Economics paper 1 set 18 and marking guide

SECTION A (20 marks)

Answer all parts of this section

1. (a)(i) What is a free market economy? (01mark)
   (ii) State three features of a free market economy. (03marks)
   (b)(i) Define the term price elasticity of demand. (01mark)
   (ii) Calculate the price elasticity of demand if increase in price of sugar from shs. 2000 to shs.2500 per kilogram resulted in a 10% decrease in its demand. (03marks)
   (c)(i) Outline any two features of the informal sector. (02marks)
   (ii) State two advantages of informal sector in an economy. (02marks)
   (d)(i) Differentiate between agricultural modernization and agriculture mechanization. (02marks)
   (ii) Mention any two advantages of agricultural modernization to an economy. (02marks)
   (e)(i) State the marginal productivity theory of wages. (01mark)
   (ii) Outline any three assumptions of the marginal productivity theory of wages. (03marks)

SECTION B (80MARKS)

Answer any four questions from this section

2. (a) Describe the characteristics of a monopolistic competitive market (08marks)
   (b) How do firms under monopolistic competition determine profit in
   (i) short run
   (ii) long run (12marks)
3. (a) Explain the Malthusian population theory (12marks)
   (b) What are limitations of the Malthusian population theory in developing countries? (08marks)

4. (a) Explain the objectives of the monetary policy. (08marks)
   (b) Examine the factors that influence the effective operation of monetary policy in developing countries. (12marks)
5. (a) Why do developing countries rely more on indirect taxes as a source of revenue? (14marks)
   (b) What are the demerits of indirect taxes? (06marks)
6. (a) Account for the formation of regional economic integration. (10marks)
   (b) Explain the challenges of regional economic integration in developing countries. (10marks)
7. (a) Describe the features of good economic development plan. (08marks)
   (b) Explain the benefits of development planning in an economy. (12marks)

Guide

SECTION A (20 marks)

Answer all parts of this section

1. (a)(i) What is a free market economy? (01mark)

A free **market economy** is an economy where the allocation of resources are determined by the market forces of demand and supply with limited or no government intervention.

(ii) State three features of a free market economy. (03marks)

- Private ownership of resources / property
- Freedom of choice and enterprise / consumer sovereignty.
- Self-interest as the dominating motive.
- Competition in product and factor markets.
- Reliance on price mechanism in the allocation of resources; prices are determined by forces of demand and supply.
- Limited / no government intervention.
- Profit maximization is the main objective.

(b)(i) Define the term price elasticity of demand. (01mark)

Price elasticity of demand is the measure of the degree of responsiveness of quantity-demanded of a commodity to changes in its price

(ii) Calculate the price elasticity of demand if increase in price of sugar from shs. 2000 to shs.2500 per kilogram resulted in a 10% decrease in its demand. (03marks)

PED = $\frac{\%change\ in\ quantity\ demanded\ of\ commodity}{\%\ change\ in\ price\ of\ the\ commodity}$

Percentage change in quantity = -10%

Percentage change in price = $\frac{2500-2000}{2000}\ x\ 100 = 25\%$

= $\frac{-10\%}{25\%} = -0.4$

(c)(i) Outline any two features of the informal sector. (02marks)

- Dominated by the small scale firms
- Produces mainly consumer goods.
- Production is mostly for local / domestic market
- Produces mainly low quality products.
- Mainly uses local resources / inputs.
- Mainly uses simple production techniques/ mainly labour intensive
- Uses mainly **unskilled** and semi-skilled labour.
- Ccharacterized mainly by low productivity/ low output is produced.
- Limited/no book keeping

(ii) State two advantages of informal sector in an economy. (02marks)

- Widens tax base i increases government revenue.
- Promote development of entrepreneurial skill /abilities.
- Facilitates the process of industrialization/increased output/ GDP / Economic growth.
- Promotes resource utilization
- Produces cheap goods/ at affordable prices.
- Reduces income inequality.
- Promote commercialization of economy/reduce subsistence production
- Widens consumer choices/produces a variety of product

- Provides employment to local population
- Promotes development of technology/technical innovation and invention.

(d)(i) Differentiate between agricultural modernization and agriculture mechanization. (02marks)

Agricultural modernization is the transition from low productivity subsistence agricultural sector to commercialized high yielding sector

Agricultural mechanization is the extensive use of machinery in farm production activity to substitute or complement human labour to increase productivity

(ii) Mention any two advantages of agricultural modernization to an economy. (02marks)

- increased output
- increase government revenue
- creates employment
- improves quality of products
- ensures food security
- widens choice or variety of food
- promotes industrial development
- promotes technological development
- promotes infrastructural development
- increases farmers' income
- improves term of trade

(e)(i) State the marginal productivity theory of wages. (01mark)

The marginal productivity theory of wages states that labour should be paid a wage that is equal to the value of its marginal revenue product.

Or

The marginal productivity theory of wages states that profit maximization dictates that labour should be rewarded according to the value of its marginal product.

(ii) Outline any three assumptions of the marginal productivity theory of wages. (03marks)

- Perfect competition in the labour market.
- Homogenous units of labour employed.
- There is no government intervention in the labour market.
- Employers know the marginal product of their workers
- Labour can measure its marginal product.
- Labour is perfectly mobile
- There is equal bargaining power between the employer and the employees.
- It assumes the law of diminishing returns in the production process.
- It assumes existence of excess capacity in the production process.

SECTION B (80MARKS)

Answer any four questions from this section

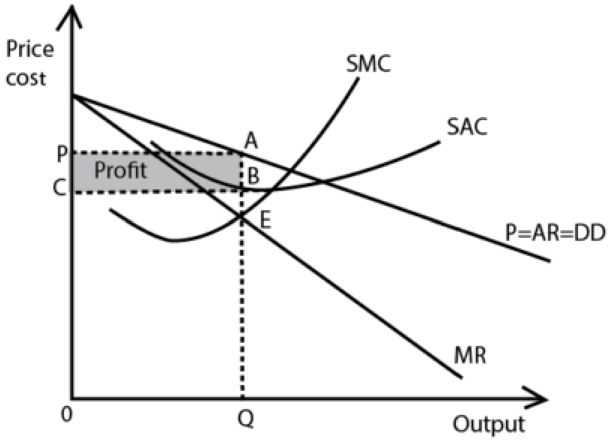
2. (a) Describe the characteristics of a monopolistic competitive market (08marks)

- **Existence of many firms.** There are many sellers and buyers involved in the exchange of closely related products.
- **There is use of persuasive advertisement.** Firms under this market structure use persuasive advertisement in order to
  convince the customers to buy their products and therefore to expand their market share.
- **Freedom of entry and exit.** When a firm makes profits in producing a certain commodity, other firms are free to enter in the production of
  the same commodity and when firms make losses, some firms are free to leave production.
- **Sellers (producers) are price makers.** Firms under monopolistic competition have the power to either their control output or price of the output to a certain extent.
- **There is government intervention.** The government can intervene by implementing certain policies like taxation, fixing prices of commodities in case firms over exploiting consumers etc.
- **Profit maximization is the major goal of producers.** That is, all producers in this market structure aim at maximizing profits and minimizing costs.
- Existence of brand loyalty. That is, certain consumers have a strong attachment to certain brands of commodities. For example Colgate, Coca-Cola products, Shell etc.
- **The demand curve under this market structure is fairly elastic**. This is because firms sell close substitutes and there is stiff competition. In addition, the demand curve is down ward sloping from left to right because each firm has the ability to control price or output a certain extent.
- **There is existence of excess capacity in production both in the short and long run**. Firms under this market structure do not fully utilize their resources to optimal level in the production process.
- **There is existence of product**
  differentiation. Product differentiation refers to the measures taken by producers under monopolistic competition to create artificial diffe rences among products of the same category to make them appear as close substitutes.

(b) How do firms under monopolistic competition determine profit in
(i) short run

The monopolistically competitive firm earns super normal profits (abnormal profits) in the short run.
Equilibrium is attained (profits are maximized) at a point where marginal cost(M C) is equal to marginal revenue(MR) and marginal cost curve should cut marginal revenue curve from below.

Illustration



From the figure above, SMC, is equal to MR at point E. Thus E is the equilibrium point. Corresponding to this equilibrium point, the firm produces OQ output and sells it at a price OP. Thus, the firm earns pure profit to the extent of PABC since total revenue (OPAQ) exceeds total cost of production (OCBQ).

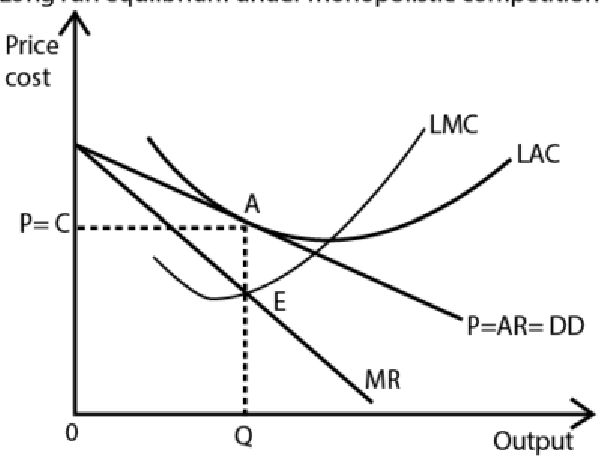
A firm, in the short run, may earn only normal profit if MC = MR < AR = AC occurs. A loss may result in the short run if MC = MR < AR < AC happens

(ii) long run (12marks)

Long run equilibrium position of a firm under monopolistic competition

- In the long run, monopolistic competition comes closer to perfect competition because the freedom of entry and exit allows firms to enjoy only normal profit.
- Equilibrium is attained (profits are maximized) at a point where marginal cost(MC) is equal to marginal revenue(MR) and marginal cost curve should cut marginal revenue curve from below

Long run equilbrium under monopolistic competition

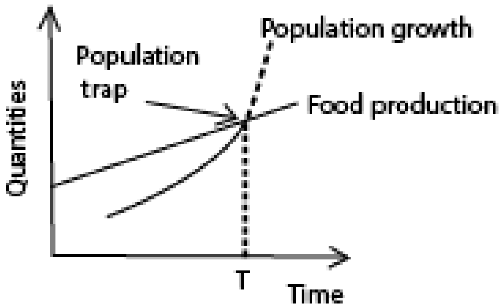


From the graph, equilibrium is attained at point E where the marginal cost (LMC) curve is equal to the marginal revenue (MR) curve. At point E, the equilibrium output OQ, is produced and sold at price OP determined at point A. Therefore, the selling price is equal to the cost price. This implies that total cost is equal to total revenue and therefore the firm earns normal profits.

3. (a) Explain the Malthusian population theory (12marks)

The theory states that **food production will not be able to keep up with growth in the human population, resulting in disease, famine, war, and calamity.**

This because food production grows arithmetically while population grows faster geometrically; thus there will came a given point in time, T, (population trap) when the population would outstrip the means of subsistence leading to starvation, diseases, wars and death (positive checks)



Malthus suggested that the only way to avoid human suffering beyond the population trap; population growth must checked by preventive negative checks such as celibacy, late marriages, family planning, moral restrain, etc.

(b) What are limitations of the Malthusian population theory in developing countries? (08marks)

- It assumes constant technology which is unrealistic since technology is ever changing/technological progress occurs.
- It assumes a closed economy, yet economies of most LDCs are open economies. He ignored the roles of international trade
- Agricultural modernization is not foreseen by the theory yet this takes place in most LDCs.
- Failure of the theory to visualize labour mobility
- Population growth does not depend on food alone.
- The theory is based on the subsistence economy yet LDCs economies are not predominantly subsistence any longer.
- The theory did not foresee great improvement in transport.
- It did no fore see the possibility of getting foreign aid/Resource from other countries.
- There is no mathematical relation regards growth in food and population.
- The theory ignored the deliberate and scientific methods of birth control/modern family planning methods.
- It did not realize that rising living standards can cause a fall in birth rates and population.
- It ignored the possibility emigration to ease pressure on resources.
- Malthus was influenced by the law of diminishing returns which is not always true/which only operates in the short run.
- Negative checks suggested by him are unrealistic due to human behaviour.

4. (a) Explain the objectives of the monetary policy. (08marks)

- To maintain domestic price stability
- To stimulate economic growth and development
- To ensure equitable income distribution
- To help to achieve full employment of resources in the economy
- To maintain a stable foreign exchange rate
- To ensure balanced sustainable growth and development of the economy
- To create a broad and continuous market for government securities (bonds and treasury bills)
- To help establish and develop financial institutions
- To ensure Balance of payments stability in the economy
- To encourage savings through the manipulation of interest rates.

(b) Examine the factors that influence the effective operation of monetary policy in developing countries. (12marks)

- Nature of distribution of commercial banks.
- Level of accountability in the banking sector.
- Level of coordination of goverm11ent objectives. , .
- Level of liquidity preference among the general public.
- Level of development of money markets / financial sector.
- Degree of external interference in Central bank activities.
- Level of liquidity in Commercial Banks.
- The size of the monetary / subsistence sector.
- Degree of awareness of the public about facilities offered by Commercial banks.
- Degree of political interference in Central bank activities especially in implementation of the monetary policy.
- The number of foreign Commercial banks.
- Level of effectiveness in the use of commercial banks

5. (a) Why do developing countries rely more on indirect taxes as a source of revenue? (14marks)

- They are relatively easy and cheap to collect / economical.
- They are difficult to evade because people do not have alternative but to pay them as they consume products
- They are less avoided due to limited loopholes that are found in the laws that set them up.
- They are more flexible / elastic.
- They are convenient to the tax payer as they are hidden in prices of goods and services.
- They are impartial i.e. non discriminative.
- They are comprehensive hence yield more revenue to government.
- They are less resented (politically).

(b) What are the demerits of indirect taxes? (06marks)

- They are regressive in nature i.e. the rich and the poor pay the same price for commodities / widen income inequality.
- They tend to be inflationary.

- They lead to misallocation of resource.
- They encourage trade malpractices for example smuggling.
- They discourage consumption thus reduce the welfare / standard of living of people.
- They strain relationships between countries/ retaliation policy.
- They discourage investment.
- They reduce the volume and benefits of trade.
- They are not certain
- They do not promote civic responsibility among the people/tax -payers.

6. (a) Account for the formation of regional economic integration. (10marks)

- Promotes to production on large scale which leads to a reduction in the cost of production and reduced inflation
- Leads to increase in product availability and customers' choice.
- Promotes market expansion and efficiency gains
- Increases investment to cater for bigger market
- Promotes economic and political stability because of stronger economic ties, which provide an incentive to resolve conflicts peacefully and lead to greater stability
- Promotes trade liberalization due to minimal government intervention
- Increase in employment opportunities and labour mobility
- Leads shared costs of public goods or large infrastructure projects
- Encourages joint research and skill development
- Promotes proper utilization of resources due to competition among member countries
- Improves product quality due to competition
- Attracts investment
- Promotes specialization

(b) Explain the challenges of regional economic integration in developing countries. (10marks)

- They tend to produce similar goods and service which limits market
- Failure/fear to share benefits equally
- Fear to lose customs revenue
- Existence of political instabilities in some of the states
- Differences in the levels of development.
- Differences in social factors e.g. culture, religion, language etc.
- Conflicts among leaders.
- Differences in currencies.
- Differences in political ideologies.
- External interference /sabotage.
- Poor infrastructure among the countries in LDCS.
- Differences in economic policies.
- Lack of political support/will/ignorance of the people.
- Limited geographical proximity between countries.
- Difference in the size of market/population.
- Ignorance of the people about the benefits of integration.

7. (a) Describe the features of good economic development plan. (08marks)

- A good plan should be compatible.
- It should have a good sequence/should be sequenced.

- It should have clear objectives to all people involved in plan formulation and implementation.
- It should ensure proportionality in allocation of resources.
- A good plan should be optimal
- It should be economically achievable/feasible
- It should be socially relevant
- It should be internationally relevant
- It should have an element of continuity.
- It should be comprehensive
- A good plan should be consistent.

(b) Explain the benefits of development planning in an economy. (12marks)

- Ensures proper resource allocation/utilization.
- Ensures equitable distribution of resource/income/regional balance.
- Reduces the level of unemployment problem.
- Corrects BOP problems.
- Ensures stability in prices.
- Ensures self-sufficiency/reduces economic dependence.
- Promotes resource mobilization.
- Encourages public participation in the development of the economic dependence.
- Promotes resource mobilization.
- Encourages public participation in the development of the economy.
- Harmonizes/ensures consistent use of resources.
- Means of attracting foreign aid.
- Helps in identifying areas suitable for public and private investment.
- Relates present to future trends; and targets.
- Corrects deficiencies of price mechanism, most especially during situations of rapid structural changes.
- Promotes economic growth.

Thank you

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