to correct any imbalance if foreign exchange rates are moving freely.
- ❖ Encourages investments into the country because they can trade freely.
- ❖ Gives a more realistic value of the domestic currency in relation to the value of other currencies.

Disadvantages Of A Flexible Exchange Rate.

- ❖ Encourages speculation in the foreign exchange market because people keep idle waiting for capital gains.
- ❖ Makes planning difficult especially the quantities to be exported because of constant instability in exchange rates.
- ❖ Creates economic instability in the value of the currency because of constant fluctuations.
- ❖ Fails to correct Balance of Payment deficit when the demand for imports is greater than the demand for exports.
- ❖ It leads to currency depreciation.

- ❖ Leads to imported inflation.

CURRENCY DEPRECIATION.

This refers to a fall/decrease in the exchange value of a country"s currency in relation to foreign currencies as a result of the interplay of forces of demand and supply in foreign exchange market.

Or

It refers to a fall/decrease in the exchange value of the local currency in relation to foreign currencies under a flexible exchange rate system.
Its demand falls relative to its supply leading to its surplus. It happens under a floating exchange rate.

UNEB 2002, 2011

(i) *Distinguish between currency devaluation and currency depreciation.* *(02 marks)*

(ii) *Give any three effects of currency depreciation in your country.* *(02 marks)*

Merits Of Currency Depreciation In An Economy.

- It makes exporters received higher local currency revenue
- Encourages foreign investment / increases foreign capital inflow
- Export producer prices increase hence stimulating production
- Increases the volume of exports which reduces balance of payment problem.

Negative Effects Of Currency Depreciation In An Economy.

- Leads to inflation/rise in prices of goods and services locally.
- Projected planning is made very difficult.
- Worsens external debt burden because the government is unable to repay foreign loans since foreign currencies become more expensive.
- Causes a lot of speculations in foreign exchange market because people expect further rise in prices of foreign currencies and the currency depreciates the more.
- Makes imports expensive thus unfavourable terms of trade.
- Discourages investment.

CURRENCY APPRECIATION.

This refers to a rise in the exchange value of a country"s currency in terms of other currencies under a floating exchange rate system. Its demand increases relative to its supply leading to its shortage.

2. Fixed/pledged exchange rate

This is one where the rate at which the local currency exchanges for a particular foreign currency is fixed by the central monetary authority.

Or

This is one which is determined by monetary authorities in relation to a particular foreign currency. No one is therefore supposed to sell below or above it. The central bank intervene in the foreign exchange market.
The exchange rate is normally fixed in terms of hard currencies such as pound sterling.

UNEB 2000, 2004

(i) Distinguish between a fixed exchange rate and a managed exchange rate. (02 marks)
(ii) Mention any two merits of a fixed exchange rate. (02 marks)

Merits Of A Fixed Exchange Rate.

- Discourages speculation in foreign exchange market and minimizes exchange rate uncertainties.
- Stabilizes incomes of exporters. It is stable and predictable and hence encourages trade transactions to take place since it exporters certainly and confidence.
- It is used to control inflation/stabilizes price in an economy.
- Stabilizes the value of domestic currency/reduces currency depreciation.
- Encourages long term planning.
- Minimizes capital outflow.
- Encourages production and investment which promotes economic growth.

Demerits Of A Fixed Exchange Rate System.

- It is very expensive to administer. Requires serious administrative network in monitoring and supervision and this is costly to the government.
- Does not show the actual purchasing power of the domestic currency in terms of other currencies.
- Discourages foreign investment which increases unemployment because it limits high inflow of foreign investors.
- Results into overvaluation of the domestic currency. Sometimes the exchange rate may be overvalued by the central bank.
- It is bureaucratic and causes delays in trade.

CURRENCY REVALUATION.

It refers to a legal/official increase in the exchange value of a country"s currency in terms of other currencies.

Or

This refers to an increase in the exchange value of a country"s currency in terms of other currencies fixed exchange rate system.

Worked example

a) Given that the exchange rate in a country is 1US dollar = 1000 shillings. Calculate the new exchange rate after revaluation of a shilling by 20%.

1000 – (20/100 x 1000)
1000 – 200
= 800 shillings
New exchange rate = 1 Us dollar = 800 shillings

b) Given that the exchange rate in a country is €1 = 3000 shillings. Calculate the new exchange rate after revaluation of a shilling by 40%

New exchange rate = 3000 – (40/100 x 1000)
3000 – 1200 = 1800shillings
New exchange rate € 1 = 1800 shillings

CURRENCY OVERVALUATION.

This is the fixing of the exchange value of a country‟s currency by the central monetary authority above the equilibrium exchange rate.

Or

This is where the exchange rate of a currency is fixed by the central monetary authority above the exchange rate determined by interaction of forces of demand and supply of a currency.

Demerits Of Currency Overvaluation.

- Reduces volume of exports.
- Worsens balance of payment problems.
- Discourages domestic production.
- Increases imports.
- Reduces capital inflow.

CURRENCY UNDERVALUATION.

This refers to the fixing of the exchange value of a country‟s currency by the central monetary authority below the equilibrium exchange rate.

UNEB 2008

(i) Distinguish between currency revaluation and currency undervaluation. (02 marks)
(ii) State any two effects of currency undervaluation. (02 marks)

Effects Of Currency Undervaluation.

- Improves balance of payment position.
- Reduces volume of imports.
- Increases exportation of goods.
- Increases foreign capital inflows.

- Encourages domestic production.

UNEB 2001

(i) Distinguish between managed exchange rate system and floating exchange rate system. (02 marks)

(ii) State any two advantages of a managed exchange rate system. (02 marks)

3. Managed or Dirty float exchange rate.

This is one in which the exchange rate is allowed to fluctuate within certain limits determined by the central monetary authority.

Or

This is one in which forces of demand and supply are left to determine the rate which the local currency exchanges for other currencies but within certain limits set by central monetary authority.

The exchange rate is not fixed at one point but simply fluctuates between certain rates.

Advantages Of Managed Exchange Rate.

- It safeguards importers and exporters from rapid and constant fluctuations in earnings.
- It controls the actions of speculations.
- Ensures a favourable exchange rate on the market.
- Enables monetary authorities to maintain control over exchange rate.

4. Dual exchange rate.

This is one where two exchange rates for priority and non priority imports operate side by side in the foreign exchange market.

A high exchange rate is always fixed for the importers of luxurious commodities and a lower exchange rate is fixed for importers of essential commodities. For instance Obote II government introduced window 1 for priority importers and window 11 non priority importers but later merged the two exchange rates.

Advantages Of A Dual Exchange Rate.

- Encourages importation of priority goods.
- Provides foreign exchange to different forms of importers.
- Promotes growth of infant industries.
- Promotes investment in the domestic economy.

NB. In July 1990, Uganda liberalized foreign exchange markets and the exchange rates over the period have been deteriorating in relation to US dollar. For instance in 1995 Ug shillings per us dollar was shs 988.6 and in 2011 it reached at shs 2675.3 (general rates).

The exchange rate system in Uganda has come from a highly regulated one to one that is highly market oriented. This has led to establishment of a wide variety of forex bureau and increased role of commercial bans in trading foreign currency.

UNEB 2005

Mention nay four factors that determine demand and supply of foreign currency in your country. (04 marks)

FACTORS THAT DETERMINE/INFLUENCE DEMAND AND SUPPLY OF FOREIGN CURRENCY.

NB: *Nuetral points must be presented*

- Price of imports.
- Debt servicing requirements.
- Volume of exports.
- Level of capital out flow.
- Degree of speculation in foreign exchange market.
- Volume of imports.
- Price of exports.
- Need to accumulate foreign reserves.
- Central bank interventions.

FOREIGN EXCHANGE RATE CONTROL.

This is where the central monetary authority regulates the rate at which a local currency exchanges for foreign currencies. Government controls over the factors that determine the rate of exchange in a free exchange rate system. It can either be full or partial exchange rate control.

The government fixes the exchange rate and maintains it by controlling transactions involving foreign currencies. The central bank becomes the chief controller of foreign exchange.

UNEB 2011

(i) What is meant by the term "foreign exchange rate control"? (01 mark)

(ii) Mention any three objectives of foreign exchange rate control. (03 marks)

Objectives Of Foreign Exchange Control In An Economy.

- To check on capital outflow or flight.
- To control the importation and consumption of undesirable goods.
- To control speculative activities in foreign exchange market.
- To protect domestic infant industries against foreign competition.
- To acquire foreign exchange for servicing the country‟s external debts.
- To encourage and facilitate long term planning.
- To encourage investment.
- To control inflation/ensure price stability.
- To correct unfavourable balance of payment position.
- To raise revenue for government.
- To ensure availability of foreign exchange so as to facilitate trade
- To stabilize exchange rates/to iron out temporary fluctuations in foreign exchange rates.

UNEB 2008

a) *Distinguish between a floating exchange rate and a fixed exchange rate. (04marks)*

b) *Explain the merits and demerits of foreign exchange rate control in an economy. (16 marks)*

Merits Of Foreign Exchange Rate Control In An Economy.

- Ensures stability in the value of domestic currency by controlling inflation
- Encourages investment because of stability and easy accessibility of foreign exchange
- Minimizes capital outflow through encouraging investors especially in the long run.
- Encourages long term planning since the value of domestic and foreign currencies tends to be stable.
- Ensures stability in the incomes of exporters by safeguarding exports from constant price fluctuations.
- Helps to prevent importation and consumption of undesirable commodities.
- Protects domestic infant industries from foreign competition. This is because restriction of forex to import foreign goods.

Demeris Of Foreign Exchange Rate Control In An Economy.

- Reduces the volume and value of international trade especially due to ability to restrict imports and exports.
- Breeds black marketing in foreign exchange market. This arises when there is hoarding of foreign currency in order to create shortages and raise profit margins.
- It is expensive to enforce. This is because it normally requires the central bank to have large amount of reserves which may not be available.
- Promotes retaliation in foreign trade and this discourages production
- Causes delays in trade because it is very bureaucratic in its operation
- Causes inefficiency and corruption among the people concerned with its administration
- Discourages foreign investments because of unnecessary bureaucracy in securing foreign exchange.

UNEB 2005

a) *Distinguish between a managed rate and a free exchange rate. (04 marks)*

b) *Explain the factors which determine the exchange rate in a money market. (16 marks)*

FACTORS THAT DETERMINE/INFLUENCE /AFFECT EXCHANGE RATE IN A MONEY MARKET.

NB: *These are presented as neutral factors and explained in two sides showing a positive side which strengthens the value of the currency and a negative side which weakens the value of the domestic currency in relation to other currencies.*

- **Level of capital outflow and inflow.** The higher the rate of capital outflow the weaker the currency because it leads to depreciation of the domestic currency and the higher the rate of capital inflow the stronger the currency because it leads to appreciation of the domestic currency.
- **Rate of inflation in other economies.** The higher the rate of inflation in foreign economies the stronger the domestic currency and the lower the rate of inflation in other economies the weaker the domestic currency.
- **Volume of imports.** The higher the volume of imports the weaker the currency and the lower the volume of imports the stronger the currency.
- **Volume of domestic output.** The higher the volume of domestic output the stronger the currency and the lower the volume of domestic output the weaker the currency.
- **Rate of domestic money supply.** The higher the rate of domestic money supply the weaker the currency and the lower the rate of domestic money supply the stronger the currency.
- **Volume of exports.** The higher the volume of exports the stronger the currency and the lower the volume of exports the weaker the currency.
- **Level of foreign exchange reserves.** The higher the foreign exchange reserves, the stronger the currency and the lower the foreign exchange reserves the weaker the currency.
- **Demand and supply of foreign exchange.**
- **Government policy on exchange rate.** For instance in case of pegged exchange rate.
- **Political climate**

UNEB 2003

a) Define the term commercial policy. (01 mark)

b) State any three instruments of commercial policy in your country. (03 marks)

COMMERCIAL POLICY.

This refers to the deliberate attempt by the government to influence, control and direct the value and volume of both internal and foreign trade in an economy.

Commercial policy refers to a set of measures taken by the government to influence, control and direct the volume and value of both internal and foreign trade in an economy.

OBJECTIVES OF COMMERCIAL POLICY.

- To increase gains from trade.
- To maintain balance of payment equilibrium.
- To achieve rapid industrialization and accelerate employment opportunities.
- To attract foreign investors into a variety.
- To encourage exports.
- To discourage given imports.
- To stabilize exchange rates.

Instruments of commercial policy.

- Taxation/tariffs especially on substitutes.
- Licensing.
- Total ban banning substitutes.
- Quality controls.
- Devaluation.
- Subsidization.
- Import quotas.
- Direct administrative control regulations.
- Trade agreements.
- Manipulation of exchange rates/foreign exchange control.

FOREIGN RESERVES/FOREIGN EXCHANGE RESERVES.

This refers to total value of all gold, dollars and special drawings rights held by a country as both a reserve and a fund from which international payments can be made. For instance in form of US dollars, gold reserves and special drawing rights from IMF, bonds and treasury bills bought from abroad.

Foreign reserves are made of gold or specific currency, marketable securities in foreign currency such as treasury bills, government bonds, equities and foreign currency loans.

NB. Special drawings rights *are financial assets created by IMF which give holders unconditional drawing rights.*

Or

Special drawings rights are financial assets created by IMF and are held by member countries as part of the international reserves meant to increase international liquidity of member countries.

Sources of foreign reserves/how are foreign reserves acquired.

- Selling of government property abroad.
- Private foreign investments abroad.
- Foreign aid in form of grants and external borrowing.
- Capital inflows from IMF, foreigners wishing to buy shares and bonds within the country.

Importances of foreign exchange reserves in an economy.

- Servicing foreign debts/payment of external debts.

- Used to clear BOP deficits.
- Used in importing capital goods.
- Paying salaries of expatriates.
- Financing diplomatic missions and travels abroad.
- Used to establish investments abroad.
- It is used to make contributions in international agencies such as United nations.
- Used for lending to other countries, provision of grants and donations.

ECONOMIC INTEGRATION/COOPERATION.

This is the coming together of two or more countries in a given region for the sake of mutual economic benefits of all member states. It aims at increasing benefits of international trade and later result into political cooperation.
It involves several countries agreeing to have a number of economic and other activities in common that can later result into political cooperation.
Two or more countries agree to cooperate with each other by removing obstacles or restrictions in their trading relationship to maximize benefits of foreign trade.

Examples of economic integration (economic blocs) in the world may include;

1. ***COMESA;*** *Common Market for Eastern and Southern Africa. This is one of the successful economic cooperation in Africa with a proven track record of achievements with member countries such as Uganda, Egypt, Malawi, Zambia, Sudan, DRC, Kenya, Tanzania , Burundi among others.*
2. ***EAC;*** East African Community
3. ***ECOWAS;*** *Economic Community of West Africa States*
4. ***EEC;*** European Economic Community

UNEB 2004

State any four conditions necessary for the success of regional economic integration.(04 marks)

CONDITIONS NECESSARY FOR SUCCESSFUL ECONOMIC INTEGRATION.

- Intending countries should be relatively at the same level of development to avoid resource distribution imbalances. This enables them to share benefits and costs equally.
- Intending countries should be geographically close to each other (share common borders) so as minimize costs of transport and other barriers.
- All member countries have the same or related political and economic ideologies i.e. either capitalist or socialist so as o avoid conflicts.
- There should be well developed infrastructural network connecting all the countries so as to facilitate easy movement such as telecommunications, roads and railways.

- ❖ All member countries should be ready to maintain good political ties between themselves. There should be good political ties and working relations among member countries.
- ❖ All member countries should preferably be of the same population size/market size in order to share equality the benefits of integration.
- ❖ Comparative advantage must differ among trading partners to allow specialization on different products. There should be differences in resource endowments to have different production capacities which helps to produce different goods.

STAGES/TYPES/FORMS OF ECONOMIV INTEGRATTION.

Economic integration is classified according to its level of development as follows

1. **Preferential trade area (PTA)** this occurs where member countries reduce tariffs among themselves on some selected commodities. Countries give preferential treatment in regard to tariffs charge on given commodities.
2. **Free Trade Area.** This occurs where member countries eliminate all tariffs between themselves but continue to charge different tariffs on goods from non member countries.
3. **Customs Union.** This is where is free trade among member countries and adoption of common/similar tariff structure on goods from non member countries. At this stage, in addition to eliminating all the tariffs between themselves, countries adopt common or uniform tariffs n all goods from non member countries.
4. **Common Market.** this is where there is free trade among member states with a common/similar tariff structure on goods from non member states plus free movement of factors of production among member states.

   This occurs when all countries abolish all tariffs among themselves adopt a common tariff against non member countries and there is free movement of factors of production.
5. **Economic Union or Community.** This is where there is free trade among member states with a common/similar tariff structure on goods from non member states plus free movement of factors production among member states and joint running of common services.

   At this stage, all the elements of the common market are in place and in addition there is joint economic planning, joint ownership of certain enterprises and facilities such as industries, roads, postal services.
6. **Monetary union.** This is where there is free trade among member states with a common/similar tariff structure on goods from non member states plus free among movement of factors of production among member states, joint running of common services and adopting a single currency for the region.

A common currency is established at this stage of different currencies but with the same exchange rate or value. For instance European Economic Community use Euro as their currency.

Member countries adopt and harmonize monetary and fiscal policies.

CHARACTERISTICS/FEATURES OF AN ECONOMIC UNION.

- Sharing of common services/joint ownership of certain enterprises and facilities.
- Use of a common currency hence a monetary union.
- Joint economic planning/harmonized economic policies i.e. common problems are dealt with jointly.
- Common external tariff structure.
- Free movement of goods and services/free trade within the union.
- Free movement of factors of production with the region.
- Strong regional institutions.

UNEB 1998, 2010

a) *What is meant by regional economic integration?* *(04 marks)*

b) *Examine the merits and demerits of economic integration.* *(16 marks)*

UNEB 1998

a) *Distinguish between the following;*
   - *Preferential trade area and free trade area.* *(06marks)*
   - *Customs union and common market*

b) *Examine the merits of regional economic integration.* *(14marks)*

UNEB 2014

(i) *Distinguish between a customs union and a common market.* *(02 marks)*

(ii) *State any two benefits of economic integration to your country.* *(02 marks)*

ADVANTAGES OF ECONOMIC INTEGRATION/COOPERATION.

- **Leads to trade creation effect.** Trade creation is where economic integration results into a shift of trade from high cost member countries to low cost member countries. This increases benefits of trade. After economic integration, trade shifts from inefficient and high cost non member country to efficient and low cost member country. This is due to a change in tariffs and non tariff barriers which enable countries to acquire cheap commodities within the union compared to importing form non member countries.
- **Stimulates establishment and expansion of manufacturing industries.** manufacturing sector expands because of increased resource base and expanded market thus promoting industrialization.
- **Better quality products are produced.** Increases competition in production among member countries especially where substitute commodities are produced hence improved quality of output.

- **Leads to easy access to foreign resources/aid.** Bi-lateral and multi-lateral donors prefer lending to integrated countries than to a single country thus increased benefits of foreign aid.
- **Leads to market expansion/creation of a wider market which increase investment.** Market for goods and services expands since trade restrictions are removed hence increasing gains from trade.
- **Encourages joint research at a cheaper cost/leads to sharing costs research.** Research and collection of information jointly is possible at a low which leads to innovations and inventions in production which increases production levels.
- **Increases bargaining power of member countries on world market.** This leads to fair trade policies with non member countries thus high export prices and increased earnings form exports.
- **Leads to joint provision of common services/infrastructure.** Countries share common services such as roads, railways, postal and telecommunication services. It leads to joint sharing and running of such services hence infrastructure development.
- **Eases trade by use of the same currency.** When countries start using the same currency, trade goes on smoothly since there are no problems/complications of converting currencies.
- **Promotes political cooperation and mutual understanding among member states.** This promotes peace and harmony and inter-state cooperation within the region necessary for economic development.
- **Increase employment opportunities.** This arises from the fact that factors of production can freely move within the region and this enhances mobility in the region especially labour which redistributes income.
- **Opens room for specialization among member states.** This is because each member country is supposed to specialize in certain industries and later exchange for what they do not produce on the basis of comparative advantage.
- **Provision of low priced goods.** Member countries enjoy cheaper priced goods due to abolition of taxes and other unnecessary expenses on borders hence reduced general price level.
- **Reduces costs of duplication of goods/resources.** One industry is established in one country to serve the whole region and this increases gains from international trade reduced resource wastage.
- **Increases volume of output leading to economic growth.** More output is realized due to joint production leading to increased economic growth.
- **Increases resource utilization thus vent for surplus.** This results from expanded market and combined development efforts among member states leading to exploitation of formerly idle resources.

ADVANTAGES OF TRADE CREATION.

- Increases in the volume of trade within the region.
- Widens choice from a variety of commodities produced.
- Saves scarce foreign exchange for importing goods expensively outside the region.
- Improves relationships among member countries.
- Expands employment opportunities.
- Promotes investment within the region where factor inputs are cheaper than outside the region.

UNEB 2000

a) What is meant by economic integration? *(04 marks)*

b) Examine the merits and demerits of economic integration. *(16 marks)*

DISADVANTAGES OF ECONOMIC INTEGRATION.

- **Leads to trade diversion.** Trade diversion is where economic integration results into a shift of trade from low cost non member countries to high cost member countries. This reduces benefits of trade. After economic integration, trade shifts from efficient and low cost non members states to inefficient and high cost member states after blocking cheap goods from non member states.
- **Leads to production of poor quality goods.** Member countries are compelled to buy commodities f poor quality from member states instead of importing better ones from non member countries. This reduces welfare.
- **Leads to uneven distribution of industries.** This leads to unfair benefits from integration. For instance during the former EAU in 1967 – 1977, many industries were located in Kenya due to transport viability and other member countries were losing.
- **Leads to loss of government tax revenue.** This is because tariffs (customs duties) are removed on trade between countries thus reducing government revenue.
- **Results into surplus of similar goods.** This occurs where similar commodities in developing countries are produced thus resource wastage.
- **Involves loss of political sovereignty among member countries.** The formation of strong economic community involves sacrifice of national political interests at the expense of member countries and a countries does not pursue independent political policies.
- **Leads to quick resource depletion.** Natural resources may be exhausted because of high market created and increased resource utilization thus over utilization of such resources.
- **High costs in its establishment i.e. staffing.** These are in form of administrative costs in financing secretariats and commissions as labourforce of the union can be transferred to fare places.

- ❖ **Sacrifice of national interest at the expense of members states.** Members countries especially those at low levels of development have to act the interest of other member states.
- ❖ **Leads to movement of goods and services in one direction.** This leads to imbalances in trade because strong members countries dominate trade. This leads to unfair distribution of benefits from the integration.
- ❖ **Leads to retaliation by other economic blocs.** Other countries impose restrictions on exports of the economic bloc leading to rival trade blocs and this reduces benefits of international trade.

UNEB 2004, 1999

(i) Distinguish between trade diversion and trade creation. *(02 marks)*
(ii) Mention any two disadvantages of trade diversion. *(02 marks)*

Effects Of Trade Diversion.

- ➢ Consumption of poor quality products due to limited competition.
- ➢ Member countries are forced to buy highly priced goods.
- ➢ Reduced government tax revenue from import and export duties.
- ➢ Home industries remain infant in nature.
- ➢ Limited variety of goods.
- ➢ Leads to regional self reliance.
- ➢ Leads to growth of infant industries in member.

UNEB 2011

a) Explain the benefits of regional economic integration. *(10 marks)*
b) What factors have undermined the achievement of regional integration in developing countries? *(10 marks)*

UNEB 2012

a) What are the features of an economic union? *(06 marks)*
b) Explain the factors that limit regional economic integration among developing countries. *(14 marks)*

LIMITATION OF ECONOMIC INTEGRATION IN LDCs/FACTORS THAT UNDERMINE THE SUCCESS OF ECONOMIC INTEGRATION AMONG DEVELOPING COUNTRIES.

NB: *These are given as one sided factors which undermine/limit the intensified efforts of ensuring successful economic integration especially in developing countries.*

- ❖ **Production of similar primary products thus limited market.** this leads to resource wastage. Most LDCs produce similar primary products such as coffee, cotton which makes specialization different and this implies a need to interact with developed countries for foreign exchange to buy most of imports.

- **Limited political will and commitment among member countries.** Some countries do not subject their individual interests for achievement of common objectives.
- **Political instabilities in some member states.** Political unrest limits trade between countries and free mobility of factors of production the region. For instance the military coup of 2971 in Uganda led to the collapse of the former EAC due to political tension.
- **Poor infrastructure among countries.** There are transport problems because railways, air and road transport are not only inadequate but in most cases existent, thus difficulty to achieve integrated communication network to facilitate trade.
- **Differences in levels of development of member countries.** This leads to unfair benefits from integration. For instance the 1967 – 1977 EAC, Kenya was developed than Uganda and Tanzania and all the resources were moved to Kenya.
- **External interference/sabotage.** In most cases developed countries and international financial institutions hinder successful integration due to unfavourable economic policies. For example the collapse of the former EAC was partly due to influence of Britain and USA since they were main trading partners.
- **Differences in social factors.** These include differences in culture, language barrier and religion which hinder trade and makes it very difficult to forge unity among member countries.
- **Differences in political ideologies.** Different countries have different conceptions as to how the goals of economic integration are to be fulfilled. For instance in 1967 EAC, Tanzania was pursuing socialism while Kenya and Uganda were pursuing capitalism and the two ideologies are incompatible.
- **Limited geographical proximity/closeness between countries.** Member countries are located far away from each other and this reduces the benefits of trade thus increasing transport costs.
- **Differences in economic policies of member countries.** Such as privatization, trade liberalization and taxation policies. Such economic policies are difficult to incorporate for mutual benefits of all members.
- **Unfair distribution and sharing benefits from the integration (Failure to share benefits equality).** For instance the former EAC failed due to failure to share benefits equally. This causes conflicts among member states.
- **Fear of loss customs revenue.** Some countries are reluctant to join others in regional groupings in fear of losing tariffs on imports and exports.
- **Differences in currencies.** Member countries have different currencies and this limits the ability of member countries to easily trade together and makes trade less profitable and tiresome thus reducing the volume of trade.

- **Conflicts among leaders in integrating countries.** This creates unnecessary disagreements on key issues meant for successful economic integration.
- **Differences in the size of the market/population.** This leads to conflict on how to share the benefits of integration among member states.

THE EAST AFRICAN COOPERATION (EAC).

The East African Cooperation is a regional intergovernmental organization of the Republic of Kenya , Uganda, United Republic of Tanzania, republic of Rwanda and Burundi. It was originally founded in 1967 and later collapsed in 1977.It was officially revived on July 7th 2000.

The East African Cooperation aims at widening and deepening economic, social and political opportunities to improve the lives of people of East Africa. The total population in the region is estimated at 133 million people (July 2009). The headquarters of EAC are found in Arusha Tazania. The total GDP of the region was US$ 79 million in 2010.

Motto: One people One destiny.

Some of the objectives of East African integration include.

- To promote peace, security and stability among member states.
- To ensure sustainable use of natural resources.
- To attain sustainable growth and development of all member states.
- To strengthen political, social and economic cooperation in research and technology development.

The East African Cooperation has to some extent registered some social, political and economic achievements such as;

- Harmonized immigration forms at border posts.
- easing cross border movement of people.
- use of temporary travel documents.
- Easing the movement of capital among member countries.
- Easing conversion of local currencies of member countries.
- Harmonized budget preparations and presentation by the ministers of finance and central banks.
- Use of preferential tariff discounts on given commodities.
- Intensified cross border disease by member countries.
- Reduction in trade barriers among member courtries.
- Cooperation in defence for political stability in all member countries.
- Abolition of students Visas for East Africa.

Chapter 13: ECONOMIC PLANNING.

Economic development planning is a deliberate conscious and continuous effort by the government to influence, direct and control major economic variables so as to achieve pre-determined objectives of development over a given period of time.

Or

It is a deliberate government attempt to formulate decisions on how production resources shall be allocated among different uses in order to achieve targeted objectives of development such as economic growth in a given period of time.

Or

It is a deliberate government effort or attempt to influence, direct and control economic activities to achieve targeted making of major economic decisions and all forms of government intervention in the operations of the economy.

Economic decisions are made on principle variables such as consumption, savings, investment, employment, infrastructure development and home trade necessary for economic development.

An economic plan is defined as a set of quantitative economic targets o be reached in a given period of time using a stated strategy.

NB. Development Planning.

Development planning is a deliberate government attempt to achieve pre-determined economic, social and political goals of development for the whole country in a specific period of time.

Development planning is the planning for the whole society so as to achieve various economic, social and political objectives. Development planning is wider than economic planning.

Development planning aims at removing obstacles that might hinder economic, social, political and national progress.

UNEB 2012

(i) Distinguish between a sectoral plan and a comprehensive plan. (02 marks)

(ii) State any obstacles to the effective implementation of economic development plans in your country. (02 marks)

TYPES OR CLASSIFICATION OF PLANS.

a) CLASSIFICATION OF PLANS ACCORDING TO COVERAGE.

(i) ***Partial plans*** are plans that cover one part or one sector or a few sectors of the economy.

Partial planning refers to planning for one part of a few sectors of the economy.

A partial plan can categorized as project by project plan, integrated public investment plan and regional plan.

A partial plan can be a **sectoral plan** which covers only one a specific sector of the economy.

A sectoral plan is one which covers one/a specific of the economy. For instance agricultural sector, industrial sector.

ii) Comprehensive plans are plans that cover all sectors of the economy. They cover the whole economy and consider inter-sectoral linkages.

It takes into account sectoral interdependence and priorities. Such as cover public and private sectors issues such as agriculture, industry, services, poverty eradication plans.

Comprehensive planning refers to planning (one) aimed at covering all sectors of the economy.

UNEB 2002, 2000

(i) Distinguish between a partial plan and a comprehensive plan. (02 marks)

(ii) Mention any two merits of a comprehensive plan (02 marks)

Advantages Of A Comprehensive Plan.

- Reduces regional imbalances in development.
- Promotes inter-sectoral linkages.
- Facilitates fair and efficient utilization of all resources.
- Widens the tax base.
- Expands employment opportunities.

Disadvantages Of Comprehensive Plan.

- Requires experienced manpower to draft and implement.
- Requires a lot of resources which are relatively scarce in LDCs.
- In case of plan failure, the country loses a lot of resources.
- Does not favour the development of leading sectors.

UNEB 2015

(i) Differentiate partial planning and perspective planning. (02 marks)

(ii) Mention any two demerits of partial planning in an economy. (02 marks)

Advantages Of A Partial Plan/A Sectoral Plan.

- Easy to manage especially with scarcity of skilled labour.
- Easy and cheap to implement with limited resources.
- Encourages competition between sectors leading to efficiency.
- Limited losses and resource wastage in case of plan future.
- Becomes effective where there is regional imbalance in development.
- Promotes development of leading sectors.

b) CLASSIFICATION OF PLANS BY TIME.

1. ***Short term plans.*** These are plans that cover a short period of time. For instance annual plans that cover a period of one year.

2. ***medium term plans.*** These are plans that cover a period of 5 to 10 years. They act as a link between short term plans and long term plans.
3. ***long term / perspective plans.*** These are long term plans that cover a period of 10 years or above. They are majority plans for long term projects of the government.

Perspective planning. Refers to long term planning in which long term targets are set in advance for a period of ten years or above. For instance planning which covers 20 years or 25 years such as recovery and development plan for northern Uganda, Poverty Eradication Action Plan.

UNEB 1999

(i) Define the term "a perspective plan". (01 mark)

(ii) State any three problems faced in formulation of a perspective plan. (03 marks)

Problems Faced In Formulating A Perspective Plan.

- Limited statistical information.
- Limited skilled man power.
- Heavy dependence on foreign resources.
- Inadequate capital/finance.

NB. *Project planning.* *Refers to planning meant to cover a specific project. For instance dam construction, power supply project.*

D) CLASSIFICATION ACCORDING TO SOCIO-ECONOMIC SYSTEM.

(i) ***Socialist/administrative/directive plan.*** This is one/a plan where resources are owned and allocated by the state through administrative directives.

(ii) ***Indicative plan.*** This is one where government indentifies appropriate investment areas, provides incentives and required information to individual economic units to achieve pre-determined targets.

Or

Is a plan where the government identities priority areas for resource allocation and provides incentives and conducive atmosphere to the private sector but without directing their decisions.

UNEB 2007

(i) Distinguish between partial planning and comprehensive planning. (02 marks)

(ii) State any two constraints to economic development in your country. (02 marks)

THE PROCESS OF PLANNING.

Planning is a comprehensive and continuous process and it involves the following steps;

- **Plan identification, goals and objectives.** It involves defining what is to be done and what is to be achieved in a given period of time.
- **Plan formation.** This is the setting of plans where ways of achieving the objectives are formulated and estimation of costs and benefits of the plan.
- **Plan implementation.** This is transforming the plan into actual work. It is the practical part of the planning process where programmes and projects are started.
- **Plan evaluation and assessment.** This is an attempt to find out whether the plan is fulfilling the intended objectives. Evaluation takes place even at implementation stages.

WAYS/SOURCES OF FINANCING DEVELOPMENT PLANS.

- Borrowing from internal and external sources.
- Use of foreign aid in form of grants and donations.
- Use of accumulated savings.
- Use of revenue from taxation.
- Sale of state enterprises.
- Profits from government bodies and investments.

UNEB 2001

a) Why is there a need for development planning in your country? (10 marks)

b) What factors that limit the effective implementation of development plans in plans country? (10 marks)

UNEB 1999

a) What is economic development planning? (04 marks)

b) Why does your country carry out economic planning? (16 marks)

UNEB 2010

a) Distinguish between partial planning and decentralized planning. (04 marks)

b) Why is development planning necessary in an economy? (16 marks)

UNEB 1998

a) Why is it necessary to carry out development planning in your country? (10 marks)

b) Examine the problems encountered in the formulation of development. (10 marks)

RATIONALE/REASONS/NEED/OBJECTIVES FOR ECONOMIC PLANNING IN AN ECONOMY/ WHY IS IT NECESSARY TO CARRY OUT ECONOMIC PLANNING.

These must be given as reasons but not as role or importance of economic planning

- **To correct deficiencies of price mechanism.** Price mechanism is associated with defects and these require government planning to reduce problems especially in the periods of rapid structural changes. For instance in periods of natural disasters.
- **To ensure proper allocation of resources.** Resources are scarce and therefore a need for proper allocation in productive projects so as to get as much output as possible. It therefore helps to identify suitable areas where scarce resources can be used most productively.
- **To ensure equitable distribution of income.** Resources and incomes need to be distributed between regions and individuals in a fair way and this requires systematic planning by the government such as the use of progressive taxation.
- **To achieve pre-determined rate of economic growth.** Systematic planning helps to utilize available resources and increase output in all sectors of the economy through favourable investment climate.
- **To reduce inflation and attain price stability.** This requires systematic planning for the use of monetary and fiscal policies to influence production levels and attain price stability. For instance reducing government expenditure and increasing direct taxes to reduce demand pull inflation.
- **To reduce unemployment problem.** This is possible through planning for economic expansion of areas that create employment where both private and public investments are encouraged to promote job creation, proper manpower planning and promote resource utilization and development to absorb the abundant unemployed labourforce.
- **To mobilize foreign resources/aid.** Plans must be presented first to both multi-lateral and bi-lateral donors before any financial assistance is given to guarantee how such resources are to be used. Development plans act as “begging lists” to attract foreign resources for project implementation for national development.
- **To identify areas suitable for both private and public investment.** Projects that benefits the entire society are less profitable and essential are fit for public investment such as roads , power supply, railways which benefit the entire society are undertaken by the public sector and others which are highly profitable are left to private sector.
- **To correct balance of payment problems/improve balance of payment position.** This is through systematic planning to increase exports by setting up export promotion industries and reduce imports thus increasing foreign exchange earnings and reduce foreign exchange expenditure.
- **To reduce external economic dependence/promote self reliance.** Planning helps tin promoting a self-sustaining integrated economy by setting up import substitution industries through suitable plans, raising enough revenue locally, increased raining of local manpower to reduce dependence on expatriates.

- ❖ **To encourage public participation in development/solicit for political support.** The government uses economic plans to highlight benefits of the plan which helps to win support and makes it possible for members of the public to be involved in process and development of a national economy. Its intended course of action and activities it opts to achieve are shown in a plan in order to win political support and participation of the public in nation building.
- ❖ **To relate present performances to future economic trends and targets.** Future economic opportunities for national development are revealed basing on present economic activities that may change in future. For instance drawing a relevant education plan basing on current education system. Current projects are therefore implemented to suit future needs of the country.
- ❖ **To ensure harmonious and consistent use of resources.** This is to ensure that resources are properly used in line with development programmes to void resources wastage, avoid duplication of projects and achieve high rates of development.

UNEB 2005

a) *Distinguish between a sectoral plan and a comprehensive plan. (04 marks)*
b) *Explain the importance of economic development planning in an economy. (16 marks)*

UNEB 2004

a) *Distinguish between a comprehensive plan and a partial plan. (04 marks)*
b) *Examine the role of planning in an economy. (16 marks)*

IMPORTANCE/POSITIVE ROLE OF ECONOMIC DEVELOPMENT PLANNING IN AN ECONOMY.

NB: *These should not be given as reasons for economic planning*

- ➢ Corrects deficiencies of price mechanism.
- ➢ Ensures efficient mobilization and utilization of resources.
- ➢ Ensures equitable distribution of resources and incomes.
- ➢ Achieves pre-determined rate of economic growth.
- ➢ Reduces inflation and ensures price stability.
- ➢ Reduces unemployment and under employment problems.
- ➢ Makes it easy to mobilize foreign resources.
- ➢ Ensures harmonious and consistent use of resources.
- ➢ Identifies areas suitable for both private and public resources.
- ➢ Corrects balance of payment problems/improves balance of payment position.
- ➢ Reduces external economic dependence.
- ➢ Relates present performance to future economic trends and targets.

NEGATIVE ROLE OF ECONOMIC PLANNING IN AN ECONOMY.

- **Limits consumer sovereignty/distorts the working of price mechanism.** Centralized planning leads to misallocation of resources thus freedom of choice by consumers is violated. Planning by the state does not allocate resources according to the needs of people but according to the objectives of the state hence ignoring the role of price mechanism.
- **Encourages bureaucracy.** There are delays in decision making and implementation of plans by the government especially under centralized planning. Planning requires a lot of consultations at different levels which leads to slow and unnecessary delays in decision making.
- **Discourages private individual initiatives.** This is especially where centralized planning is undertaken where chances of private individuals to take action in economic decisions regarding production are reduced, this limits creativity and innovativeness among private individuals.
- **Breeds corruption and embezzlement.** Planning involves high level of corruption during plan formation and implementation by official responsible which limits success of plans.
- **Promotes inefficiency in production.** This is especially where high level of centralized planning is undertaken where there is limited level of competition in plan implementation leading to underutilization of resources and production of low quality goods.
- **Promotes political dictatorship.** Sometimes, there is no consultation of all democratic institutions especially during centralized planning and the public may oppose such plans. Politicians in most cases are end up dictating certain plans in order to achieve their objectives which may not be supported by the public.
- **Plan formulation and implementation is a very expensive/costly process.** It needs a lot of resources in monetary form and manpower which are not easy to mobilize on part of government.
- **Encourages wastage of resource due to over production.** It is hard to assess accurately what is needed by consumers especially under centralized planning. Resources may be allocated to certain projects whose output is not demanded by the public.

UNEB 2002

a) *Differentiate between centralized planning and indicative planning. (04 marks)*

b) *What are the factors that influence the effectiveness of economic development planning in developing countries? (16 marks)*

UNEB 2013

(i) *What is meant by economic development planning? (01 mark)*

(ii) *Give any three factors that affect the implementation of development plans in your country. (03 marks)*

UNEB 2015

a) *What are the benefits of economic development planning? (08 marks)*

b) *Explain the factors that influence the implementation of economic development plans in your country. (12 marks)*

FACTORS THAT INFLUENCE/DETERMINE THE EFFECTIVENESS OF ECONOMIC PLANNING IN AN ECONOMY.

NB: *These must be presented as neutral points and each point should be explained fully in two sides catering for effective / successful economic planning and ineffective/ unsuccessful economic planning.*

- **Rate of inflation/general price level.** High rate of inflation makes economic planning unsuccessful while economic stability in form of low rate of inflation leads to effective economic planning.
- **Population growth rate.** High population growth rate affects the limited resources for successful economic planning which hinders effective economic planning whereas a low population growth rate makes economic planning more effective.
- **Availability statistical data.** Availability of enough statistical data about economic variables encourages effective economic planning while limited statistical data about economic variables hinders effective economic planning.
- **Efficiency of the implementation machinery/quality f administrative staff.** Presence of efficient administrative machinery in planning sections leads to successful economic planning while inadequate efficient administrative machinery in planning unit limits economic planning.
- **Availability of financial resources/funds from within and abroad.** Availability of enough financial resources makes enough planning more effective which inadequate financial resources limits effective economic planning.
- **Level of corruption and embezzlement in planning process/level of accountability.** High level of corruption and embezzlement in planning process hinders effective economic planning while low level of corruption and embezzlement in planning process leads to effective economic planning.
- **Political climate.** Poor political climate limits effective economic planning whereas favourable political climate encourages effective economic planning.
- **Level of infrastructure development.** High level of infrastructure development leads to successful economic planning but underdeveloped infrastructure limits successful economic planning.
- **Level of dependence on nature/level of occurrence of natural calamities.** Frequent occurrence of natural calamities hinders effective

economic planning while limited occurrence of natural calamities leads to successful economic planning.

- ❖ **Political will and support of the masses.** Good political will and support from masses in planning process leads to successful planning while limited political leads to unsuccessful economic planning.
- ❖ **Availability of trained manpower in planning/skills of planners.** Increased supply of trained manpower in planning leads to successful economic planning while limited supply of skilled manpower in planning limits successful economic planning.
- ❖ **Degree of responsiveness of the private sector.** A rapidly growing non response private sector limits successful planning compared to where the private sector is weak and responsive.
- ❖ **Degree of dependence on external resources/aid for planning.** High degree of dependence on external resources limits successful economic planning while limited degree of dependence on external resources for planning leads to successful economic planning.

UNEB 2011

a) What are the features of a good economic development plan? (06 marks)

b) Explain the challenges faces during the implementation economic development plans in your country. (14 marks)

UNEB 2008

a) Describe the features of a good economic development plan. (10 marks)

b) Account for the failure of developing countries to effectively implement economic development plans. (10 marks)

CHARACTERISTICS/QUALITIES/FEATURES OF A GOOD ECONOMI PLAN.

- ❖ **A good economic plan should be economically feasible.** It should be achievable and not too ambitious in relation to the available resources. if planned programmes exceed the available resources, the objectives of the plan cannot be fully achieved.
- ❖ **It should be as comprehensive as possible.** It should cover almost all the sectors of the economy taking into account linkages between various sectors.
- ❖ **A good economic plan should be consistent in nature.** Should be in line with the country"s development goals for easy implementation.
- ❖ **It should be internationally relevant.** It should be in line with the international or word economic policies and programmes such as policies of financing bodies, world prices since they affect achievement of objectives of the plan.
- ❖ **A good economic plan should be socially relevant.** The plan should address the social needs and aspirations of the society to encourage public participation.

- **A good economic plan should sequential.** It should enable the establishment/implementation of projects in an orderly/logical manner. Projects should be set up step by step procedure. For instance improving transport systems before expanding the mining sector.
- **The plan should be politically acceptable.** It should be in line with the political systems of the country and in the interest of majority of the public to reduce political sabotage in plan formulation and implementation.
- **A good economic plan should ensure compatibility.** It should fit in other relevant plans or support other plans to ensure linkages between plans in different sectors of the economy.
- **A good economic plan should ensure proportionality.** Allocating resources to various projects or sectors according to some degree of priority.
- **A good economic plan should ensure optimality in the use of resources.** it should ensure full utilization of planned resources to ensure maximum social welfare.
- **It should ensure simplicity.** It should be easy to understand by the general population to encourage participation.

CONDITIONS/REQUIREMENTS NECESSARY/PRE-REQUISITES FOR SUCCESFUL ECONOMIC PLANNING.

- **Availability of enough reliable statistical information.** Statistical data should be available and up to date about various variables such as population, GDP, income levels, employment and foreign trade to enable fixing priorities in suitable investment programmes for successful plan implementation.
- **Clearly stated objectives of planning.** Realistic priorities and objectives of planning should be set in that they are specific, measurable, achievable, realistic and time bound such as ensuring price stability reducing income inequality, annual rate of job creation.
- **Availability of enough capital resources.** These can be mobilized from both internal and external sources for financing the plans in both formulation and implementation stages.
- **Efficient administration which is not corrupt.** Strong, efficient and incorrupt administrative staff as a major pre-requisite for successful economic planning since it helps to allocate resources properly during plan implementation.
- **Availability of enough skilled labour in planning process.** There should be a planning authority or machinery such as economists, engineers, accountants, planning committee of cabinet and central planning agency which are necessary to collect reliable statistical data.
- **Adequate political will or political good will.** The government should be committed to implement the plans and degree of political sabotage should be low for easy plan implementation.

- ❖ **Enough public participation and support.** Planning must win support from the masses who should actively participate in plan implementation.
- ❖ **Political stability.** This is necessary to allow easy mobilization of funds and plan implementation.

UNEB 2014

a) *Why is it necessary to formulate an economic development plan in a country? (08 marks)*

b) *Explain the factors that limit successful implementation of economic development plans in developing countries. (12 marks)*

UNEB 2009

a) *Define the term perspective planning. (04 marks)*

b) *Explain the factors limiting economic development planning in developing countries. (16 marks)*

UNEB 2005

a) *Distinguish between centralized planning and decentralized planning. (04 marks)*

b) *Explain the factors that limit the successful implementation of economic development plans in developing countries. (16 marks)*

LIMITATIONS/CHALLENGES /CONSTRAINTS OF ECONOMIC PLANNING IN LDCs.

These are given as one sided factors which undermine/limit the process of plan identification, formulation of goals/objectives of planning, implementation of plans and evaluation of plans leading to unsuccessful economic planning.

- ❖ **Limited reliable statistical data/information.** The quality and quantity of data about performance of different sectors, economic variables is limited which does not allow accurate planning. This is due to poor record keeping, many people are not willing to give accurate information thus plan future.
- ❖ **Limited control over natural factors/unfavourable natural factors.** Natural calamities such as climatic changes, floods, earthquakes, landslides are unpredictable and make planning difficult since funds are diverted from financing various plans to rescue the situation.
- ❖ **Inefficient implementation/administrative machinery.** This leads to poor coordination between planners and implementers. Therefore, no suitable institutions to implement plans at both local and regional levels leading to poor coordination in planning.
- ❖ **Inadequate capital/limited funds.** LDCs lack adequate capital for effective planning process because of low tax revenue and difficulty to secure loans. Planning in LDCs s only on papers but not in reality and

most plans are not translated from paper into actual practice/practical implementation while others are partially implemented.

- **Failure to identify viable or worthwhile projects/priorities.** This leads to resource wastage because projects which are profitable and income generating are hard to find out due to limited skilled personnel.
- **High dependence on foreign aid.** Most LDCs depend on foreign resources to implement their plans because of low tax revenue and other domestic revenue sources but foreign aid is inadequate, inconsistent/uncertain and tied thus some plans are never implemented due to adequate funds from donors.
- **Drawing of over ambitious plans.** Over generalized plans are drawn, sometimes unrealistic and therefore are not east to achieve since they aim at achieving too many objectives in a short time and end up failing.
- **External influence and pressure from developed countries.** For instance IMF unrealistic conditionalities of liberalization, cost sharing, privatization and restricting of public service. There is external pressure from donor countries and agencies which normally dictate on the type of projects to sponsor or be undertaken that may not a priority to LDCs' development.
- **Corruption and embezzlement of funds in planning process.** This is especially on the part of plan formulators and implementers and therefore false accountabilities are presented thus failure of plans thus leaving certain plans never implemented.
- **Non responsive growing private sector.** The government may not have direct control over given activities of the private sector in the process of planning. Some plans are supposed to be implemented by the private sector which may be non responsive towards plan implementation.
- **High inflation rates.** Most LDCs experience persistent inflation which makes plan implementation difficult since the value of money is reduced overtime. This leads to plan failure since it will be difficult to complete projects being implemented since the cost of plan implementation goes high.
- **Political sabotage/interference by politicians.** Because of differences in political motives among politicians, some plans which would have been good are sabotaged, stopped to meet their political interests and plan implementation becomes very difficult.
- **Political instabilities and insecurity.** Political insurgencies in LDCs make economic planning difficult since most of the resources are diverted for suitable plans to stabilize political climate and restore peace. Frequent military coups and popular uprising have left many plans on paper since investment is discouraged.
- **High population growth rate which affects limited resources for planning.** Most LDCs have high population growth rates which increase dependence burden and high expenditure on provision of social services, which limits resources to implement plans leading to plan failure.

- **Limited political will and full support by the people/conservatism.** People do not have full support for government programmes such as poverty reduction, controlling diseases and plans tend to remain on paper. There is limited support of the plans from the public and this creates difficulty during plan implementation.
- **Poorly developed infrastructure.** Poor road network and telecommunication services limit coordination of various plans during plan implementation thus plan failure since some areas cannot be accessible by planners.
- **Limited supply of qualified planners/skilled manpower who are also nationals.** There is too much over reliance on expatriates who have limited knowledge about planning in developing countries which limits plan process. There are limited economists and staticians to draw accurate plans and implement them.

PRINCIPLES OF ECONOMIC PLANNING.

- **Comprehensiveness.** Planning should cover all the sectors and regions of the economy so as to address the various elements of development and promote linkages among sectors.
- **Sequencing.** Activities of economic plans should be established before secondary projects. For example establishment of roads before industries.
- **Optimality.** Planning should ensure utilization of available resources more efficiently so as to ensure maximum welfare.
- **Feasibility.** The objectives of planning should be SMART. Plans need to be economically achievable in line with the available resources. it should clearly show the time period the projects are supposed to be completed.
- **Proportionality.** Resource allocation and timing should be according to some degree of priority and resources should be allocated between different sectors according to their importance on the economy.
- **Consistency.** It should be in line with the country"s economic development goals for easy financing. This is meant for easy implementation.
- **Compatibility.** Various plans should be related and bale to support one another to ensure maximum linkages between sectors such as agriculture and industry. Objectives of the plan should not conflict with the already existing objectives.
- **Simplicity.** Plans should be easily understood by planners themselves, implementers and the general population for successful implementation.
- **Acceptability.** A good economic plan should be accepted by the masses and politically acceptable among politicians to ensure their full participation in implementation.

UNEB 1998

a) *Distinguish between centralized planning and decentralized planning. (04 marks)*

b) *Account for the existence of decentralized planning in your country. (16 marks)*

DECENTRALIZED PLANNING AND CENTRALIZED PLANNING.

Decentralized Planning.

This is one/planning where economic decision making and implementation of plans in line with set targets are undertaken by local governments/local authorities instead of central government or authority for instance planning at district level.

Planning activity begins from the grass root/regional/district level and the plans made are incorporated of integrated in the central government plan. Such plans must be in line with attainment of national objectives.

REASONS WHY THERE IS DECETRALISED PLANNING IN LDCs/WHY IS DECENTRALIZED PLANNING NECESSARY IN DEVELOPING COUNTRIES.

- ❖ **To encourage use of local resources for efficient utilization.** Local resources are utilized fairly since suitable local plans are made to utilize them on the grass root level.
- ❖ **To reduce bureaucratic tendencies of central planning.** There is high level of bureaucracy in centralized planning which makes decentralized planning suitable. This leads to quick decision making and plan implementation since there are limited consultations to be made
- ❖ **To promote division of labour central and local government.** Regions plan for their own development and the central government plans for other sectors which reduces the burden to the central government.
- ❖ **To promote regional balance in development.** Local opportunities in each region are maximumly tapped if there is suitable planning and such region develop equally thus promoting regional development.
- ❖ **To ensure fair distribution of employment opportunities to local people.** It provides employment to local people through increased utilization and identification of various rural opportunities increases employment opportunities.
- ❖ **To ensure efficient tax revenue collection.** Taxes and other forms of revenue are easily collected by local authorities since they can easily be identified to increased government tax revenue and better service delivery is offered.
- ❖ **To favour interests by involving local people in plan implementation.** This enables each region to take advantage of its priorities.
- ❖ **To reduce rural urban migration.** Decentralized planning helps to expose local opportunities and local projects are set up which increases employment to rural labour.

- **To promote a sense of belonging and participation in development among citizens.** Decentralized planning enables the public to participate in policy making and implementation and feel part of the development process.
- **To promote equitable distribution of income.** Decentralized planning enables every region to utilize its resource potentials and provide income to local people, therefore a tendency of such regions to develop equally.
- **To ensure that each region takes full advantage of its priorities.** This helps to cause meaningful development in such localities.
- **To suit poor countries with limited capital to plan for whole country at ago.** There is limited capital to cater for all regions at the same time which leaves each region to suffer on its own and mobilize resources for development.
- **To suit large countries.** Decentralized planning breaks a large country into small units which are effectively controlled and planned for so that resources are effectively controlled.

UNEB 2008

(i) What is meant by decentralized economic planning? *(01 mark)*

(ii) State any three merits of decentralized economic planning. *(03 marks)*

Merits Of Decentralized Planning.

- Reduces bureaucratic tendencies of centralized planning.
- Promotes a sense of belonging and participation in development among local people.
- Reduces rural urban migration.
- Enables each region to take full advantage of its priorities.
- Promotes fair distribution of employment opportunities.
- Promotes regional balance in development.
- Encourages use of local resources.
- Promotes equitable distribution of income.
- It promotes division of labour between central and local government.
- It ensures efficient tax revenue collection.
- It is appropriate for large country.

Demerits Of Decentralized Planning.

- Promotes regional imbalance in development because some regions with enough resources develop than others with inadequate resources.
- Leads to duplication of development projects which leads to resource wastage. This is due to lack of coordination in project implementation among districts therefore; similar projects are developed at the same time.
- Promotes corruption at local levels. This leads to plan failure.

- Creates conflict between local and national interests. This is because local interests may differ from national interests hence limiting development.
- Worsens imbalance between sectors due to poor coordination while developing different sectors.
- It promotes nepotism and discrimination. This is because jobs tend to be given to some local people even without necessary qualifications.
- Leads to over taxation at local levels. Local people are normally over taxed by local governments to raise more revenue for project implementation.

CENTRALIZED PLANNING.

This is planning by the central authority which determines resource allocation in the whole economy and directs implementation of plans in line with the set targets/objectives. Planning is made by the central authority (central government) by addressing the concerns of different regions and sectors.

Planning is done at the national level to cover all the economic activities within the whole country. The central planning authority formulates a central plan, fixes objectives, priorities and targets for every sector of the economy.

UNEB 2012

a) *What is meant by centralized planning.* *(04 marks)*
b) *Explain the rationale for centralized plannimg in an economy.(16 marks)*

RATIONALE/REASONS/NEED FOR CENTRALIZED PLANNING IN AN ECONOMY.

- For easy mobilization of resours.
- To achieve a pre-determined rate of economic growth.
- To indentify areas suitable for public and private investment.
- To relate present to future economic trends and targets.
- To reduce unemployment problem.
- To solicit for foreign aid.
- To ensure proper coordination in sectoral developmet since the private sector is still weak.
- To correct deficiencies of price mechanism especially during the periods of rapid structural changes.
- To promote self reliance.
- To fight income inequality/ensure equitable distribution of resoures.
- For proper sequencing of operations of the economy.
- For political support.
- To ensure economic stability.
- To reduce the problem of shortage of manpower at local levels.
- To protect national interest.

- To ensure consistency of plans in centralized planning since it is done in line with the available resources.
- To ensure proportionality and compatibility of plans.
- To eliminate duplication of development projects.

INDICATIVE PLANNING.

Indicative planning is planning where government identifies appropriate investment areas and provides incentives and relevant information to individual economic units to achieve pre-determined targets. This is planning where the government identifies priority areas for resource allocation and provides incentives and conducive atmosphere to the private sector without directing their decisions to achieve pre-determined tagets.

The government indentifies priority areas for resource allocation and provides necessary incentives such as subsidies,tax exemptions and other conducive atmosphere to private sector to achieve the pre-determined targets. The government influences the level of economic activity indirectly through fiscal and monetary policies.

HOW TO EXCEL IN ECONOMICS EXAMINATION.

Economics is among the subjects offered by many students at “A” level in Uganda‟s current education system.

Currently, it is highly competive and therefore one must highly contend to be among the many students who excel in economics. It is wide subject which almost touches every aspect of human life.

In the past, economics used to be purely a theoretical subject and most of the ancient economics text books were not in any way different from the bible.

Economics forms the basis of most courses offered in higher institutions of learning such as universities especially in the department of economics and other related fields. This implies that one must have passed economics to be able to be offer such related courses.

GUIDELINES ON HOW TO EXCEL IN ECONOMICS EXAMINATION

- Now days students tend to answer economics like any other subject which should not be the case for instance a question asking for problems encountered in compiling price indices, a student gives general problems such as poor transport and communication, political instability, poor government policy, poor climatic conditions which do not apply to such a question at all.
- Every question must be given an independent economic interpretation.
- Spellings and grammar are very important because wrong spellings of major economicwords/technical words/key terminologies qualify for zero especially in definitions.
- Do not abbreviate your work because this qualifies for zero except for known abbreviatetions in economics and to examiners on some given questions.
- Begin with any section of your choice and ensure clear numbering of your work to ease the work of the examiner when marking to avoid loss of marks.
- For section B, emphasis should be put on stating the point and explaining it since in most cases there is a mark for a well stated point and a mark for correct explaination depending on how marks are to be distributed especially for paper two. Your explanation should briefly try to bring out how or why or effect element depending on the question or point given and this should not contradict with the main point stated.
- Any wrongly stated point but with correct explanation qualifies for zero This implies that you should aim at giving only valid points by reading the question critically. For instance discus the factors that limit capital accumulation in an economy and what are the factors that leads to an increase in supply of a commodity. All these two questions require one sided points but the former requires negative points implying thatv your points should be clearly stated to appear as one sided negative answers while the latter requires positive points implying that your points should be clearly stated to appear as one sided positive points.
- When distinguishing two economic aspects, use of a contrasting word for example wheras, while is very important. If a contrasting word is ingored you are likely to lose a mark implying that you must write on all the two concepts.
- Observe clearly the tense used in the question and remain in that tense when answering. Avoid setting your own questions. For instance what factors have influenced industrial development in your country, what measures are being taken to attract direct foreign investment, what policy measures have been undertaken to reduce unemployment in your country. Your explanation must follow the tense used in such questions.
- Observe whether the question is in singular or plural and your answer should be that direction for instance explain the role of multinational

corporations and explain the role of a multinational corporation in your country, what are partial plans and what is a partial plan, define factor prices and define a factor price.

- Observe whether the question requires special phrases and qualifiers to be used when stating points for example To , When, It ingnores For,If,icase, Differences,change and the use of qualifiers such as limited,dominated,mainly,few,most,majority,basically, predominatly, many among others.
- Rubric numbers/extra numbers attempted are not marked,so put all your efforts and time on the required questions in the examination.
- Avoid unnecessary illustrations,introductions and conclcusions unless they are called for or relevant for given questions. There are no marks for introductions,unnecessary definitions and conclusions. Productive and relevant diagrams are necessary and should be clearly drawn , named,defined and explained. Give only productive diagrams that are likely to give you marks.
- Number all the parts of your work properly and give a clear opening statement for every question attempted to give a direction to the examiner and this will also help you to remain in line with the question when answering.
- Alternative definitions are allowed where a question requires you to define. This is very advantageous especially if you are not sure on which definition is most a ppropriate for a given concept.
- Avoid duplicating and repeating points since there are no marks for repeated points.Try to read extensively and master necessary points on a given concept.
- Avoid using a speculative language/suggestive words where it is not necessary such as may, could,might,will, can among others unless they are used in the question or the question itself requires you to suggest. For instance what are the objectives of monetary policy/fiscal policy in your country?, assess the role of trade liberalization in your country, there is no way you can use suggestive language anywhere in such questions.
- For mathematical numbers,always state the formula,substitute the values in the formula and come up with an answer. Observe whether the answer should be give units or not. Refer to the units that are used in the question. For instance price indices, multipliers do not have units.
- Paper two is a practical paper which requires a student to have a wider knowledge on economic aspects of his country through giving vivid examples/facts that help to bring out a clear meaning of the point given where necessary but not ordinary examples. For instance if a question is asking for the measures that have been undertaken to reduce income inqualities in Uganda, points such as setting of aminmum wage and use

of price control will not work, therefore student should have knowledge on the economic aspects of his country.

- Quote relevant statistical data only when you are sure about it because such data changes overtime and unrealistic figures given are likely to make your work wrong.
- For neutral questions, always state the point in a neutral manner and explain it fully in two sides and avoid incomplete explanation on such numbers. Make sure that the point is fully explained in both sides for instance Explain the factors that influence/affects/determine the growth and size of affirm in an economy.
- General points/ambiguous points given qualify for zero, therefore specificity is very important in economics. Points such as it increases general standard of living, leads to economic development, full utilization of all resources, leads to equal distribution of resources, inadequate resources, government policies, maximum rural development, interest rate among others are generalized or too ambiguous and therefore should be avoided. Try to emphasize the element of being specific when waiting your work.
- Indentify the questioning word used in each question and give your answers in that direction. Various questioning words may include: determine, influence, affect, hinder, problems, limit, impact, undermine, challenges, limitations, effects, constraints, relevancy, applicability among others.
- Questions about to what extent are open to judgement but most of the theories in economics to a greater extent are not applicable to LDCs and a student is supposed to have a stand point. Stick to where the question is meant to be relevant/irrelevant i.e whether to developing countries or your country when explaining your work.
- Do not limit yourself on only the points required, give extra points since the examiner will mark and give marks to only the points that are correct. But still do not waste time giving numerous points where it is not necessary as you may end up duplicating points and wasting the limited time.
- Try to establish the procedure that must be followed when answering methodological questions such as procedure of compiling price index, process of credit creation by commercial banks. These must be presented in a given logical order.
- Look at the distribution of marks because some questions require many points each to be muitiplied by one if it is well stated and explained and other require limited points each to be multiplied by two if it is well stated and explained. This will help you to manage time in an examination.
- Economics is a dynamic subject since it keeps on changing because economies keep on changing and progressing where new economic

aspects come up and old ones cease to exist. This implies that definitions and some points in the subject keep on changing and you must read widely to find out these emerging changes and be incorporated in the subject to suit the current economics UNEB marking standards.

- Sectors of the economy such as import and export sector, public sector, industrial sector, agricultural sector experiences new changes year after year due to emerging development requirements of the country.
- Government policy and plans on various economic variables such as money supply, employment, fiscal policy, production, inflation, investment among others keep on changing and these changes must be incorporated in the subject.
- Major variables such as the size of public debt, government budget, inflation rate, percapita income, real GDP and nominal GDP grow rate, interest rates, foreign exchange reserves, money supply, unemployment rate, ratev of resource untilization are never static year after year. These changes must be incorporated in the subject.
- UNEB, National Curriculum Development Centre and Ministry of Educatio are now emphazing the aspect of practicability in education system implying that students must not be selective to cram the subject when reading. Attempts should be made to understand the subject must matter in totality to avoid being disappointed in exam in case you find the numbers you have read are not examined.
- Avoid developing negative attitude about certain topics since most students tend to ingnore given topics giving immature reasons that such topics are complex and abstract. Any question can be set from any part of the subject implying that you should have wider knowledge about all examinable aspect.
- Read various sources of information on economics such as teachers notes, UNEB marking guides, relevant textbooks, internet, listen to radios, watch tevevisions, read magazines, newspapers, study national budgets, policy papers or reports released by various ministries and government agencies on employment, inflation,population and price indices, national income, monetary policy, balance of payment, size of national and public debt. This will help you to get current information concerning the economics of your country.

Economics is highly a practical subject and students should never try to cram it and itv should enable students to-

1. Understand the role of government in economic development.
2. Understand major economicconcepts.
3. Use the scarce resources productively and in the most economic manner. If all things were free, economic would not exist and there would not be a need to economize.

4. Be able to develop a set of economic measures to the problems facing modern economies especially in developing countries.
5. Understand the major economic problems facing modern economies/developing countries.

"You may not be interested in economics but economics is definitely interested in you, it is part of your daily life experiences"