BACKGROUND TO THE SUBJECT OF ECONOMICS

There are two examinable papers i.e. Paper one (P220/1) and paper two (P220/2)

The duration of each paper is 3 hours. Each paper has two section i.e. Section A and B.

SECTION A

This is a compulsory section and it carries 20 marks with each question ferrying 4 marks. The answers in this section must be precise and concise.

SECTION B

This section carries 80 marks and it is made up of essay questions. Six questions are set and a candidate is expected to answer only four. Each question carries 20 marks.

Paper 220/1

This paper concentrates on examining the general theory of economics in an economy. The questions which are set in this paper are open and usually demand for answer which can apply in any economy e.g. Explain the causes of income inequality in an economy.

Paper 220/2

The questions which are set in this paper require students to apply the theory of economics to Uganda in particular. When answering questions in paper two, students must pay attention to the tense used in the question i.e. if a question is phrased in a present simple tense, the answers must be written following the same tense e.g. what measures should be taken to reduce income inequality in your country? The answer can be basic infrastructure should be constructed in all parts of the country.

Recommended reference text books.

1. Basic Economics by DdumbaSsentamu
2. Principles of Economics by Livery
3. Micro Economics theory by Jhinghan
4. A text book of economics by J.L Hanson
5. Introductory Economics by Stanlake
6. Economics for Eastern Africa by Livingstone and Ord
7. Certificate of Economics book 3 and 4 by Akampurira
8. Fundamentals of Economics by Ochan
9. Economics for the developing world by Todaro.

COURSE OUTLINE

The introductory part
Price theory
Production
National income
The structure of Uganda's economy
Development and under development
The development process and the choice of a development strategy
Development of agriculture and industry
Population and labour
The unemployment
Money and Banking
The role of international trade in development
Inflation
Economic development planning
Public finance and the physical policy
Public enterprises.

THE INTRODUCTION / THE CORE OF ECONOMICS (WHAT ECONOMICS IS CONCEREND WITH)

Economics is greatly centered on the problem faced by man to make effective use of the limited resources. It is concerned with the distribution of goods and services among individuals and different economic entities in society. It is regarded as a practical science of how man handles the production, distribution and consumption of goods and services.

The meaning of resources.

Resources are the tangible or intangible things including human labour which man makes use of to satisfy his unlimited wants.

THE DEFINITION OF ECONOMICS

Definition in terms of wealth

According to Adam smith, Economics is the science of the accumulation of wealth.

According to him, economics is concerned with how wealth is distributed among individuals. However, this particular definition of economics is criticized for being narrow because it does not address the issue of scarcity of resources. It only emphasizes that man engages in economic activities to get profits and accumulate wealth.

Definition in terms of scarcity

The generally accepted definition was given by Robins and it is as follows;

Economics is a science which studies human behavior as a relationship between <u>ends</u> and the <u>scarce means</u> which have <u>alternative uses.</u>

NB: The word ends is used by Robins to refer to human wants or needs.

The scarce means are the scarce resources which can be put to alternative uses. Robin's definition is preferred because it carries the three important factors in economic analysis i.e.

i) It explain that human wants are unlimited or endless
ii) It mentions that resources to satisfy their unlimited wants are scarce.
iii) It states that resources have alternative uses.

Questions

Define economics according to Robins.
Why is Robin's definition preferred when defining economics?

WEALTH

Wealth is the stock of assets existing at a particular time.

Characteristics / features / traits of wealth

i) It must be scarce. It should be limited in supply so that individuals supply greater efforts towards work in order to earn income and acquire that wealth.
ii) It has an exchange value in terms of money. Wealth must have a price expressed in terms of money. This enables the owner to value it in case of the need to transfer it.
iii) It should possess utility. Wealth should be able to satisfy human needs.
iv) It must have transferable ownership. Individuals should be able to sell their assets that represent wealth to others there by transferring wealth i.e. the ownership of land can be transferred from one person to another.

TYPES / FORMS OF WEALTH

Personal wealth. This consists of personal assets that satisfy the individual owner. It includes individually owned assets like a private vehicle, clothes, shoes, house, etc.

Business wealth. This refers to a stock of assets owned by a business firm with a view of making profit e.g. machinery, stock of raw materials etc.
Public / Social / Collective wealth. This consists of assets that are owned by the state or government and are meant to provide services for the good of all citizens e.g. public roads, public hospitals, street lights etc.

Questions

What is meant by the term wealth?
Outline any three features of wealth.

Define social wealth
Give any three examples of social wealth

HUMAN WANTS AND NEEDS

Human wants are the desires of man. They are the things that man requires to live a comfortable life. The satisfaction of human wants is met using the scarce resources and this is the basic of economics.

Human needs are the basic essentials for man's life e.g. food, water, shelter, medicine. The needs and wants are jointly referred to as ends.

The idea of man's unlimited desires to be satisfied by the limited resources leads to the concepts of scarcity, choice and opportunity cost. These are the three fundamental economic problems.

Features / Traits / Characteristics of Human wants

1. They are re-current i.e. they are continued and they re-appear from time to time e.g. ones' desire for food is re-current.
2. They are unlimited i.e. they are endless or numerous.
3. They are dynamic i.e. they keep changing depending on the prevailing social, political, and economic conditions.
4. They are complementary i.e. they re-enforce one another e.g. the desire to own a mobile phone calls for other desires e.g. airtime, memory cards etc.
5. They are competitive in nature i.e. human needs cost money and compete for it. They compete for the limited income that man gets.

Questions.

a. Outline any four features of human wants

TYPES OF HUMAN WANTS

1. **Material wants.** These are wants that are in form of physical items. They are satisfied by the consumption of goods e.g. the desire for phones, desire for T.V sets
2. **Immaterial wants**. These are wants satisfied by the consumption of service e.g. health care, entertainment, insecurity etc.
3. **Private wants**. These are desires of individuals and are always satisfied exclusively e.g. the desire for a wheel chair by a lame person, desire for spectacles for the partially.
4. **Public wants**. These are wants satisfied collectively by all the individuals in the society. They are also called collective needs e.g. the desire for public health centres, desire for public roads, desire for street lights.
5. **Satiable wants**. These are wants which cannot be satisfied using the available resources in a short period of time. This is because they re-occur (they are re-current) e.g. the desire to have money or knowledge.

Question

a) Distinguish between satiable and un satiable wants

b) Mention three examples of human wants.

Why is Economics studied?

Economics is studied to give students a scope of the main issues and problems that LDCs are faced with.

Economics is studied for students to acquire basic skills which will in turn enable students appreciate and participate in the formulation and design of appropriate economic policies geared towards achieving rapid and sustainable economic development.

The knowledge of economics will help students to participate effectively in the development of their country especially in rural areas where most of them came from. This is implementation of government development strategies like District focus for rural development, integrated rural development initial industrialization in other needs like local personnel.

Students are better prepared to interpret government policies then the rural counterparts.

A student who has basic knowledge of economics is not illiterate when it comes to discussion and interpretation of economic issues like unemployment, population explosion, inflation and so on. He will be equipped with adequate tools to interprete census reports and economic surveys.

Economics prepares students for further academic and professional studies. Applied economies, statistics, law, commerce and other related fields, that require theological knowledge of economics.

The knowledge of economics will help students to understand the basic economic concepts and principles so that the individuals can require basic skills which help to be better prepared to face realities of life. After they will visualize and experience problems of economic nature, because it deals with practical, theory, unemployment, money theft.

ECONOMICS AS A SCIENCE AND SOCIAL SUBJECT

a) Economics has several aspects which to some extent qualify it to be a science discipline i.e. it is research based.

b) It looks at facts in real life

c) It has developed theories, principles and laws like any other science discipline.

d) It makes scientific conclusion.

e) However, economics is also considered as a social science because it deals with the dynamic / changing behavior of man in his changing environment over time. This is due to changes in the social, economic and political conditions.

Assumptions of economics

Economics normally takes assumptions by holding some factors the income or constant in order to make realistic conclusions. Assumptions are taken when comparing economics e.g. quantity demanded in the revenue and consumer. We normally use the phrase “ceteris paritus” which is a Latin phrase meaning keeping other factors constant.

STATEMENT IN ECONOMICS.

The statements made in economics are of two types.

- **i)** Positive statements
- **ii)** Normative statements

POSITIVE STATEMENTS

These are statements concerned with facts in life. They can be verified by looking at facts in real life. They rotate around what the society was, what it is now and what it will be in future for example, after 10 years of UPE all Ugandans will be able to read and write or the economic growth of Uganda is four times higher than the economic growth of Swaziland.

NORMATIVE STATEMENTS.

These are statements made basing on people’s feelings, opinion and value judgment about what is good or bad. They reflect peoples’ opinion and moral values on what ought to be done or what should be done. They are written with words “should” and “ought”. They cannot be verified by looking at facts in real life. They are normally settled by putting matters to voting e.g. the government should encourage Christianity in order to control prostitution. The government should suspend all the corrupt officials in order to improve on service delivery in the country.

Question

- **i)** Distinguish between a positive and normative statement
- **ii)** Give any two examples of normative statements
- **iii)** What is the meaning of the phrase ceteris paribus?

THE FUNDAMENTAL ECONOMIC PROBLEMS

There are three basic economic problems;

- **i)** Scarcity
- **ii)** Choice
- **iii)** Opportunity cost

Scarcity

This refers to the limited supply of resources relative to demand. It is the insufficiency of resources relative to people's demands. Man has many desires but the resource to satisfy him is limited in supply.

Choice

This is the act of a producer or consumer to select the desired alternative from a set of alternatives. It is the preferential determination between ends or wants. Man has to choose / select among the alternative needs, he therefore makes a scale of preference in order to make rational desires.

Scale of preference

This is a list of needs or wants arranged in order of priority or importance. A rational consumer always begins with the more pressing and ends with the least pressing needs.

Opportunity cost

This is the alternative foregone when choice is made. It is the alternative which is foregone when consumption or a production decision is made. Since resources are limited in supply, consumption of one commodity means not consuming the other and production of one commodity means not producing the other. This is the basis for opportunity cost.

Question

What is the relationship between scarcity, choice and opportunity cost?

Answer

Due to limited resources (scarcity) a choice has to be made between alternatives. The choice for one alternative implies fore going the other which is opportunity cost.

USES OF OPPORTUNITY COST IN ECONOMICS

1. It guides producers when making production discussions i.e. when deciding the allocation of resources to the production of different commodities.
2. It guides consumers when making consumption decisions i.e. it enables them to select what to consume and what to leave out in order to maximize satisfaction.
3. It guides when determining prices for factors of production i.e. when estimating the rewards to different factors of production.
4. It guides in economic planning. The government planners always look at the alternatives before they make choices e.g. the government may plan to construct more primary schools compared to the sports stadium.
5. It guides the country when dealing on what to produces and specialize in. a country produces a commodity where it has the highest opportunity and it imports those commodities with low opportunity cost.

THE LIMITATIONS OF THE CONCEPT OF OPPORTUNITY COST

1. Not all producers and consumers are rational

2. Opportunity cost has no monetary value i.e. it lacks cardinal values and therefore hard to interprete.

3. The concept of opportunity cost lacks uniformity. This is because what individuals go for during consumption varies from one individual to another according to sex, tastes and preferences, age, economic status.

4. It assumes a situation of full employment of resources but is not always the case. What happens in real life is that some resources remain underutilized in the economy.

Excess capacity

This refers to the underutilization of resources.

THE PRODUCTION POSIBILITY FRONTIER / OPPORTUNITY COST CURVE / THE TRANSFORMATION CURVE.

THE PRODUCTION POSSIBILITY BOUNDARY (PPF)

It refers to a locust of points which shows possible combinations of two commodities that can be maximumly produced when all the available resources are fully and efficiently utilized.

ASSUMPTIONS OF PPF

1. The available resources are fully utilized

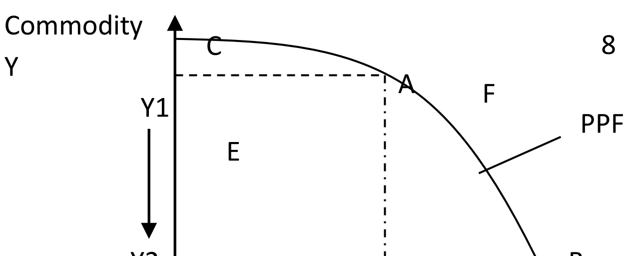
2. It assumes that the level of technology is constant i.e. the production techniques never change.

3. It assumes that a country produces only commodities

4. It assumes that producers are rational

5. It assumes that the resources are fixed in supply.

Illustration of a PPF



Y_0

Possible combinations

O (Y_0, O)

A (Y_1, Y_2)

B (X_2, X_1)

D (X_0, O)

The curve X_0, Y_0 is called the opportunity cost curve. In order to increase the amount of one commodity e.g. commodity X there is need to reduce production of another commodity Y.

For example;

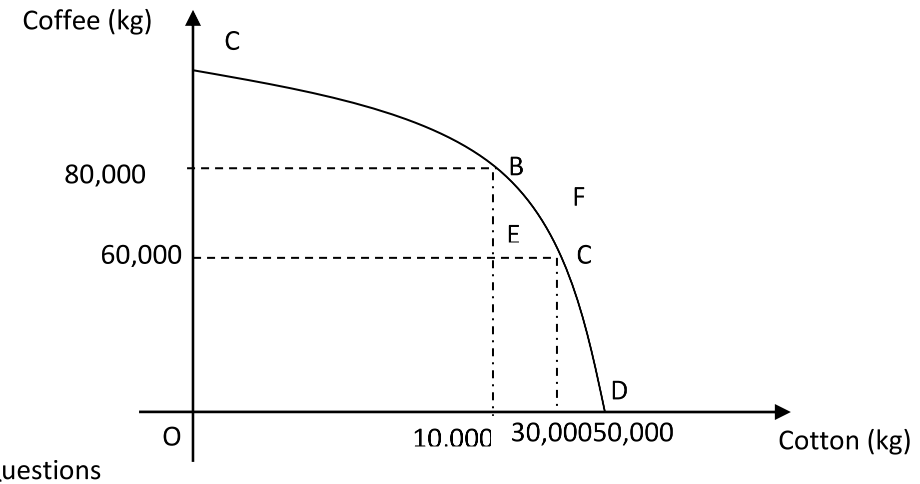
To increase the production of commodity X from X_2 to X_1, the economy must reduce this production of commodity from Y_1 to Y_2. This is indicated by a movement from A to B. the movement along the opportunity cost curve illustrates the concept of trade off (gain X and lose Y).

From the diagram above, if all the resources are put to the production of commodity X when the economy can produce X_0 units of commodity X and O units of commodity Y as indicates at combination D. alternatively, if all the resources are devoted to the production of commodity Y when the economy can produce a maximum amount of Y0 units of commodity Y and O units of commodity X as indicated at point C.

However, it is possible for the economy to produce units of X and Y e.g. at points A and B. points C, A, B and D represent full and efficient utilization of resources. Point E or any other point that can be inside the PPF represents excess capacity or underutilization of resources. Point F or any other point that can be outside the PPF is not attainable using the existing resources because of scarcity of the resources.

The production of more units of commodity X leads to production of less units of commodity Y. therefore increasing the P units of commodity X leads to an opportunity cost, the units of Y that are foregone have the same opportunity cost curve. A movement along the PPF involves transforming units of one commodity e.g. X into units of another commodity e.g. Y hence the name the transformation curve.

Example



Questions

Why is production at pint E undesirable?
This is because it represents underutilization of resources or excess capacity.

Why is production at point F unattainable?
This is because of scarcity of resources

Give any two points that indicate full utilization of resources.
Point D and C
Point A and B

Give the production combinations at points A, B, C and D.

A	-	O of cotton and 80,000 of coffee
B	-	10,000 of cotton and 60,000 of coffee
C	-	30,000 of cotton and 40,000 of coffee
D	-	50,000 of cotton and 0 of coffee

What is the opportunity cost of producing at point A?
Cotton of 50,000kg

What is the opportunity cost of producing at point D?
80,000kg of coffee

What is the opportunity cost of producing coffee at C instead of B?

20,000kg of cotton

What is the opportunity cost of producing coffee at B instead of D?
40,000kg of cotton

What is the opportunity cost of producing coffee at D instead of B?
60,000kg of coffee. (look at which side has lost)

What is the opportunity cost of producing cotton at C instead of D?
20,000kg of cotton. (look at which side has lost)

What is the opportunity cost of producing coffee at point B?
40,000kg of cotton

What is the opportunity cost of producing cotton at C?
40,000kg of cotton (50,000 -10,000)

What is the opportunity cost of moving along the PPF from point A to point B?
20,000kg of coffee (80,000 – 60,000)

Why wouldn't you advice the economy to produce at point A and point D?
This is because these points make the consumer irrational i.e. they are irrational choices.

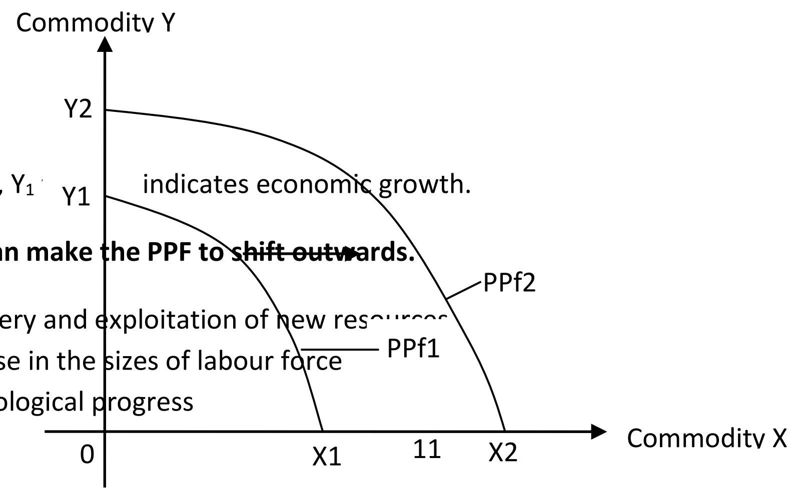
USING OPPORTUNITY COST CURVE TO ILLUSTRATE ECONOMIC GROWTH

Economic growth is the persistent and sustained increase in the volume of goods and services produced by the country in a given period of time.

OR

Refers to persistent quantitative increase in goods and services produced in a country in a given period of time. It is illustrated by a shift outwards of the PPF.

Illustration



A shift from X_1, Y_1 indicates economic growth.

Factors that can make the PPF to ~~shift outw~~ards.

- Discovery and exploitation of new resources
- Increase in the sizes of labour force
- Technological progress

- Increase in the efficiency of workers
- Increased capital inflow
- Improved entrepreneurship skills

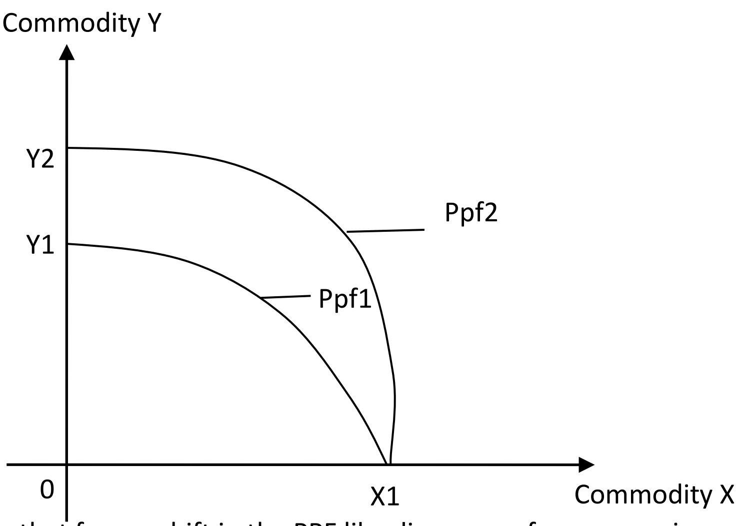
Factors that can make the PPF to shift inwards.

- Decline in technological progress
- Decreased capital inflow
- Decrease in the size of labour force
- Exhaustion of resources
- Decline in efficiency of workers
- Decline in entrepreneurial skills.

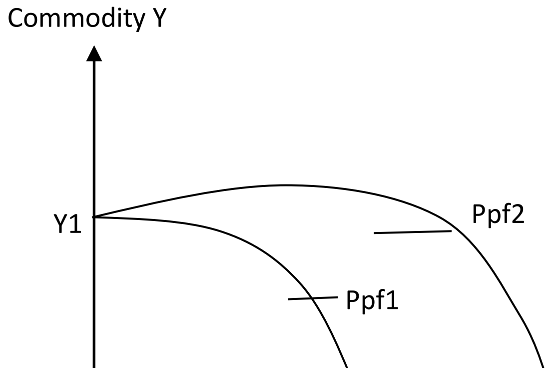
Factors that can cause the PPF to shift

- A shift in the level of capital inflow
- A shift in the level of efficiency of workers
- A shift in the level of technology progress
- A shift in the level of entrepreneurship skills
- A shift in the level of discovery of new resources.

Rotation of the PPF



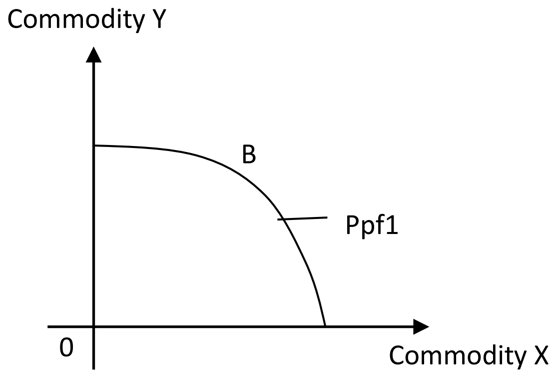
There are factors that favour shift in the PPF like discovery of resources, increase in entrepreneurial sills, increase in size of labour force are all available but only favour commodity Y that is why it has increased from Y1 to Y2 but the X has remained the same.



Here the factors that favour shift in PPF like discovery of resources increase in entrepreneurship skills, increase in size of labour force are all available but favour increased production of commodity X that is why it increased from X1 to X2 but Y has remained the same.

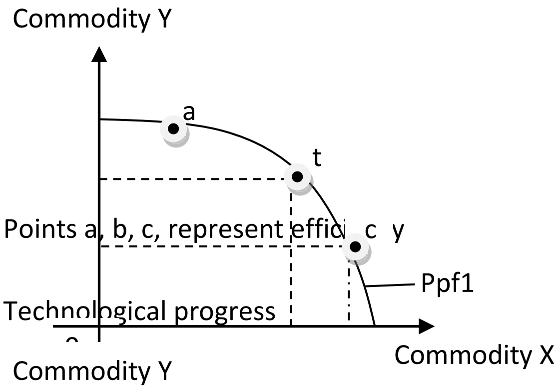
Using a PPF to illustrate economic concepts

Scarcity



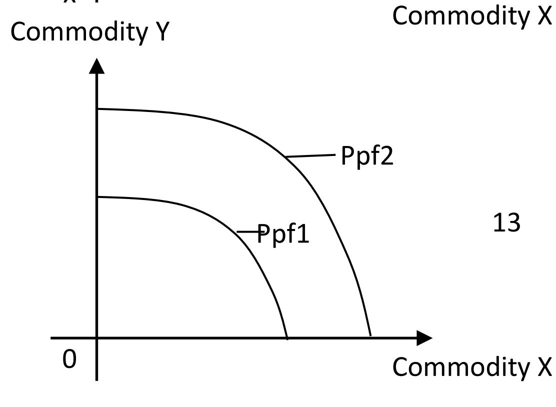
Point B represents scarcity

Efficiency



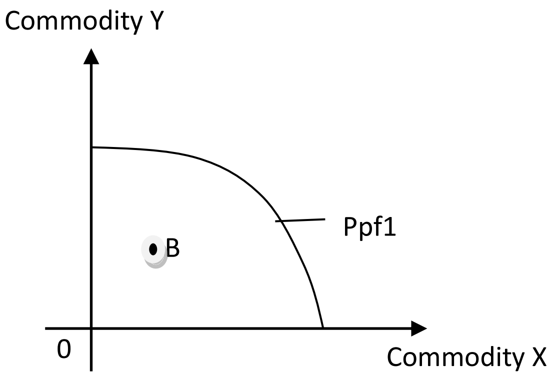
Points a, b, c, represent efficiency

Technological progress



The shift outwards shows technological progress

Excess capacity



Point B represents excess capacity

Questions

Under what circumstances may the concept of opportunity cost be useful? (uses of opportunity cost).

1. When making production decisions
2. When making consumption decision
3. When pricing the factors of production
4. When deciding on what to produce and what not to produce
5. When carrying out economic planning
6. Under what circumstances may the PPF shift outwards?
7. When there is an increase in entrepreneurial skills
8. When there is an increase in labour force
9. When there is an increase in efficiency of workers
10. When there is increased capital inflow
11. When there is technological progress
12. When there is discovery of resources.

MICRO AND MACRO ECONOMICS

Micro Economics

This is a branch of economics that studies the economic behavior of an individual economic unit e.g. house hold or a producer or a firm.

Micro economics studies how an individual economic entity allocates its resources e.g. to determine output or what to produce. It studies how individual businesses determine prices and output levels.

Question

(a) Define micro economics
(b) Explain the importance of micro economics.

Macro Economics

This is a branch of economics which studies the aggregate or total behaviour of all economic units in a country. It looks at the economy as a whole. It considers issues like national income, the rate of inflation, the population growth rate, the aggregate demand and the aggregate supply in the economy. It looks at the economy as a single functioning unit. It therefore studies decisions that affect a larger nation or the entire economy.

TYPES OF GOODS AND THEIR CHARACTERISTICS

1. **Free goods / free good**

   This is a good which is in a natural abundant supply and its consumption is at zero price i.e. air, rain water, sunshine.

   Characteristics
   - Consumed at zero price
   - Provided by nature
   - They are in abundant supply
   - They provide utility or satisfaction

2. **Economic goods**

   This is one which is scarce has money value and yields utility or satisfaction. It is paid for in terms of money e.g. clothes, land, shoes, cars, houses etc.

   Characteristics of economic goods.
   - They are relatively scarce
   - They are paid for in terms of money
   - The ownership is transferable
   - They provide utility or satisfaction to the users.

3. **Public goods**

These are goods provided by the state to a particular group of people and once provided they become available for others to use at no cost without excluding anyone e.g. street lights, public toilets, public roads, public schools.

Characteristics of public goods

- Non divisibility
- A public good cannot be divided among individuals. It's collectively used e.g. once street lights are installed; they cannot be divided for specific individuals.
- Non excludability
- One's consumption of a public good does not reduce the amount available to other users e.g. a driver using a public road does not affect other users of the same road.
- Non excludability
- No individual should be left out in the consumption of the public good. Public goods are open to all users. There is no way of excluding an individual from gaining benefits from a public good.
- Non rivalry
- Their consumption is not competitive. The users do not compete with each other in order to consume a public good

4. Private goods

These are goods owned and used exclusively by a single person. The act of consuming a private good excludes others from using it or whoever is not the owner, must seek permission from the owner before using it. They include personal items e.g. personal clothes, personal shoes, personal books, private vehicles etc.

5. Merit goods

These are goods whose consumption is derived to be of a high social value (high intrinsic value) and are meant to improve the quality of life of the people e.g. safe water, education and safe water.

6. De – merit goods

These are goods which inflict damage in harm to consumers and impose costs on the society e.g. cigarettes, alcohol, addictive drugs.

7. Inferior goods

These are goods whose amount demanded reduces as the consumers' income increases e.g. second hand clothes.

8. Normal goods

These are goods whose demand increases as the consumers' income increases i.e. more amount is demanded for when the consumer gets richer e.g. first hand and first days, things like firsthand cars, first hand shoes etc.

9. Necessity goods

These are goods whose demand first increases with increase in the consumers' income up to a certain point beyond which demand becomes constant. They are mainly essential items e.g. items which the consumer cannot do without e.g. soap, fuel, sugar, salt etc.

10. Producer / capital goods

These are goods used to produce other items. They facilitate the production of other goods. They are also known as goods of second order e.g. factory machines, sewing machines, blending machines, oven etc.

11. Consumer goods

These are goods which are meant for final use. They are capable of providing direct satisfaction to wants. They are also known as goods of first order or final goods e.g. a pen, a book, a sauce pan, cake, tv set etc.

12. Intermediate goods

These are goods or raw materials that can be processed further in order to make final goods. e.g. sugar on the making of a cake and sweets, salt in the making of bread, baking flour to bread, limestone in making of cement, cotton for making clothes.

13. Durable goods

These are goods capable of giving a long term service i.e. there capacity to satisfy human wants takes a long period of time e.g. furniture, tv set, a car, clothes etc.

14. Perishable goods

These are goods whose capacity to satisfy human wants ends after a short period of time e.g. bread, milk, tomatoes etc.

15. Material goods

These are goods which are tangible. They constitute all the physical objects that man uses to satisfy his needs.

16. Immaterial goods

These are the ones that are tangible. They are basically services e.g. services offered by teachers, services offered by doctors and cooks.

17. Giffen goods

These are goods that take a larger proportion of the low income earners income e.g. maize flour, potatoes, beans, bread etc if there prices increase, the people devote more of their income towards purchasing them.

NB: All Geffen goods are inferior goods, however, not all inferior goods are Geffen goods. This is basically because some inferior goods can easily be abandoned or postponed when their prices increase e.g. second hand clothes.

18. Goods of ostentation / status symbols.

These are goods that are desirable only when they are expensive. People buy them to show their class, the higher the price, the higher the quantity demanded by the rich e.g. expensive cars, jewellery, expensive or golden watches.

SOME IMPORTANT TERMS AND CONCEPTS IN ECONOMICS

An economy

This is a set of productive activities of a country.

Economic agents

These are the big decision makers in an economy. They are the major owners of the productive resources in the country. They include;

- Households / consumers
- Business firms
- Government

Agents of production (factors of production)

These are the major inputs used in the production of goods and services. They include, land, labour, capital, entrepreneurship. All these factors of production are rewarded factor prizes for their contribution in the production process.

NB: A factor price is a monetary reward to a factor of production for its contribution in

the production process e.g. wages for labour.
Interest for capital
Rent for land
Profit for entrepreneurship

Economic infrastructure

These are facilities which support further production of goods and services e.g. the road network, storage facilities, power dams etc.

A market

This is an arrangement through which buyers and sellers are brought into close contact to exchange goods and services.

Economic laws

These are statements of scientific proof which guides economists when deciding the allocation of the scarce resources to satisfy the unlimited wants of man e.g. the law of demand which states that the higher the price; the lower the quantity demanded and the lower the price, the higher the quantity demanded keeping other factors constant.

Over production

This refers to producing more goods than what the market requires.

Excess capacity

This refers to underutilization of resource or it is a situation where a firm underutilizes productive resources.

Question

a) Outline the causes of excess capacity in your country.
b) Limited capital
c) Low levels of technology
d) Limited supply of skilled labour
e) Limited supply of some raw materials
f) Small markets
g) The desire to make high profits by entrepreneurs by restricting output
h) Poor infrastructure.

THE BASIC ECONOMIC QUESTIONS AND HOW THEY ARE ANSWERED.

These are the basic questions that economists or producers or business men seek to address in an economic system. The help to direct economic resources towards the most pressing needs of society. They help in directing business men in the process of producing and distributing of goods and services in an economy; they include;

a) What to produce?
b) How to produce the output?
c) For whom to produce?
d) When to produce?
e) Where to produce from?

Answers

Decisions regarding what to produce.

Due to scarcity of resources, the decision on what to produce involves a lot of sacrifice. It involves opportunity cost because by producing one item, the producer leaves out the others. To minimize opportunity cost, choice is always made in favour of those items with high prices where the producers can get a high profit.

Decisions regarding how to produce.

Having decided on what to produce, there is need to decide how the resources are to be combined to produce the desired goods and services. A choice must be made either in favour of labour intensive or capital intensive techniques; or a combination of the two techniques (intermediate technology)

NB: labour intensive techniques of production are the ones that use more units of labour compared to the other factors of production especially capital. Capital intensive techniques are those that user more units of capital compared to other factors of production especially labour.

Decisions regarding whom to produce for.

The producer must take a decision about whom to produce for i.e. whether to produce for the low income groups or for the high income groups of people. To maximize profit producers prefer making output for those who can pay.

Decisions regarding when to produce

Producers need to choose the appropriate time for producing the output. Where goods are seasonally demanded, there is need to produce them in the right season e.g. examination success cards in October and November. It is also important to make a decision of whether to produce now or in the future. Such a decision requires what is called time preference i.e. the individual's decision on whether to produce or consume now or in the future. Time preference has two preferences;

Positive time preference

Is one where an individual prefers to consume more at the present than in the future.

Negative time preference

Is one where an individual foregoes current consumption for future use. This enables him to increase his current savings for investment.

Decisions regarding where to produce from.

This decision involves selecting the location or sight of the production unit. A decision must be made whether the firm should be located near the source or raw material / near the market / near the power source / near the source of water. The decision here depends on the nature of the firm.

ECONOMIC SYSTEMS

An economic system is an arrangement through which the resources of a country are owned, controlled and distributed. The major decisions of how, when, where and for who to produce are made in different ways depending on the prevailing economic systems. The following are the economic systems;

a) The traditional economic system
b) Free enterprise economic demand system
c) Socialist economic system
d) Mixed economic system

THE TRADITIONAL / SUBSISTANCE ECONOMY

This is one where resources are owned, controlled and distributed communally. The mode of exchange under the system is barter. However, this system has gradually been phrased as a result of import in scientific research, greater use of better technology; it was association with the following advantages.

- It promoted unity among people
- It maximizes wastage
- It minimized income inequality

It had the following disadvantages;

- Makes people sluggish and lazy
- There was little individual progress and creativity.

FREE ENTERPRISE / MARKET / CAPITALISTIC / LAISSER FAIRE ECONOMY.

This is an economy in which the ownership controls and distribution of resources is done by market forces of demand and supply. In this economy, the economic activities are controlled by the private sector and guided by the market sources of demand and supply also called price mechanism.

There is private enterprising under this system and everything is guided by the interplay of the forces of demand and supply. Examples of capitalistic economies include U.S.A, U.K, Germany, Canada, France, Japan, and Australia.

CHARACTERISTICS OR FEATURES OF A MARKET ECONOMY.

1. There is substantial private ownership of wealth i.e. the private individuals have a right to own private and are free to use it to generate more wealth.
2. There is stiff competition for the available resources
3. There is limited government interference in the way resources are controlled and distributed among the alternative uses. The role of government is taken over by the market forces of demand and supply. (price mechanism)
4. The economic enterprises aim at profit maximization and therefore profit is the greatest motivation to the enterprise to invest more in the economy.
5. There is freedom of choice i.e. producers are not forced to produce certain items and consumers are not forced to consume what they don't want.
6. There is emphasis on consumer sovereignty.

NB: **consumer sovereignty** is an idea in a free enterprise economy where the consumer

takes an upper hand in the making of the major economic decisions e.g. the consumer influences decisions on what to produce, how to produce etc. the consumer is taken as king and is given priority whenever a production decision is made.

ADVANTAGES / MERITS OF A FREE ENTERPRISE ECONOMY

1. It is a cheap method of allocating resources. This is because the allocation of resources is done automatically by the market forces of demand and supply. There is no one employed by the government to monitor the distribution and allocation of resources.
2. It promotes consumer sovereignty. This system indicates and fulfills the wishes of the consumers. Producers produce according to consumers' desires. It enables the consumer to get what he exactly wants.
3. There is efficient is production.
4. This is because production is profit motivated. The desire to maximize profits encourages producers to make high quality output.
5. It improves the creativity and innovativeness of producers.
6. This is because it is guided by stiff competition. It also leads to production of quality output.
7. It checks or reduces consumers' exploitation. This is because they are able to buy goods at fair prices. As the sellers compete, they lower prices.
8. There is limited wastage of resources. This is due to the fact that production is according to demand. Producers only make those items the consumers want. It therefore reduces over production.
9. There is production of a wide variety of goods and services. This enables consumers to make choices hence improving their wellbeing.

10. The idle but potential resources are put to full use under this system. This is because production is profit motivated and any resource that can yield a profit is taken on to produce goods and services. This enables economic growth.

11. There is flexibility in production. Producers are free to change from one line of production to another i.e. they always change from less profitable activities to more profitable uses. This raises the level of their profits hence enabling quicker business expansion.

12. It widens employment opportunities. This is because participation in production and investment has a free entry i.e. whoever wishes to start production is allowed. Therefore more productive activities are created and this leads to creation of more job opportunities.

13. It reduces bureaucracy. This minimizes wastage of time when deciding what to produce, for whom to produce for, where to produce from etc.

DISADVANTAGES / DEMERITS OF FREE ENTERPRISE ECONOMY.

1. It leads to income inequality. This is because individuals are given the liberty to own productive. Some people end up owning more than others. This creates undesirable economics and social gaps.

2. Vital commodities that are less profitable are ignored e.g. the construction of hospitals and schools may be ignored if the entrepreneurs fail to raise adequate profit levels.

3. It encourages private monopoly and the associated disadvantages e.g. over charging, production of low quality products, restricted supply etc.

4. Monopoly is brought about because the stiff competition makes the strong firms outcompete the weak ones forcing them to quit production.

5. There is wastage of resources due to the stiff competition producer's waste money and other resources in advertisement, such resources could be put to better use e.g. expanding the production plants.

6. Some resources remain idle. The resources that cannot generate commercial profits are ignored by most producers. It leads to resource redundancy and hence excess capacity.

7. It leads to over exploitation of some resources. The resources that have high profit prospects are over exploited leading to quick depletion. This reduces the ability of the economy to grow in the long run.

8. It is characterized by a lot of economic instabilities e.g. unemployment, inflation, regional imbalance in development etc. all these undermine the development process of a country.

9. Private gains are over emphasized at the expense of social gains. The need to maximize profit by private producers of goods and services increases social costs like noise, water and air pollution.

10. It is characterized by failure to cope with rapid structural changes in the economy i.e. it fails to work well in situations of emergency e.g. during flooding, famine, destruction due to earth quakes and outbreak of epidemics.

SOCIALISM / COMMAND / PLANNED / COMMUNISM / CENTRALISED ECONOMY

This is an economy where resources are owned, controlled and distributed by the state or government. It is that economy where the state or government through the central planning authority determines what to produce, how to produce etc. the major economic decisions are handled by the state. Examples of states that are largely socialists e.g. China, Juba, Libya etc.

FEATURES / TRAITS OF A COMMAND ECONOMY

- All the productive resources are owned by the state
- There is extensive planning by the central planning authority.
- Decisions pertaining all economic activities are done by the government through the central planning authority. (CPA)
- There is limited competition in production and consumption basically because producers are not profit motivated.
- The main aim of production is promoting welfare of the people.
- Economics and productive resources are jointly owned through the state. Therefore in an element of "things are owned" other than "Things are mine".

ADVANTAGES / MERITS OF A COMMAND ECONOMY

- It caters for the production of essential goods and services. Essential items are given the due attention when allocating resources.
- It eliminates wasteful competition and duplication. This is because there is absence or limited competition among producers.
- It improves the welfare of the people. Productive activities are aimed at maximizing the production of those goods and services that improve peoples' welfare.
- There is limited production of undesirable goods. This is because productive activities are regulated by the government or state. Therefore undesirable items like cigarettes, alcohol, and hard spirits are reduced in supply.
- There is reduced consumer exploitation. This is because every economic activity is aimed at improving the welfare of everyone and therefore good products are offered at the least possible price by government.
- It reduces uneven distribution of wealth of income. This is because during planning, the government considers all individuals and regions. Productive activities are fairly distributed and income differences are minimized.
- It improves on economic stability. The prices of goods and services and the rate of interest are made more stable. This is because such variables (prices and interest rate) are controlled or fixed by government.
- It makes it possible for the government to make long term plans. This is because the government is in charge of the productive activities and whatever it decides prevails. It is less affected by private individuals / market forces because government controls all of them.

- The socially desirable commodities which may not be profitable are catered for e.g. the provision of education and health care is given priority. This improves the welfare of the people.

DISADVANTAGES / DEMERITS OF DEMAND ECONOMY

- It is an expensive system of resource allocation. This is because it requires that government employs officials to work in the central planning authority (CPA) in order to coordinate the different productive activities and decisions.
- There tends to be wastage of resources. This is because production is based on estimates. Sometimes, there is an estimation leading to over production and resource wastage.
- It is characterized by bureaucracy. There are always delays in making important decisions i.e. decision in what to produce or how much to produce are delayed due to bureaucracy.
- This is inefficient allocation of resources. This is because production is not competitive. Therefore, existing resources are wastefully utilized.
- There is a limited variety of goods and services produced. This limits consumer choice hence negatively affecting the consumers' level of welfare.
- The quality of goods and services produced is basically low. This is because the production of commodities is not competitive or profit motivated.
- The system is a dis– incentive to private or individual creativity and innovation. It kills private or individual enterprises because productive resources are jointly owned.
- It reduces consumer sovereignty. This is because the consumer has no right to choose or decide what is to be produced. All the decisions are made by the central planning authority.

THE MIXED / UNIFIED ECONOMY

This is an economic system where the resources are owned, controlled and distributed by both the private sector and the public sector. It is an economy which has both socialistic and capitalistic elements co – existing side by side. Under such a system, resource allocation and ownership is influenced by both price mechanism and the central planning unit. The system is said to be unified because it combines features of a market economy and those of a planned economy.

CHARACTERISTIC FEATURES OF A MIXED ECONOMY.

- Ownership of resources is by both private individuals and the state or government i.e. some productive activities belong to private individuals while others are government owned.
- Production is for both profit and welfare maximization i.e. the public sector aims at welfare maximization while the private sector largely aims at profit maximization.
- Economic decisions are made by both the state and private individuals however the state I can make decisions to influence the activities of the private sector.
- The allocation of resources is done by both price mechanism and the central planning.
- There is regulated competition in the consumption and production of goods or services.
- The private sector co-exists with the government sector.
- There is existence of indicative planning or planning by inducement.

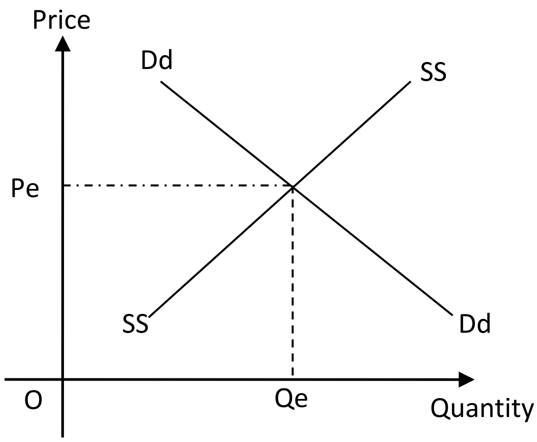
PRICE THEORY

Price. This is the exchange value of a commodity in monetary terms.

TYPES OF PRICE

i) **Market price**. This is the ruling of prevailing price of a product at a particular time.

ii) **Equilibrium price**. This is the one which is established where quantity demanded equals to quantity supplied i.e. it is the price determined at the intersection of the demand and supply curves.



OPe = Equilibrium price.

Normal price / ideal price.

This is a long term equilibrium price. It is established where the demand and supply forces are equal in the long run. It is the price that regulates the flow of consumption and production so that they stand at equilibrium in the long run.

Reserve price / reservation price.

This is a price below which a seller is not willing to sell his or her commodity. It is the least acceptable price to the seller below which he or she does not actually sell his commodity e.g. if a trader is willing to offer clothes at a price not less than shs. 50,000 then that is the reserve price.

The determinants / factors that influence the reserve price.

The length of the gestation period. This is the time it takes the producer to make a commodity ready for sale. The longer the gestation period, the higher the reserve price and the shorter the gestation period, the lower the reserve price.

The time it takes the seller to get new supplies from the producers. The longer it takes the sellers to get new supplies from the producers, the higher the reserve price and the shorter the time it takes the seller to get new supplies, the lower the reservation price.

The expected future demand for the commodity. A producer who expects demand to increase in the near future sets a high reserve price hoping that buyers can take the product at that price and even when they fail, he can easily sell it later when demand increases. However, a seller who expects future demand to fall sets a low reserve price to avoid the bad situations of reduced demand in the future.

The nature of the product. A seller who deals in durable items sets a high reserve price. This is because his item is long lasting and he can manage to keep it until he finds a suitable buyer. However, a seller who deals in perishable items sets a low reserve price to enable him or her to sell off the items before they go bad.

Cash flow requirement of the seller. Liquidity preference of the seller.

NB: Liquidity preference refers to the desire of an individual to hold his wealth or assets in cash form or metal cash form other than other assets. Where the seller has urgent need for cash he gets a low reserve price. However a seller who has no urgent need for cash sets a high reserve price.

Storage and carriage costs of the seller with high storage and carriage costs sets a low reserve price in order for him or her to actually sell the products and avoid suffering such costs again. While a seller with low storage and carriage costs sets a high reserve price because ever when the buyers fail to buy, he is not inconvenienced to carry the goods back to the store.

The expected future price for the commodity. A seller who expects the price for his product to increase sets a high reserve price. However, one who expects the price to fall in the near future sets a low reserve price to actually sell the product in order to avoid the lower prices in the future.

The expected future cost of production. A produce who expects the cost of production to increase in future sets a high reserve price in order to raise enough resources to enable future production. However, if the producer expects a fall in the future costs of production, he or she sets a low reserve price.

Question

a) Distinguish between minimum price and reserve price
b) Explain the factors that determine the reserve price
c) Explain the factors that lead to a low reserve price by the seller.
- Selling a perishable product
- Short gestation period of a product

- Limited time taken to get new supplies from the producers
- Expectation of a fall in future prices
- High storage carriage costs
- Urgent need for cash / high cash flow requirement
- Expectation in a fall of demand for the products.

Question

a) Explain the factors that lead to a high reserve price.

- Selling a desirable product
- Long gestation period of a product
- Expectation of an increase in future cost of production
- Long time taken by seller to get new supplies form the producers
- Expectations of a rise in future prices.
- Low storage and carriage costs
- Seller without urgent need for cash sets a high reserve price
- Expectation in rise in demand for products.

Sample

Selling a durable product.

A seller selling a durable product, sells a high reserve price because the product cannot easily get spoilt and a seller selling perishable products sets a low reserve price so that he can sell all his products before they get spoilt for example tomatoes are perishable and can easily get spoilt so the seller sets a low reserve price for them.

PRICE DETERMINATION / METHODS OF DETERMINING MARKET PRICE IN AN ECONOMY.

Through bargaining / Haggling.

This is where the seller and the buyer negotiate till when they reach an agreeable price. The seller starts by setting a high price and the buyer mentions a much lower price. The two parties negotiate until when they reach an agreement.

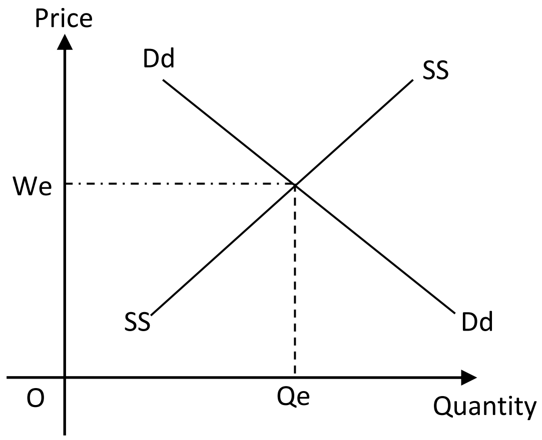
Bidding / Auctioning.

This is where the seller offers the products for sell and invites for bidders. (offers of prices from buyers). Anybody interested in purchasing is free to offer his or her own price but the item is sold to the highest bidder. Therefore, the highest bidder sets the price. It is used by commercial tasks when selling collateral securities.

Fixing prices through market forces of demand and supply.

The price is set at equilibrium where quantity demanded equals to quantity supplied. It is common in a free enterprise economy. The price set under this system is called equilibrium price

Illustration



Owe is the equilibrium price

Agreements / Treaties. In this case the buyer and seller make a contract which specifies the price at which the product is to be exchanged. The price is agreed upon at the time of signing the treaty or agreement.

Resale price maintenance. This is a system of setting price by the manufacturers for the retailers to sell at e.g. the newspaper publishers set the price, the soda and beer producers set the resale price.

ADVANTAGES OF RESALE PRICE MAINTENANCE.

1. It reduces the exploitation of consumers
2. It stabilizes the profit or income of retailers
3. It saves time because there is no bargaining
4. It facilitates collection of taxes by government because it makes prices and incomes stable
5. It enables the consumer to make consumption plans
6. It is a cheap method for the seller to determine price because the retailer does not need many sales representatives.
7. Offers at fixed prices by monopoly firms. In this case, monopoly firms fix prices for their commodities.

Offers at fixed prices by monopoly firms.

In this case monopoly firms fix prices for their commodities unless interrupted by government e.g. national water and sewerage cooperation fixes price for water it supplies.

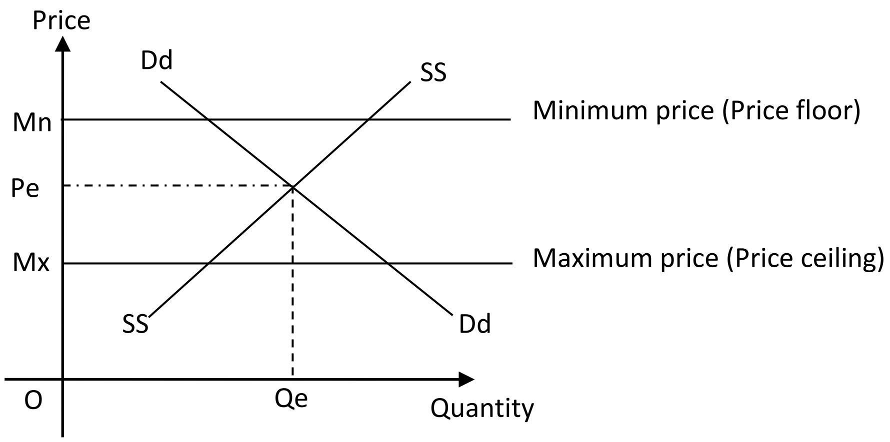
Price leadership (collusion of firms).

This is common in the oligopoly market structure where firms fix prices jointly. The price leadership has two major types;

1. Perfect price leadership (perfect collusion). Here all firms mutually agree to charge a uniform price for their products.
2. Imperfect price leadership. (Imperfect collusion). Here a leading firm sets prices for other firms to follow. This is also called Tarad price leadership e.g. Zain / Airtel initiated the 3/= per second price and other companies like Warid and MTN followed.

Government legislation of prices (fixed prices by government)

This involves the government setting price through its policy known as price control. The government can fix a price above the equilibrium price (minimum price) or a price below the equilibrium price (maximum price)



OPe = Equilibrium price.

PRICE CONTROL / PRICE LEGISLATION

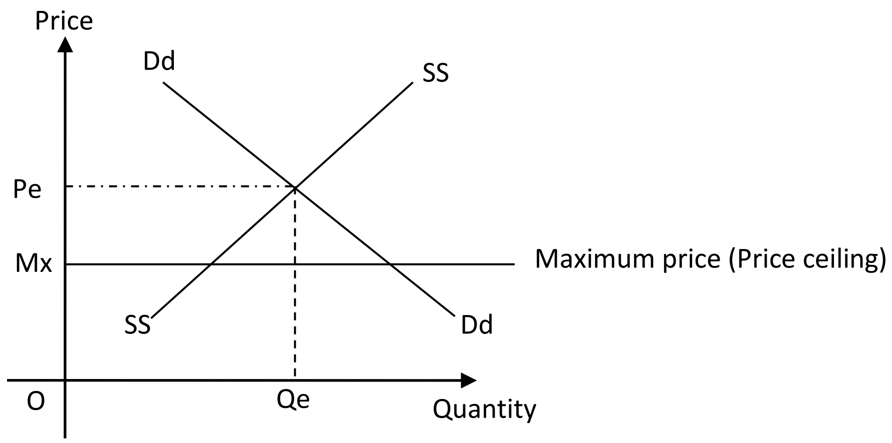
This refers to the deliberate act of government to fix prices of commodities either above eh equilibrium price to protect producers of below equilibrium price to protect consumers. The price set above the equilibrium price is called the minimum price while the one set below the equilibrium price is called the maximum price.

MAXIMUM PRICE / PRICE CEILING

This is a price set by government below the equilibrium price and it is illegal to sell to consumers above it. This price is set with a major aim of protecting consumers from being exploited by profit hungry business men.

Maximum price legislation is the setting of a price by government below equilibrium price and it is illegal to sell to consumers above it.

Illustration



OPe = Equilibrium price. m

OBJECTIVES / REASONS FOR SETTING / LEGISLATING A MAXIMUM PRICE

Question.

What are the objectives of setting a maximum price?

1. To protect consumers from being exploited by business men. Government fixes a maximum price to protect buyers from unfair prices that can be set by sellers. It becomes illegal for a trader to sell to a buyer at a price above the maximum price.

2. To create price stability or to check inflation in a country. This is achieved since the government sets a stable price below equilibrium. This price reduces price increases.
NB

3. Inflation is the persistent rise in the general price level of goods and services in an economy in a given period of time.

4. To encourage consumption of some commodities. The government normally sets a maximum price on particular essential goods to encourage their consumption. Such items may include; safe water, medical care, milk etc.

5. To control monopoly powers in the economy. It becomes illegal for monopoly sellers or producers to charge a price above the equilibrium price. This protects consumers from exploitation by monopolists.

NB

6. Monopoly is a market situation where there is a single seller of a good or a service without a close substitute.

7. To reduce the economic gap between the rich and the poor or to reduce income inequality in the economy. A maximum price enables government to make goods affordable, even to the poor. It thus enables improvement in the standard of living of the poor. This reduces the defects of income inequality.

8. To discourage the production of some undesirable commodities. The government sets a maximum price to discourage production of those commodities and supply of socially undesirable goods e.g. the government may set a maximum price to reduce the production and supply of cigarettes, alcohol.

ADVANTAGES / MERITS OF A MAXIMUM PRICE

NB: These are developed by considering the positive effects of the objectives.

1. It protects consumers from being exploited by business men
2. It creates price stability or checks inflation
3. It encourages consumption of commodities
4. It controls monopoly powers in the economy
5. It reduce the economic gap between rich and the poor
6. It discourages production of undesirable commodities.

DISADVANTAGES / DEMERITS OF A MAXIMUM PRICE (ADVERSE EFFECTS)

1. It causes shortages or scarcity of commodities in the market. The sellers or producers are discouraged from producing and supplying commodities; some of them create scarcity by hoarding / holding commodities. This results into a black market.

2. NB: A black market

3. This is the selling of goods at prices higher than the legislated maximum price of government especially behind counters.

4. It results into trade mal – practices e.g. smuggling of goods. The traders may smuggle away goods to other countries in order to sell them at a higher price. This leads to scarcity of goods in the local market.

5. It discourages some producers from producing hence creating excess capacity. A maximum price leads to underutilization of resources because it discourages producers from producing.

6. It increases government expenditure. Enforcing a maximum price requires high administration costs in terms of government officials who must be recruited to work in the different parts of the economy.

7. It leads to unemployment due to the reduced levels of investment. A maximum price discourages entrepreneurship because it is basically a low price. This leads to a fall in investment levels and a decline in employment opportunities.

8. The rationing of commodities becomes inevitable (unavoidable) rationing refers to the system of distributing the scarce commodities at fixed prices set by government in limited quantities on the basis of first come first serve. However this practice is associated with problems like long queues / lines, favouritism, bribery etc.

MINIMUM PRICE / PRICE FLOOR

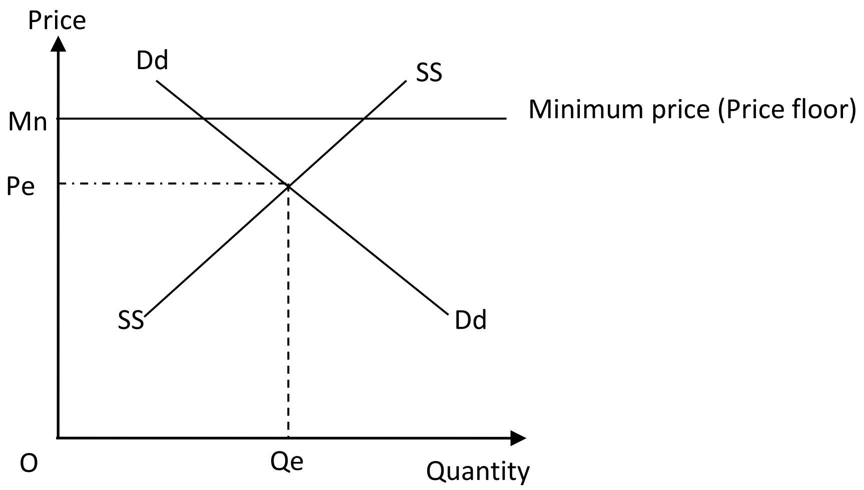
This is a price set by the government above the equilibrium price and it becomes illegal to buy from producers or sellers below it. The main intension of this price is to protect primary producers like farmers from being cheated by profit hungry business men or buyers who may wish to pay them very low prices.

Question

What is minimum price legislation?

This is the selling of a price

Illustration of minimum price / price floor



OPe = Equilibrium price.

REASON / OBJECTIVES FOR SETTING A MAXIMUM PRICE.

Question

Explain the objectives of setting a minimum price by government.

1. To control price changes or fluctuations. A fixed minimum price is used by government to minimize price instabilities especially in the agricultural sector.

2. To encourage and promote production of particular commodities. A minimum price is set by government to encourage the production of socially desirable items or enable commodities like food, soap, milk etc.

3. To protect producers from being exploited by the buyers. Primary producers like farmers are always cheated by buyers who offer those low prices for their products. Therefore the government fixes a minimum price to reduce this exploitation.

4. To stabilize incomes of primary producers. Government fixes a minimum price to stabilize the incomes of primary producers like farmers. Whose income is always unstable because it changes with the charges in prices?

5. To upset an economic depression. An economic depression is a situation characterized by how economic activities how low output, low profits, and high levels of unemployment and spread poverty. The government fixes a minimum price to boost production in order to check an economic depression.

6. To create industrial peace. A minimum price can be set in form of a minimum wage. Once a minimum wage is set, workers get a pay that is fair enough and this checks industrial actions or go on strikes.

NB: A minimum wage This is a wage set by government above the equilibrium wage to protect workers from exploitation and <u>it becomes illegal to pay workers labour it.</u>

7. To discourage consumption of undesirable goods or services. The government fixes a minimum price on socially undesirable goods in order to limit their consumption e.g. the government may fix a minimum price on cigarettes in order to reduce their consumption.
8. To protect domestic producers / local firms from excessive competition with the imports.The government may set a minimum price on the imported goods e.g. imported cement to make such goods expensive in order to discourage people from buying them. The government is therefore able to reserve the local market for local producers.

Question

What are the advantages and disadvantages of a minimum price?

ADVANTAGES

1. It controls price changes or fluctuations
2. It encourages and promotes production of particular activities
3. It protects producers from being exploited by the buyers
4. It establishes income of primary producers
5. It offsets an economic depression
6. It creates industrial peace
7. It discourages consumption undesirable goods or serves
8. It protects domestic producers or local firms from excessive competition with the imports.

DISADVANTAGES OF A MINIMUM PRICE

1. It results into storage problems. A minimum price encourages production and makes producers' supply more than the market demand. The surplus output requires more storage facilities which in most cases are not readily available.
2. A minimum price may result into inflation. It can act as the beginning of price increases. This is because once it is set; sellers are free to charge any price above it.
3. It discourages consumption of certain goods. A minimum price makes goods expensive. This limits the consumption and it discourages further production.
4. A minimum price in form of a minimum wage makes labour expensive. This increases the cost of production. It therefore makes the employers opt for capital intensive means of production leading to technological unemployment.
5. It increases government expenditure. This is because the government has to employ officials to monitor and ensure the success of the minimum price.
6. It leads to surplus output with the associated defects. A minimum price set by government encourages production leading to flooding of the markets with many commodities over production results leading to wastage of resources.
7. NB:
8. Price support
9. This is the act of government buying the surplus output resulting from the setting of a minimum price to ensure its success.

Questions

Distinguish between minimum price legislation and maximum price legislation.
Explain the consequences of setting prices by government. (advantages and disadvantage of both)

POSITIVE CONSEQUENCES

1. It protects consumers from being exploited by business men
2. It creates price stability or checks inflation
3. It encourages consumption of some commodities
4. It controls monopoly powers in the economy
5. It reduces the economic gap between the rich and the poor
6. It discourages production of undesirable commodities
7. It controls price changes or fluctuations
8. It encourages and promotes production of some commodities
9. It protects producers from being exploited by buyers
10. It stabilizes income of primary produces
11. It offers an economic depression
12. It creates industrial peace
13. It discourages consumption of undesirable goods or service s
14. It protects domestic producers / local firms from excessive competition with the imports.

Negative consequences

1. It causes shortage / scarcity of commodities in the market
2. It results into trade malpractices like smuggling of goods
3. It discourage some producers from producing hence causing excess capacity
4. It increases government expenditure
5. It leads to unemployment due to reduced levels of investment
6. The rationing of commodities becomes unavoidable
7. It results into storage problems
8. It may result into inflation
9. It discourages consumption of certain goods
10. It leads to surplus output with associated defects
11. Minimum price in form of minimum wage makes labour expensive

NB : Each point must be explained in details using one of the prices (minimum or maximum)

Failure to use a price in the explanation may lead to complete failure to earn marks.

Question

Explain the objectives of legislating prices by government
Explain the reasons why government may avoid the setting of prices.

Question 2 answers

1. Fear of causing a black market
2. Fear of raising the costs of production
3. Fear of creating technological unemployment
4. Fear of high administration costs
5. Fear of causing excess capacity
6. Fear of causing inflation
7. Fear of causing shortage of goods in the market.

THE THEORY OF DEMAND

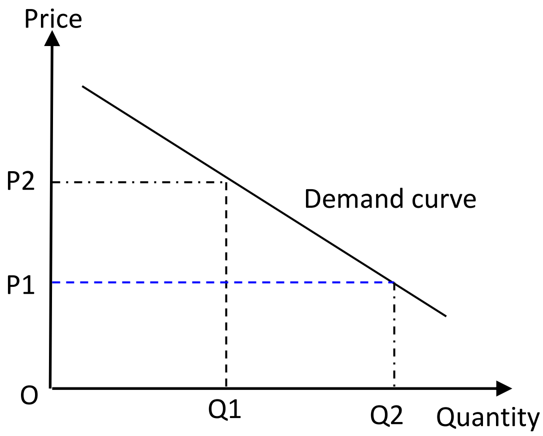
Demand refers to the desire backed by the ability and willingness to buy a given commodity at a given time from a given place.

The actual buying or purchasing of a commodity from the market at a given price and time is called effective demand services in the market.

THE LAW OR DOCTRINE OF DEMAND

It 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 keeping other factors constant.

Illustration



At a low price QP1, the quantity demanded is high i.e. OQ2 and at a high price OP2, the quantity demanded is low i.e. OQ1.

FACTORS INFLUENCING DEMAND / DETERMINANTS OF DEMAND.

The price of commodity in question (low and high). At high price of the commodity in question, the quantity demanded is low and at low price of the commodity in question, the quantity demanded is high, keeping other factors constant.

The price of substitute goods; e.g. coffee and tea leaves or Omo and Nomi. An increase in price of one e.g. coffee loads to an increase of the amount demanded of the other e.g. tea leaves therefore a decrease in price of one e.g. coffee leads to a decrease in the amount demanded of the other e.g. tea leaves.

NB: Substitute goods are the ones that serve more or less the same purpose.

The price of complementary goods. The higher the price of one e.g. Shoe polish the less the amount demanded of the other e.g. shoe brushes. However, the less the price of one e.g. shoes polish, the more the amount demanded of the other e.g. shoe brushes.

NB: Complementary goods. Are the ones that are jointly demanded or the ones that are bought simultaneously. The consumer cannot use one without the others. They include a car and fuel, a phone and a line, a gun and bullets.

The consumer's tastes and preferences. Favourable consumer tastes and preferences result into high demand while unfavourable tastes and preferences lead to low demand for the commodity in question keeping other factors constant.

NB: The consumer's tastes and preferences may change due to changing seasons, fashions, social class, age etc.

The size of the population / the size of the market. A small size of the population leads to low demand for the commodity while a big size of the population leads to high demand for the commodity in question keeping other factors constant.

The expected prices in the near future. Expectation of increase in price in the near future leads to high demand for the commodity currently. While anticipation of a fall in price in the near future leads to low demand currently because the buyer hopes to buy more when prices fall in the future.

Seasonal factors / changes in seasons. Some commodities are demanded in large quantities during given seasons and are demanded in less quantities when their seasons set off e.g. examination cards (success cards) are highly demanded during the exam period i.e. October, November and December and when the seasons set off, their demand falls.

The Degree of advertising. Persuasive and aggressive advertising campaigns lead to high demand for the commodity being advertised. On the other hand low level of advertising leads to low demand for the commodity.

The government policy on taxation and subsidization. The favourable government policy on taxes and subsidizes e.g. low taxes and more subsidies to consumers, increases the quantity demanded. However, unfavourable government policy on taxes and subsidizes leads to low demand.

The prevailing economic conditions. Demand tends to be high in periods of economic boom. This is because during such periods, people are employed and get adequate income to buy goods and services. However, during periods of economic depression or recession, demand is low.

The low of diminishing marginal utility. The law states that as more and more units of a commodity are consumed in succession, the marginal utility derived from each additional unit decreased / diminishes. The higher the marginal utility, the higher the willingness of the consumer to buy more units and the less the marginal utility, the less the willingness to the consumer to buy more units.

The income of the consumer. The higher the consumer's income, the higher the quantity demanded and the lower the consumer's income, the lower the quantity demanded keeping other factors constant.

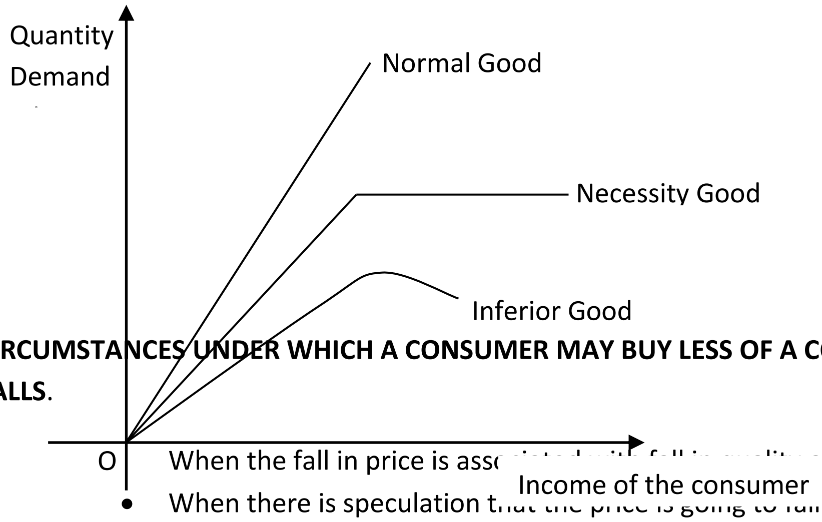
NB: **The influence of income depends on the type of goods in question,**

Normal goods. increase in income leads to increase in the amount demanded and decrease in income leads to decrease in amount demanded.

Necessity goods. Increase in income increases amount demanded up to a given point and remains uncharged / constant even when the consumer's income increases further.

Inferior goods. Amount demanded may increase up to a given point beyond which any increase in income leads to a decrease in quantity demanded.

Illustration of normal, necessity and inferior goods on the income consumption curve (Angel's curve)



CIRCUMSTANCES UNDER WHICH A CONSUMER MAY BUY LESS OF A COMMODITY WHEN IT'S PRICE FALLS.

- When the fall in price is associated with fall in quality of the product.
- When there is speculation that the price is going to fall further in the near future.
- When consumers prefer goods of satiation / status goods.
- When there is a period of economic depression
- When there is emergency of cheaper substitutes.

THE DEMAND FUNCTION

It is an expression in algebra representing quantity demanded and the major factors that affect demand for example;

Qd = fn(p, pr,Y,r,........2)

Where

Qd	=	Quantity demanded	Y	=	Income of the consumer
fn	=	Function	K	=	Capital
p	=	Price of commodity in question	C	=	Consumption
Pr	=	Price of related goods.	I	=	Investment
T	=	Government policy in taxes	i	=	Interest rate

Z = Other factors.

THE DEMAND SCHEDULE

This is a table showing the different amounts of a commodity demanded at alternative prices. It is drawn on the basis of that other factor affecting demand are held constant but price changes. It follows the law of demand.

Illustration

Price (shs)	**Quantity (kg)**
5000	10
4000	15
3000	20
2000	25

(i) Distinguish between an individual demand schedule and a market demand

Schedule.

An individual demand schedule is a table showing the different quantities bough by an individual / household at alternative prices at a given period of time where as a market demand schedule is a table showing the different quantities bought by all individuals or households at alternative prices at a given period of time. It is the horizontal summation of different quantities of a commodity that different individuals are willing to buy from the market at alternative prices at a given time.

Examples of individual demand schedule

A B C

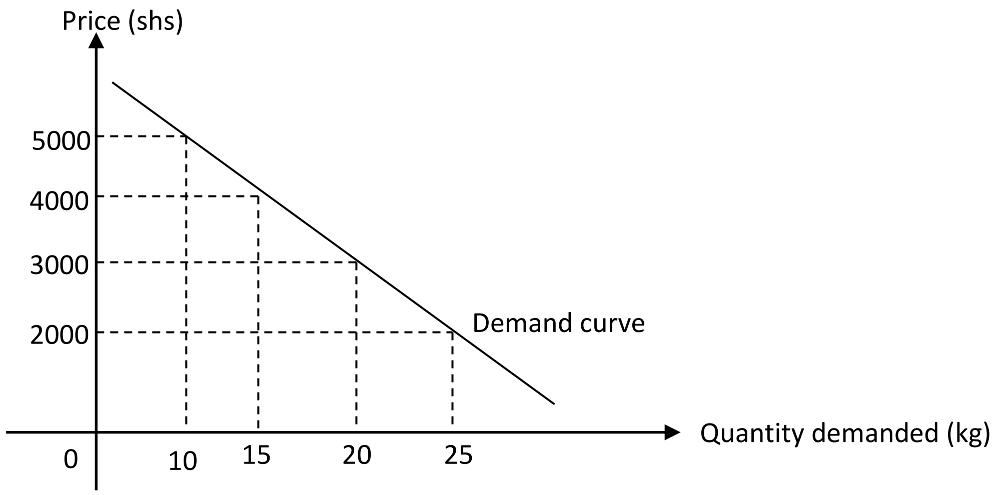
Price (shs)	Quantity (kg)		Price (shs)	Quantity (kg)		Price (shs)	Quanity (kg)
5000	10		5000	8		5000	5
4000	15		4000	12		4000	10
3000	20		3000	16		3000	15
2000	25		2000	20		2000	20

Market demand schedule for A,B and C

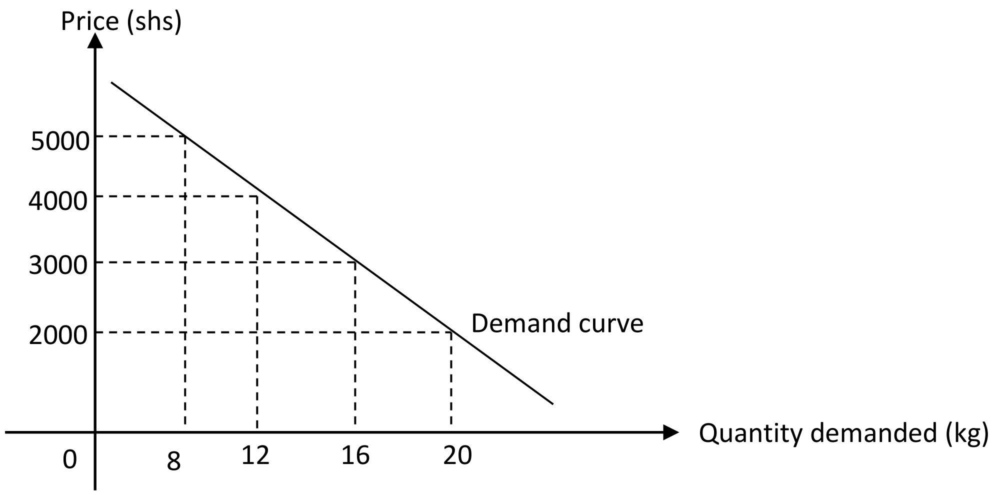
Price (shs)	**Quantity (kg)**
5000	23
4000	37
3000	51
2000	65

ILLUSTRATING A DEMAND SCHEDULE ON A CURVE

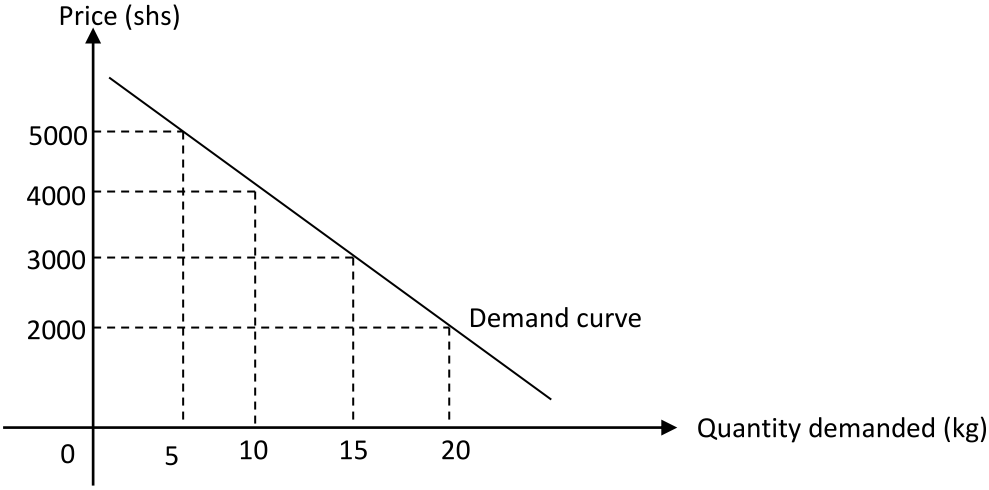
A



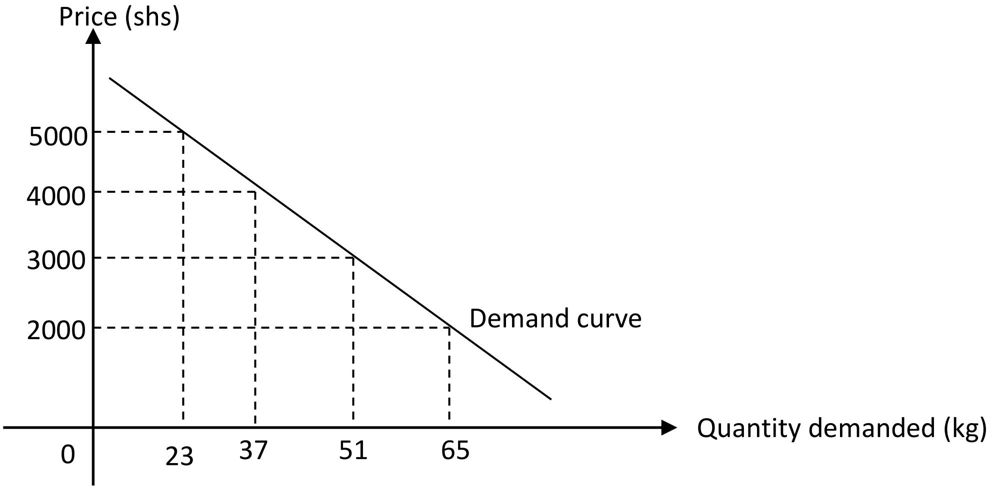
B



C



D

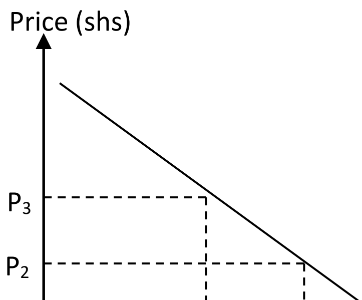


THE NATURE OF THE DEMAND CURVE

The demand curve is a locus of points showing the different quantities demanded for a commodity at various / alternative prices at a given period of time. It is the graphical representation of the demand schedule. The quantity demanded is plotted along the horizontal axis (x – axis) while the price on the vertical axis (y – axis). The points which indicate quantity demanded at alternative prices are marked and joined to form the demand curve.

NB: A normal curve has a negative slope. This is because it slopes downwards from the left to the right. Thus indication that more of a commodity is demanded at lower prices and less at higher prices ceteris peribus. .

ILLUSTRATION OF THE DEMAND CURVE



REASONS FOR THE DOWNWARD SLOPING DEMAND CURVE / WHY THE DEMAND CURVE IS NEGATIVELY SLOPPED

Question

Explain the reasons why consumers buy more units at lower price and less units at higher prices.

Price effect.
A fall in a price of a commodity attracts new consumers to start buying it. This increases amount demanded. However, as increase in the price of the commodity scares away some buyers and limits the quantity bought by the existing buyers. This causes a decline in the amount demanded hence the negative slope of the demand curve.

Income effect.

A low price of a commodity increases the real income of the consumers i.e. a decline in the price of the commodity makes the consumer able to buy more units using the same income. However an increase in price reduces the real income of the consumer i.e. the consumer buys less units using the same income hence the negative slope of the demand curve.

NB

(i) Nominal income is ones income expressed in monetary items e.g. a monthly income of shs. 2,000,000 per month.

(ii) Real income in the purchasing power of nominal income or it is the amount of goods and services that nominal income can buy.

Factors that influence the size of the income

- Price level
- Size of nominal income

- Availability of goods and services
- Level of indirect taxes

Substitution effect. This is the effect that arises when a consumer takes on the alternative commodity when prices change. An increase in the price of one commodity e.g. coffee makes the consumers to substitute it for the alternative item e.g. tea leaves. However, a decrease in the price of a commodity e.g. coffee makes the consumers to ignore the alternatives e.g. tea leaves. Therefore, there is high demand at a low price and low demand at a high price leading to the negative slope of the demand curve.

The operation of the law of diminishing marginal utility. The first units consumed of a commodity yield high marginal utility and this is why the price is high. However, the additional units yield less and less marginal utility and that is why the price is low.

Presence of low income groups of people. (Existence of marginal consumers). A marginal consumer is one who is the first to buy when prices decline and the last one to buy when prices increase. Marginal consumers largely come from low income groups. They turn up in big numbers when prices reduce leading to high quantity being demanded. However, they also disappear in large numbers when prices increase leading to low quantity demanded at a high price.

The different uses to which commodities are put. (Existence of composite demand). The different uses of a commodity can be responsible for the negative slope of a demand curve. Increase in the price makes consumers to restrict the use of the commodity to a few purposes e.g. electricity for lighting only. This leads to low quantity demanded at a high price. However, a fall in price makes consumers to use the commodity for several purposes e.g. electricity for lighting, cooking, washing etc. this leads to high quantity demanded or a low price hence the negative slope of the demand curve.

> NB: Composite demand. This is the demand for a commodity with several uses e.g. the demand for cotton wool, demand for water, demand for electricity and the demand for sugar.

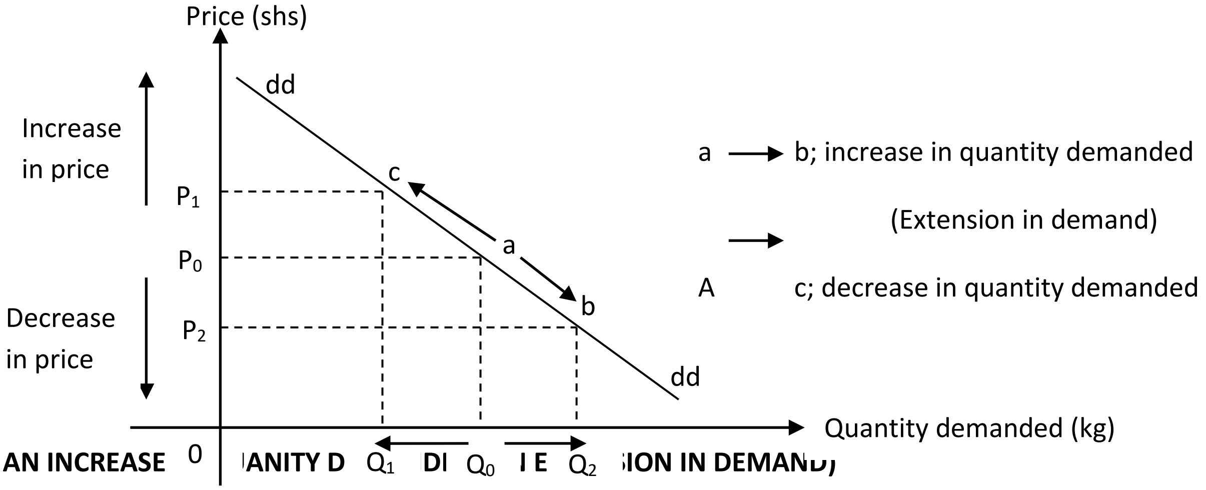
CHANGE IN QUANTITY DEMANDED AND CHANGE IN DEMAND

CHANGE IN QUANTITY DEMANDED

This refers to the <u>increase </u>and <u>decrease</u> in the <u>amount </u>of a commodity demanded due to charges in the price of that commodity other factors affecting demand remaining constant.

It involves a movement along the same demand curve. This movement is either upwards or downwards on the same demand curve. The movement upwards is called decrease in quantity demanded (contraction in demand) and the movement downwards is called increase in quantity demanded (extension in demand).

Illustration of change in quantity demanded.



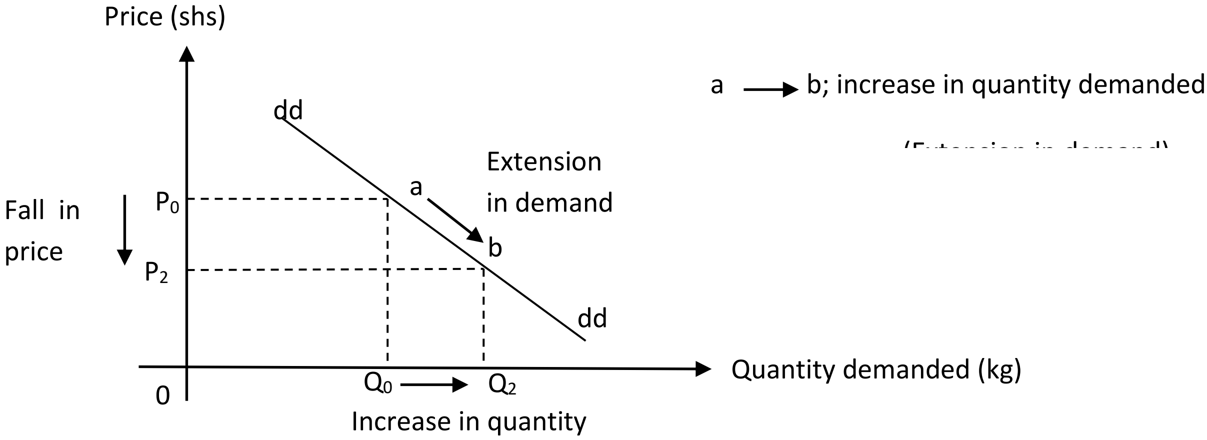
AN INCREASE ... ANITY D ... DI ... E ... ION IN DEMAND)

This refers to the increase in the amount demanded of a commodity due to a fall in the price of that commodity other factors affecting demand being constant.

OR

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

Illustration



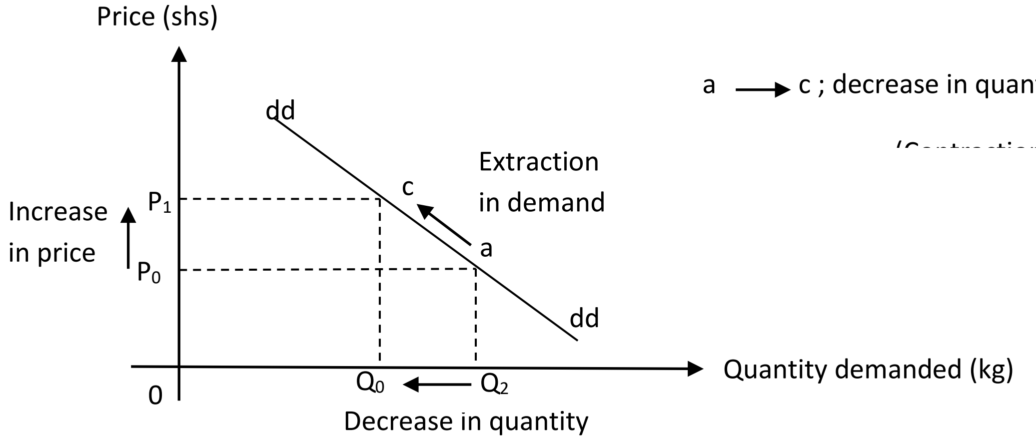
A DECREASE IN QUANTITY DEMANDED (CONTRACTION IN DEMAND)

This refers to the fall in amount demanded of a commodity due to an increase in the price of that commodity other factors affecting demand being constant.

OR

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

Illustration



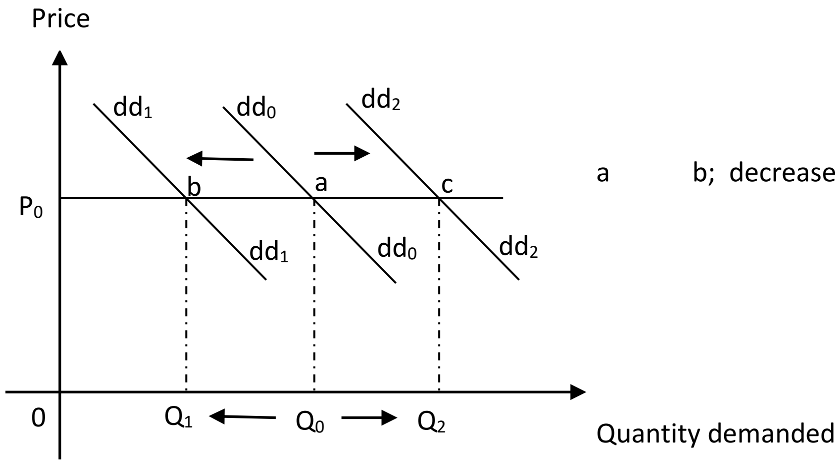
a $\longrightarrow$ c ; decrease in quantity demanded

(Contraction in demand)

CHANGE IN DEMAND (A SHIFT IN THE DEMAND CURVE)

This refers to an increase or decrease in the amount demands of a commodity due to changes in the other factors affecting demand when the price of that commodity in question is constant. It involves the shifting of the entire demand curve either to the left or to the right of its original position. At the same price of that commodity, more or less is demanded due to changes in the other factors affecting.

Illustration



a b; decrease in demand

FACTORS THAT CAUSE CHANGE IN DEMAND FOR A COMMODITY

NB: The stating of the points must start with the words <u>change in</u> and the explanation must use words like increase, rise, a positive change, a favourable change. You can also use decrease, fall, decline, negative change, unfavourable change.

The explanation becomes wrong if one uses the words low and high.

A change in the level of income of the consumer. An increase in the consumers income leads to <u>increase</u> in demand while a <u>decrease</u> in the consumer's income leads to a <u>decrease</u> in demand.

A change in tastes and preferences of the consumer. A favourable change in the consumers' tastes and preferences leads to an increase in demand and an unfavourable change in consumer's tastes and preference leads to a decrease in demand.

Change in the population size. An increase is population size creates a big market for goods and services which leads to an increase in demand while a decrease in population size creates a small market for goods and services which leads to a decrease in demand.

A change in the season. Favourable change in seasons attract consumers to buy a c commodity which leads to an increase in demand while unfavourable change in seasons discourages consumers from buying a commodity which leads to a decrease in demand.

Change in the level of advertisement. An increase in the level of advertisement increases the awareness of the consumers about the commodity which leads to an increase in demand while a decrease in the level of advertisement reduces the awareness of the consumers of the commodity which leads to a decrease in demand.

Change in the price of substitute goods or commodities (use rise and fall). An increase in the price of a substitute discourages the consumers from buying the substitute which leads to an increase in demand of the commodity in question while a fall in the price of a substitute attracts consumers to buy that substitute which leads to a decrease in demand of the commodity in question.

Change in price of complimentary goods. An increase in price of a complementary good discourages consumers from buying it which leads to a decrease in demand for the commodity in question while a fall in the price of a complimentary good encourages consumers to buy it which leads to an increase in demand for the commodity in questions.

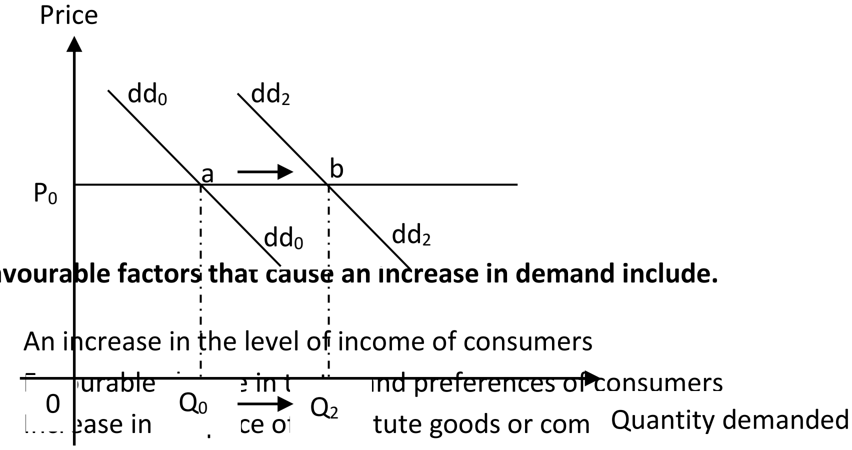
Change in the level of taxation and subsidization. An increase in the level of taxation accompanied by low levels of subsidization discourages consumers from buying a commodity which leads to a decrease in demand while a decrease in the level of taxation accompanied by increase in subsidization result into an increase in demand because it encourages consumers to buy a commodity hence increase in demand.

Change in the quality of the product. An increase in the quality of the product attracts consumers to buy a commodity which leads to an increase in demand while a fall in the quality of the product discourages consumers from buying a commodity which leads to a decrease in demand.

Change in the level of addiction of a commodity. An increase in the level of addiction of a commodity encourages consumers to buy that commodity which leads to an increase in demand while a decrease in the level of addiction of a commodity discourages consumers from buying that commodity which leads to a decrease in demand.

FACTORS THAT CAUSE AN INCREASE IN DEMAND

An increase in demand refers to the rise in the amount demanded of a commodity due to favourable changes other factors affecting demand, the price of the commodity in question being constant.

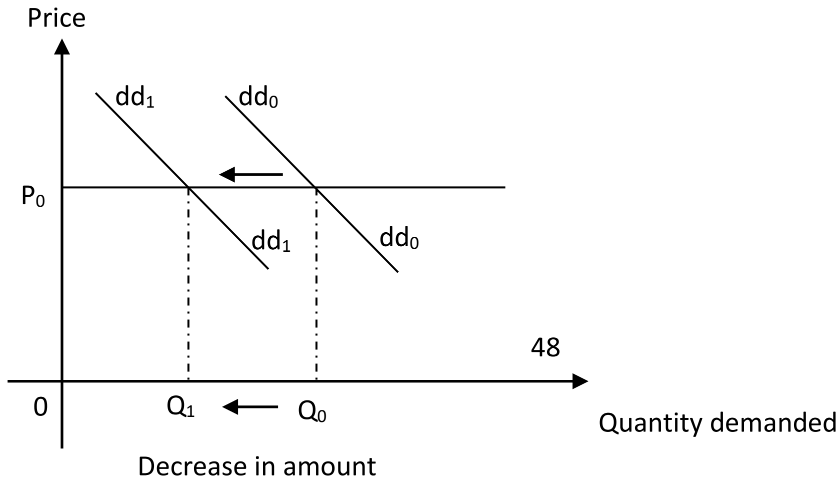


The favourable factors that cause an increase in demand include.

1. An increase in the level of income of consumers
2. Favourable change in tastes and preferences of consumers
3. Increase in price of substitute goods or com
4. A favourable charge in the season
5. An increase in the size of the market
6. A favourable change in government policy of subsidisation
7. An expected increase of the price of a commodity in future
8. Increase in the level of advertisement
9. Increase in income distribution among individuals
10. Increase in the quality of the product
11. Increase in the level of addiction of the commodity.
12. Increase in the level of income of consumers. An increase in income of the consumers increases consumers purchasing ability hence increase in demand.
13. Increase in the level of advertisement. An increase in the level of advertisement increases demand because more consumers get to know about the commodity.
14. Decrease in the price of a complimentary good. Decrease in price of a complimentary good increases demand for the other commodity because the consumer requires both of them at a time so decrease in price of one leads to increase in demand for other.

A DECREASE IN DEMAND

This refers to the fall in the amount demanded of a commodity due to unfavourable changes in the other factors affecting demand, the price of commodity in question being constant.



Factors that cause a decrease in demand

NB:

The unfavourable changes in the other factors that affect demand apart from price of the commodity in question.

1. Decrease in level of income of consumers
2. Unfavourable change in taste and preferences of consumers
3. Decrease in the price of substitute goods
4. An unfavourable change in season
5. A decrease in the size of market
6. An unfavourable change in government policy on taxation and subsidization
7. An expected decrease in the price of the commodity in future
8. Decrease in income distribution among individuals
9. Decrease in the level of advertisement
10. Increase in the price of a complimentary good
11. Decrease in quality of a complimentary good
12. Decrease in quality of the product
13. Decrease in the level of addiction of the commodity.

Decrease in price of substitute goods. For example a decrease in price of tea leaves leads to a decrease in demand for coffee. This is because the consumers avoid coffee for the much cheaper tea leaves.

Increase in price of a complementary good. An increase in price of one of the complements leads to a fall in demand for both items. For example a rise in the price of shoes leads to a fall in demand of show polish.

Question

(a) Distinguish between change in demand and change in quantity demanded.
(b) Explain the factors that can cause a change in demand at a constant price.
(a) Distinguish between increase in demand and increase in quantity

demanded.

(b) Explain the factors that cause increase in demand at the same price of the commodity in question.

NB:

The uses of price are an economy.

What are the functions of price in an economy?

1. Price measures the value of commodities. In a monetary economy, the value of goods and service is expressed in terms of money or price. Always the higher the prices, the greater the value and the lower the price the lower the value.

2. Price guides producers on what to produce. Producers normally prefer making items where consumers are willing to offer a high price.

3. Price guides consumers when making consumption plans. Consumers put into consideration prices when making their consumption budgets. Price guides them when selecting what to buy and what to leave out.

4. Price guides producers on how to produce i.e. when selecting the technique of production to be used, to be used; the producer is guided by price. He or she always takes on the degree technique of production relative to the price of the commodity.

5. Price guides producers on where to produce from. Producers always set up their producing plans in areas where consumers can afford to pay the price for the final good / service.

6. Price helps in deciding who to produce for. The producer uses price to decide who to produce for. Normally, the high income groups are preferred because of their high purchasing ability or their ability to pay a high price.

7. Prices guide the income distribution in the economy. Producers buy factors of production at prices called factor prices. Therefore the incomes move from the producers to households. After making the final goods and service, the producers sell them to the final buyers at the existing market prices. In this case, incomes move from households back to producers.

UTILITY AND DEMAND

Utility refers to the ability of a commodity to satisfy human wants. It represents the satisfaction which is derived from the consumption of a commodity. Utility is measurable in economics using standard units known as utils.

Total utility is the sum of the satisfaction that a person derives from consuming a given number of units of a commodity.

Marginal utility. This is the additional satisfaction derived from consuming an additional unit of a commodity. It is got / computed using the formular

Marginal utility = change in total utility change in number of nits consumed.

$$M.O = \frac{\Delta T.O}{\Delta Q}$$

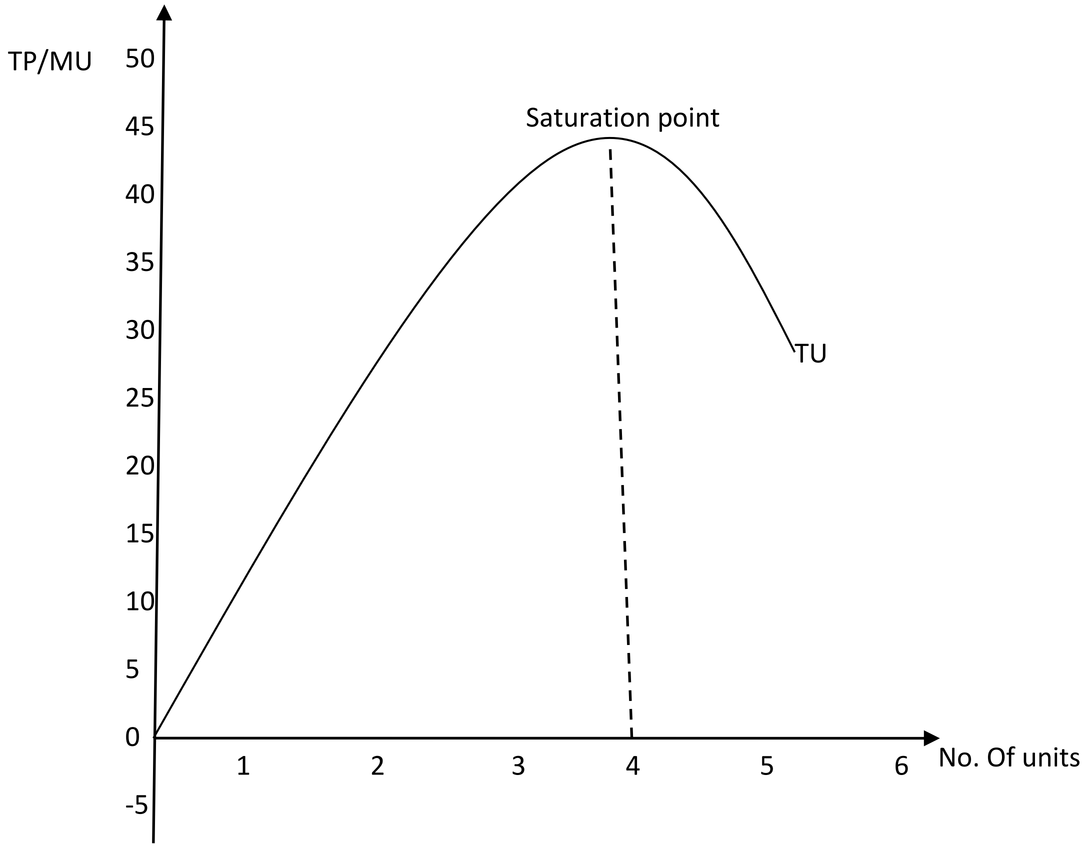
A table showing total utility and marginal utility

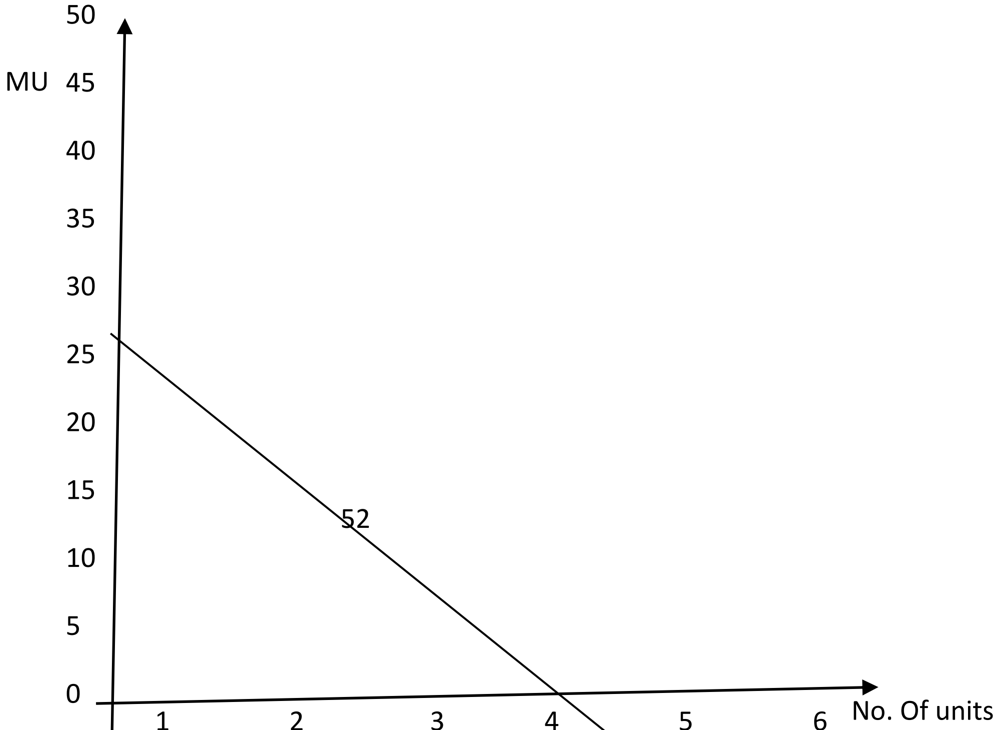
Units consumed	Total utility (T.U)	Marginal utility (M.U)
0	0	
1	20	20
2	35	15
3	45	10
4	45	0
5	40	-5

$\frac{45-35}{3-2} = \frac{10}{1}$, $\frac{45-45}{4-3} = \frac{0}{1}$ $\frac{40 - 45}{5 - 4} = \frac{-5}{1}$

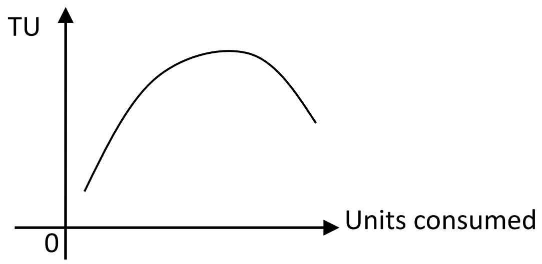
$$\frac{\text{Use current total utility - previous one}}{\text{Unit consumed currently - previous one}}$$

THE RELATIONSHIP BETWEEN TOTAL UTILITY AND MARGINAL UTILITY

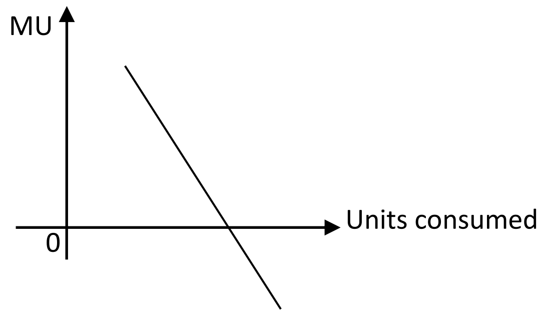




Total utility curve



Marginal utility curve



Relationship between total utility and marginal utility

As total utility increase, marginal utility falls
When total utility is at maximum, marginal utility is zero (0)
When total utility starts to fall, marginal utility becomes negative. (-ve)

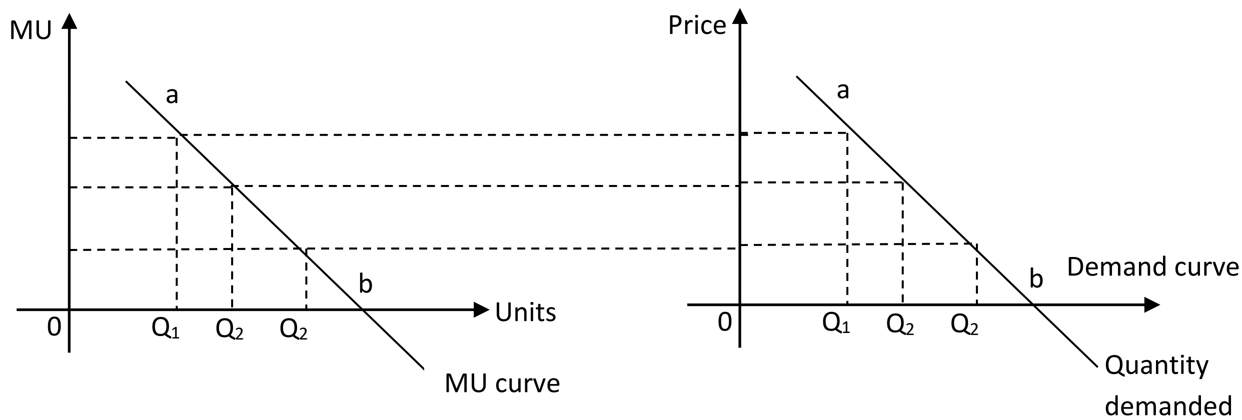
Bliss point / point of satiety / saturation point

This is a point on total utility curve at which total utility becomes maximum. It is the highest point on the total utility curve. At this point, marginal utility is 0.

Using the marginal utility curve to derive the demand curve.

Marginal utility curve

Demand curve



The upper part of the marginal utility curve is the demand curve.

The upper part of the marginal utility curve i.e. a b represents the demand curve. The consumer is unable to buy more units beyond point b because they are associated with disutility. (loss of satisfaction).

Units consumed	**Total utility**	**Marginal utility**
0	-	-
1	3	3
2	7	4
3	9	2
4	10	1
5	10	0
6	8	-2

Marginal utility = $\frac{\Delta T.U}{\Delta Units} = \frac{7-3}{2-1} = \frac{4}{1}$

= 3 - 0 = 9 - 7 = 2

= 1 - 0 = 10 - 9 = 1

= $\frac{3}{1}$ = 3

THE LAW OF DIMINISHING MARGINAL UTILITY

It states that as more and more units of a commodity are consumed in succession, the marginal utility derived from each additional unit decreases or diminishes. (Other factors being constant). The first unit consumed gives the highest amount of marginal utility and the last unity gives the least amount of marginal utility.

ASSUMPTIONS OF THE LAW OF DIMINISHING MARGINAL UTILITY

1. It assumes that the consumers are rational i.e. that the consumes have a calculating mind.
2. It assumes that the commodity has standard uniform sizes i.e. that a commodity can be divided into standard uniform portions.
3. It assumes no change in the consumers tastes and preferences i.e. the consumer should maintain the same preference / liking for the commodity.

4. It assumes that the consumers' level of income is the same or fixed.
5. It assumes continuity in consumption.
6. The law assumes that utility is measurable in units known as utils.
7. The law assumes that the level of addition of a commodity is constant i.e. it works best when the consumers are not addicted to the commodities in question.
8. The price of the different units that are being consumed should remain constant.
9. It assumes a single commodity being consumed at a time.

LIMITATIONS / DEFECTS /CRITICISMS OF THE LAW OF DIMINISHING MARGINAL UTILITY.

1. Consumers are not always rational as the law assumes
2. The consumers' income is not always constant but it changes depending on the prevailing economic condition.
3. The law assumes that the consumers tastes and preferences are constant but these change depending on time, age, environment et.
4. Consumption is not always continuous i.e. consumers take breaks when using different items.
5. Not all commodities are divisible e.g. it is difficult to divide chicken into similar portions
6. Consumers do not always consume a single commodity at a time but a number of related items.
7. Prices of commodities change a lot. It is not true that a commodity can have a constant price over time.
8. The law does not apply for commodities which are luxurious e.g. posh cars, golden jewellery, silver.
9. The law fails to apply for commodities which are addictive like ice cream, chips. The more people use them, the more they like them.
10. Utility is not measureable numerically. It is unrealistic to assume that individuals can measure the amount of satisfaction derived from each unit consumed.
11. The law cannot apply for money or money income. This is because the more people get the money, the more they love it.

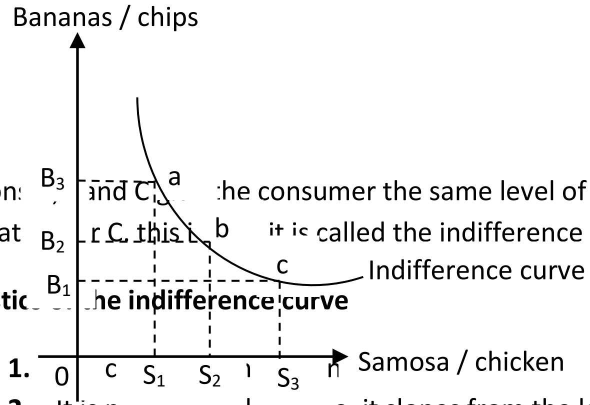
Questions

State the law of diminishing marginal utility
Give the assumptions of the law of diminishing marginal utility
What are the limitations of the law of diminishing marginal utility?

INDIFFERENCE CURVE ANALYSIS

An indifference curve is a locus of points showing different combination of how commodities that gives the consumer the same level of satisfaction. The consumer is taken to be indifferent at the different points of the indifference curve.

Illustration



Combinations [illegible] and C [illegible] the consumer the same level of satisfaction i.e. the consumer is indifferent at [illegible] r C. this [illegible] it is called the indifference curve.

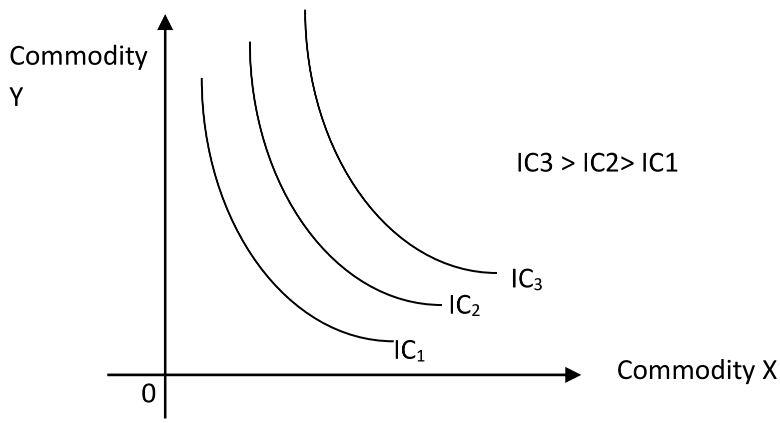
Characteristic[illegible] the indifference curve

1. [illegible]
2. It is negatively sloped i.e. it slopes from the left to the right
3. It assumes two commodities being consumed
4. It does not touch any axis
5. Two or more indifference curves under the same axis do not meet
6. The higher the indifference curve the higher the level of satisfaction

AN INDIFFERENCE MAP

It's a group of indifference curves drawn under the same axes. They are normally drawn to enable comparison i.e. the higher the indifference curve, the higher the level of satisfaction and the lower and indifference curve the lower the level of satisfaction.

An illustration of an indifference map

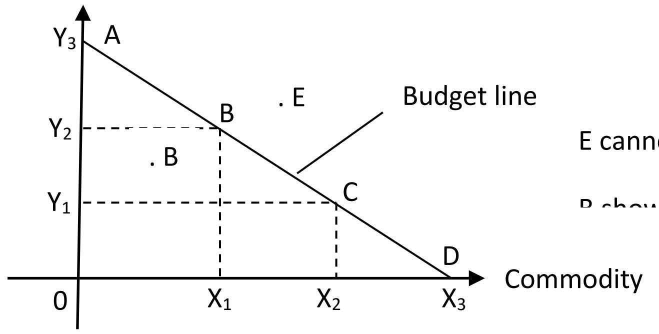


Indifference curve 3 has greater satisfaction than indifference curve 2 and indifference curve 2 has greater satisfaction than indifference curve 1.

BUDGET LINE

This is a locus of points showing various combinations of two commodities that use up all the fixed income of the consumer. The budget line is also called the consumption possibility curve or line.

Illustration



E cannot be got because of limited income.

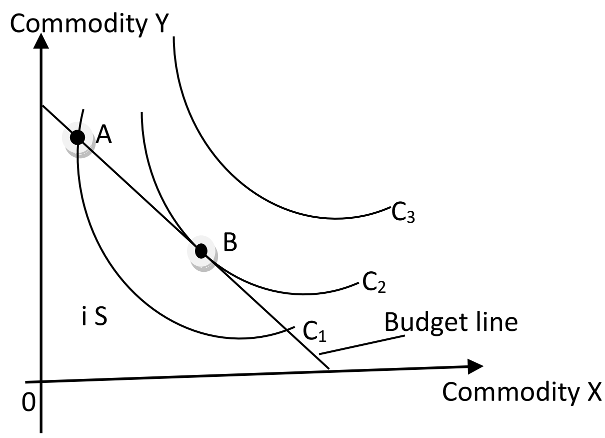
B shows surplus

All the points along the budget line i.e. T, D, C and D exhaust or use up all the fixed income of the consumer. Any point beyond the budget line is not attainable because of limited income of the consumer. Any point insider the budget line indicates that the consumer has surplus income.

Characteristics of a Budget line

1. It is negatively sloped
2. It can rotate inwards or outwards
3. It can shift inwards or outwards
4. It is based on two commodities
5. It is based on fixed income of the consumer
6. It assumes that price for the two commodities is constant.

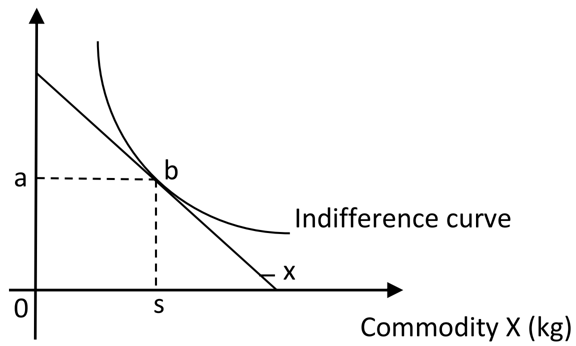
CONSUMER EQUILLIBRIUM



Consumer equilibrium is a point at which the consumer derives the highest possible level of satisfaction when he consumes two commodities using his fixed income. At this point, the budget line is tangent to the highest indifference curve i.e. at point B, point A and C are attainable but have lower satisfaction because they lie on a lower indifference curve, indifference curve (3) three is not attainable because of the limited income of the consumer.

Question.

Study the diagram below and answer the questions that follow;



(i) Name X

Budget line

(ii) What concept is illustrated by point B?

Consumer equilibrium

(iv) Given that the consumers' income is fixed at shs. 100,000 and the price of commodity Y is 10,000sh per piece. Determine the price of each kg of commodity X

Income / budget = Expenditure on commodity Y + Expenditure on commodity X

10,000 = (10,000 x 8) + 5x

100,000 = 80,000 + 5x

100,000 - 80,000 = 5x

$$\frac{20,000}{5} \; x \; \frac{5x}{d}$$

x = 4,000

Each kg of commodity X is 4000shs.

CONCEPT OF CONSUMER SURPLUS

This is the difference between what a consumer is willing to pay for a commodity and what he actually pays or it is the additional utility which a consumer enjoys without paying for it. Consumer surplus arises when the actual expenditure is less than the planned expenditure of the consumer it is computed using the formula.

Consumer surplus = Planned expenditure of the consumer - Actual expenditure

OR

Estimated expenditure - actual expenditure.

Example 1

Given that a consumer plans to spend shs. 80,000 to buy commodity y. however, on teaching the market, the consumption of commodity y is subsidized and the consumer actually spends 55,000 compute the consumer surplus.

Consumer surplus = estimated expenditure - actual expenditure

80,000 - 25,000

Shs. 25,000

The consumer surplus = shs 25,000

Example 2

Planned price (shs)	Units purchased
500	1
450	2
400	3
350	4
300	5
250	86

Calculate the consumer surplus if each unit is consumed at shs. Consumer surplus = planned expenditure – actual expenditure.

= (500 + 450 + 350 + 300 + 250) - (6 x 350)

= 2250 - 2100

= 150 shs.

Example 3

Study the table below and answer the question that follows.

Planned price (shs)	Units purchased
300	1
250	2
200	3
150	4
100	5
50	6

Calculate the consumer surplus if four units (4 units) of a commodity are purchased at shs. 150 each.

Consume surplus = planned expenditure - actual expenditure

= (300 + 250 + 150 + 100 + 150) - 4 x 150)

= 1050 - 600

= Shs. 450

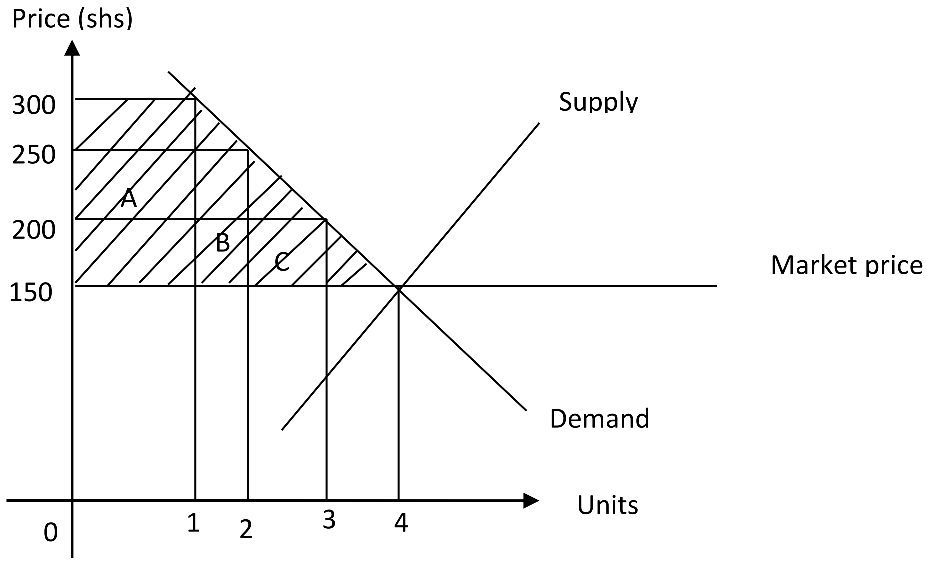
Consumer surplus = (300 + 250 + 200 + 150) - (4 x 150)

= 900 - 600

= Shs. 300

GRAPHICAL ILLUSTRATION OF CONSUMER SURPLUS STAGES

Draw a graph and represent price and the units bought on the horizontal axis.
Mark off the market price and draw a horizontal line at that level.
Indicate the region above the market price but follow the demand curve at various units.
Calculate the area of the region above market price to determine consumer surplus.



Consumer surplus is indicated by the shaded region

Consumer surplus = A + B + C

Area A	=	L x W
L	=	300 - 150
A	=	150 x 1
	=	150
Area B =	250 – 150	
	=	100
B	=	100 x 1
	=	100
Area C =	200 – 150	
	=	50
C	=	50 x 1
	=	50

= 150 + 100 + 50 = 300

THE TYPES OF DEMAND

1. **Inter – related demand.**
   This is where demand for one commodity affects demands for another commodity. The effect can be positive or negative.

2. **Competitive Demand or demand for substitutes.**
   This is demand for goods that serve more or less the same purpose e.g. the demand for omo and nomi, the demand for coffee and tea leaves, demand for a bic pen ad nice clear pen.

3. **Joint or complementary demand.**
   This is demand for goods that are used simultaneously. One item cannot be used without the other e.g. demand for shoe polish and show brush, demand for tooth brushes and Colgate (tooth paste) demand for books and pens, demand for a car and fuel.

4. **Composite demand.**
   This is the demand for a commodity that has served or many uses e.g. demand for water, demand for kimbo, demand for cotton wool, and demand for electricity.

5. **Derived demand**.
   This is demand for a product not for its own sake but for the sake of what it helps to produce. Demand for all the factors of production is derived demand e.g. demand for labour and land is derived from the demand of the products that labour and land are to produce.

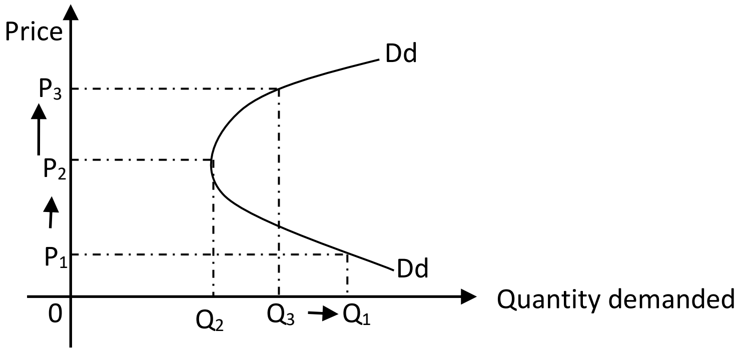
6. **Independent demand.**
   This is where demand for a commodity does not affect or is not affected by the demand for other commodities e.g. the demand for shoes and sweets. However, there is always an indirect link between the demand for all commodities because they are all influenced by the income of the consumer.

THE ABNORMAL / REGRESSIVE / EXCEPTIONAL DEMAND CURVES

An abnormal demand curve is one which does not comply or conform to the conventional law of demand. It does not respect the shape of the normal demand curve. Abnormal demand curves are encountered in the following situations.

- In case of goods of ostentation (in case of status symbols)
- These goods are usually consumed in larger quantities when they become expensive. They are usually bought by the rich to act as objects of status or class.

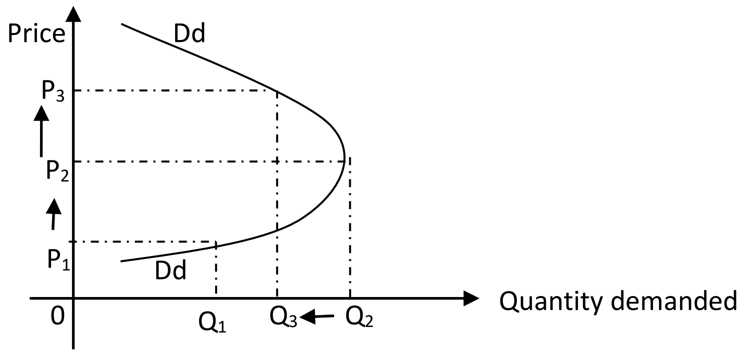
Illustrations



When the price is very low i.e. OP1, the quantity demanded is very high i.e. OQ1. This is because status symbols are always high quality items. When the price is raised to OP2, the quantity demanded reduces to a very low figure OQ2. This is because the price does not appeal to the poor and the rich. However, if the price is raised further to OP3, the quantity demanded increases to OQ3 because this very high price appeals to many rich people.

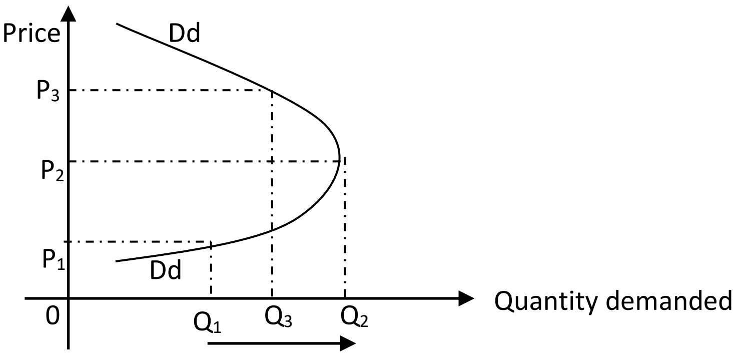
In case of giffen goods. When there is an increase in a price of giffen good, its quantity demanded increases this is because a rational consumer suspends the buying of other items and diverts his or her income to the buying of a giffen good. However, if the price increases further, the consumer may abandon the consumption or buy more of the distant substitutes to a giffen good.

Illustration



In case of speculation or anticipation of increase in future prices. When the consumer anticipates that in the future prices are going to increase, they increase the quantity demanded even when prices are currently increasing. This is done in order to avoid paying much higher prices in the future. However, further increase in the price leads to a fall in the amount demanded.

Illustration



In case of an economic depression or in case of an economic boom. In times of an economic depression, the amount demanded reduces despite falling prices. This is because people are very poor. However, during an economic boom, the amount demanded increases despite increasing prices. This is because people have adequate income or money to buy goods or services.

In case of consumer ignorance about market situation. Some consumers may buy more at increasing prices because they are ignorant i.e. a consumer may regard commodities of higher prices to be of higher quality and value.

In case of necessity goods. The amount demanded only increases up to a given point when price falls. Any further decline in price does not affect the amount demanded.

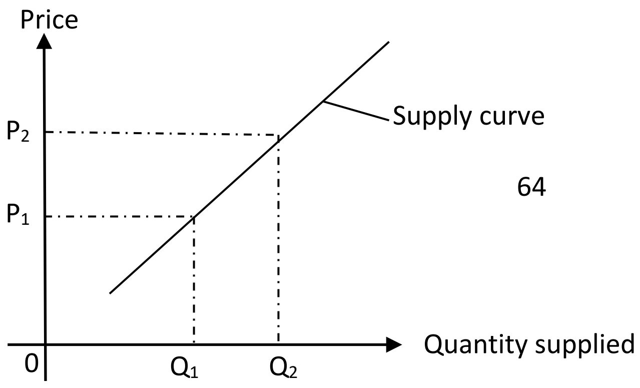
THE SUPPLY THEORY

It refers to the quantity of a good or service that a producer is able and willing to offer for sale at alternative prices in a given period of time. Supply is different from stock because stock is the total amount of a commodity that a producer makes. However supply is part of that stock which the producer is willing to offer at alternative prices at a given time.

THE LAW OF SUPPLY

The higher the price of a commodity, the higher the quantity supplied and the lower the price o a commodity, the lower the quantity supplied keeping other factors constant.

Illustration



THE SUPPLY SHEDULE

Distinguish between an individual supply schedule and a market supply schedule. An individual supply schedule is a table showing different quantities of a commodity supplied at alternative prices at a given period of time by an individual supplier while a market supply schedule is a table showing different quantities of a commodity supplied to alternative prices by all the suppliers at a given period of time.

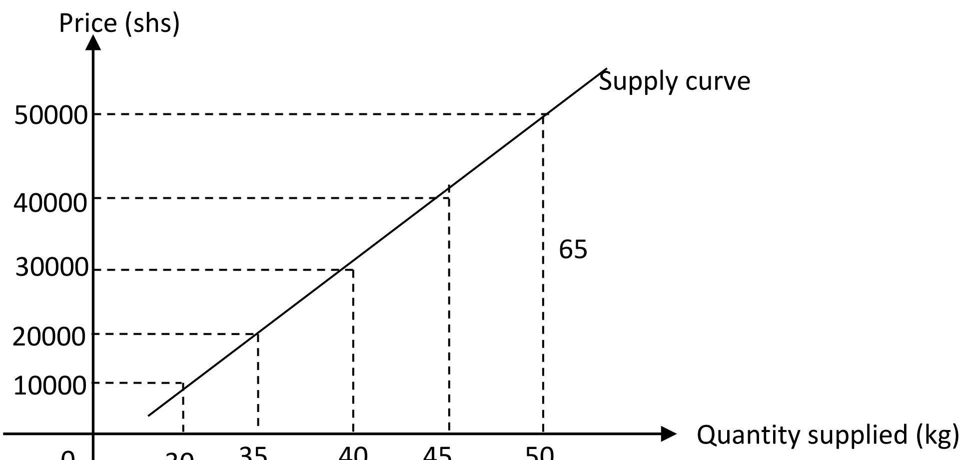
Individual supply schedule = A + B + C

Market supply schedule = A + B + C

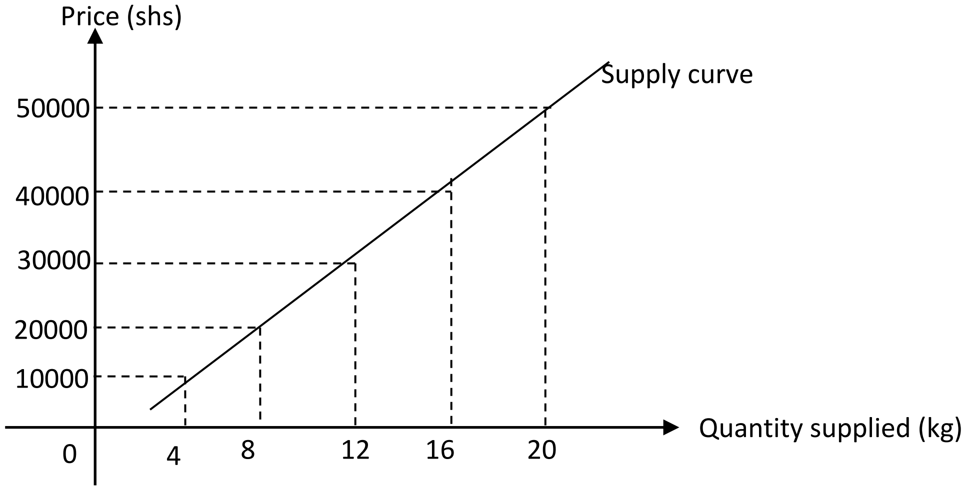
Graphical illustration of = A + B + C

A		B		C	
Price shs.	Supplied quantity (kg)	Price shs.	Supplied quantity (kg)	Price shs.	Supplied quantity (kg)
50,000	50	50,000	20	50,000	40
40,000	45	40,000	16	40,000	38
30,000	10	30,000	12	30,000	36
20,000	35	20,000	8	20,000	34
10,000	30	10,000	4	10,000	32

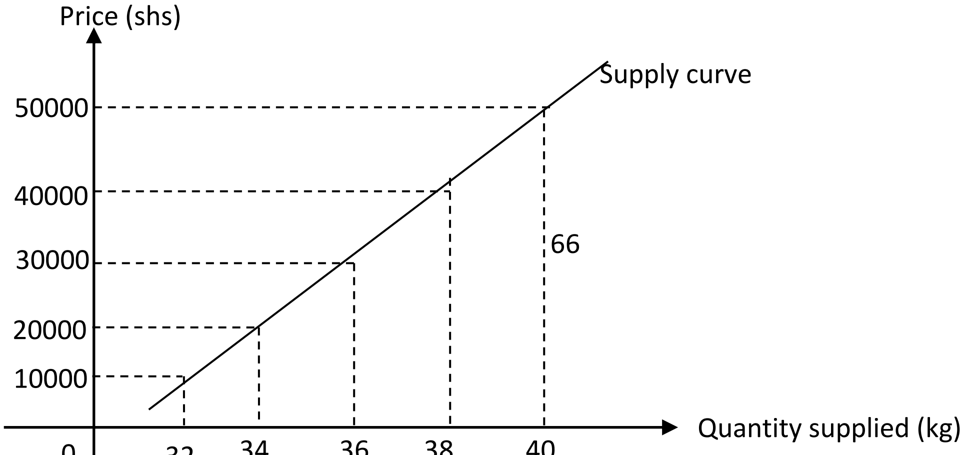
Supply curve for A



Supply curve for B



Supply curve for C

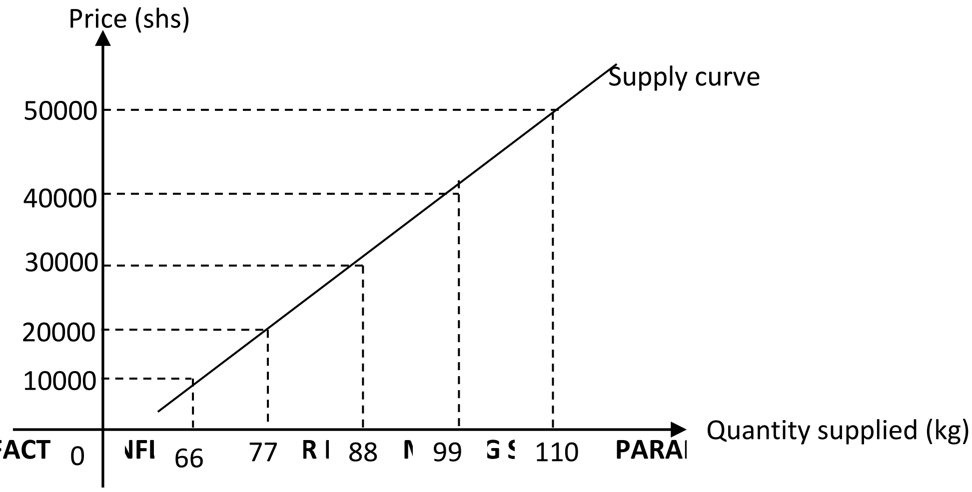


66

Market supply schedule

Price (shs)	Quantity supplied (kg)
50,000	110
40,000	99
30,000	88
20,000	77
10,000	66

Market supply curve



FACT NFI R I PARA

1. **The price of the commodity in question**. The higher the price of the commodity in question, the higher the quantity supplied. This is because a high price enables the producer to maximize profits. However at a lower price, the quantity supplied reduces since the producers cannot maximize profits.
2. **The cost of production.** (The prices of the factors of production used). At a high cost of production, supply is low. This is because the producer is not able to mobilize many factors of production to produce. However, at a low cost of production, supply is high because producers find it cheap to mobilize many factor inputs to price a lot and increase supply.

3. **The level of technology**. Use of modern and advanced mans of production leads to high supply. This is because modern technology improves the speed at which goods are produced. However, poor methods of production limit the pace at which goods are produced leading to low supply.
4. **The government policy of subsidization and taxation**. A favourable government policy e.g. increased subsidies and lower taxes to producers encouraging production leading to high supply. However, unfavourable government policy e.g. in form of high taxes discourages production on leading to low supply.
5. **Length of the gestation period**. Gestation period is the time taken for inputs to be transformed into final goods. The longer the gestation period, the longer it takes the producer to make goods or services and the lower the supply. However, a short gestation period leads to high supply.
6. **The number of producers or suppliers in the market.** The greater the number of producers, the higher the volume produced and supplied on the other hand, the fewer the number of producers or suppliers, the less the quantity offered for sale.
7. **The objective of the firm or producer.** Firms whose main objective is to maximize sales produce a lot of output leading to high supply. However the firms whose main objective is to maximize profit produces less output in order to change high prices and maximize profit. This leads to low supply.
8. **The price of a jointly supplied good**. Jointly supplied goods are the ones that are produced at the same time from the same raw material if the producer cannot make one without producing the others. One of the items is the main product and the other is the bi – product e.g. cotton wool and cotton needs, mutton and wool, beef and hides, petrol and diesel, timber and raw dust, etc increase in price of one e.g. beef leads to increase in supply of the other e.g. hides. However a decrease in price of one leads to a decrease of supply of the other.
9. **The price of a competitively supplied good**. Competitively supplied goods are the ones that use or result from the same raw material. If the producer uses the raw material to make one of the items, then he fails to produce the other or if he increases production of one, he has to reduce the production of others e.g. increase in price of one leads to reduction of supply of the other and on the other hand a decrease of one leads to high supply of the other product.

10. **The size of the market being served**. (Level of demand of the product). Existence of a large market encourages production. Producers make a lot of output to serve the big market. This leads to high supply. However, a small market discourages production leading to low supply.

11. **The political state in the country**. Political stability encourages economic activities because produces are sure of their investment which leads to high supply while political instability discourages economic activities because investors are not sure of their investments of life leading to low supply.

12. **The level of development of infrastructure** like roads and power dams. Well-developed infrastructures make it easy to transport raw materials to production centres and the final product to market centres which leads to high supply while poorly developed infrastructures make it difficult to transport raw materials to production centres and finished goods to market centres which lead to low supply.

13. **The climate conditions.** Favourable climatic conditions e.g. reliable rainfall, fertile soils encourage production of agricultural commodities which leads to high supply while

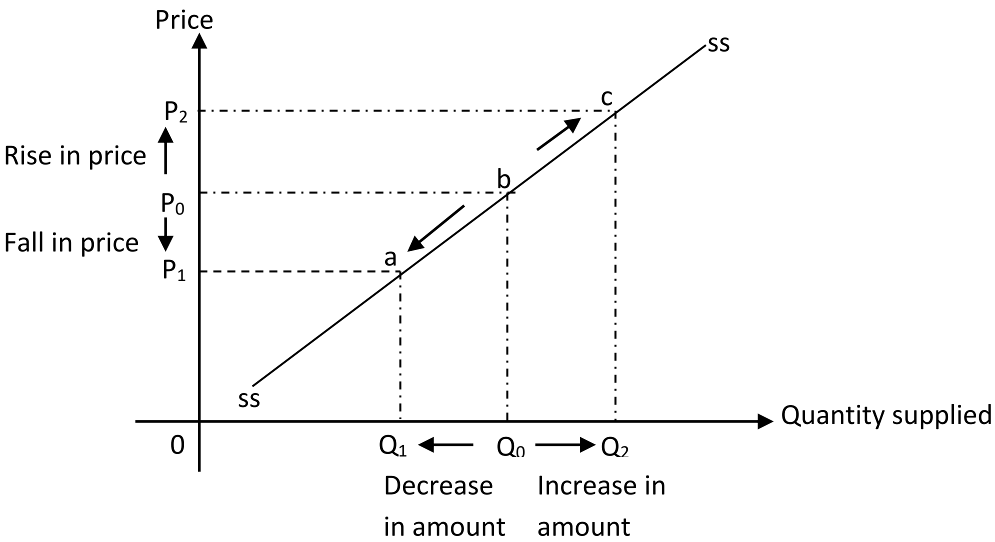
unfavourable climatic conditions e.g. pests and diseases, unreliable rainfall destroy agricultural products leading to low supply.

14. **The availability of factor input / raw materials**.

CHANGE IN SUPPLY AND CHANGE IN QUANITY SUPPLIED

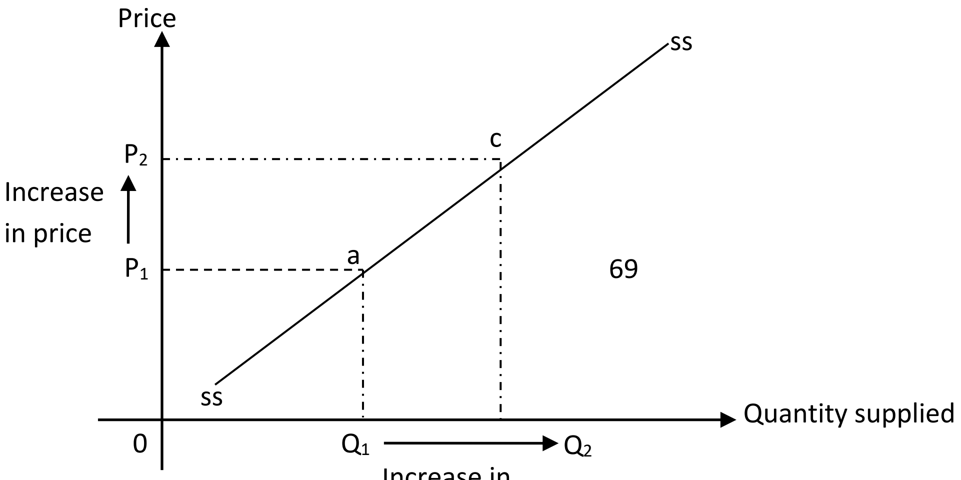
Change in Quantity Supplied. This refers to the increase or decrease in amount of a commodity supplied due to changes in price of that commodity other factors affecting supply remaining constant.

Illustration.



INCREASE IN QUANTITY SUPPLIED. This is the rise in the amount supplied of a commodity due to increase in the price of the commodity in question other factors affecting supply remaining constant.

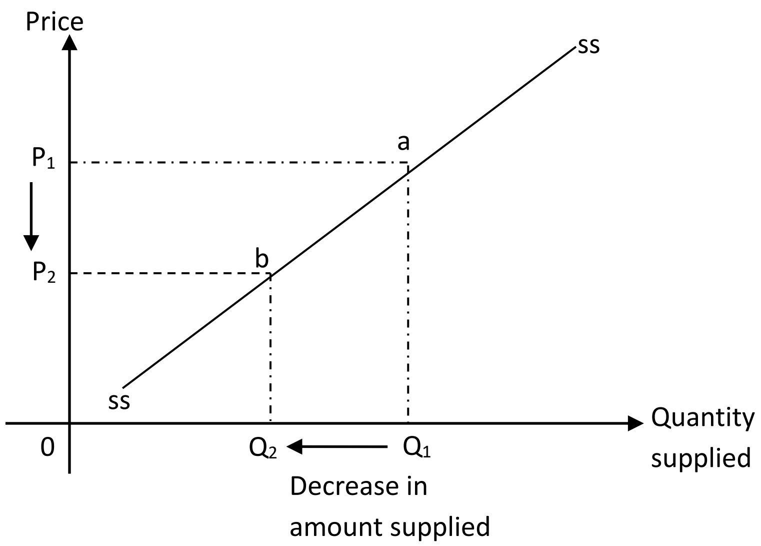
Illustration



DECREASE IN QUANTITY SUPPLIED

This is the fall in the amount supplied of a commodity due to decrease in its own price other factors affecting supply being constant.

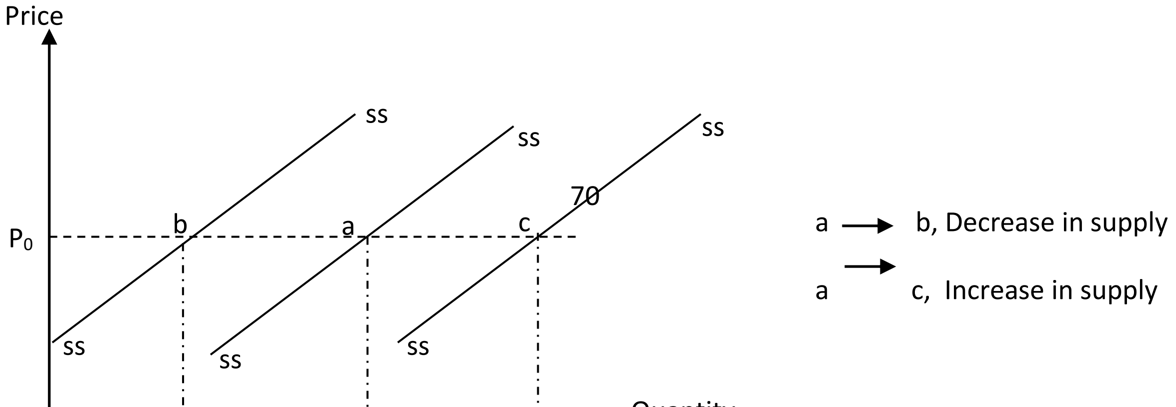
Illustration



CHANGE IN SUPPLY

This refers to the increase or decrease in the amount supplied of a commodity due to change in the other parameters of supply, the price of the commodity in question being constant. It is illustrated by the shift of the entire supply curve to the left or the right at a constant price.

Illustration



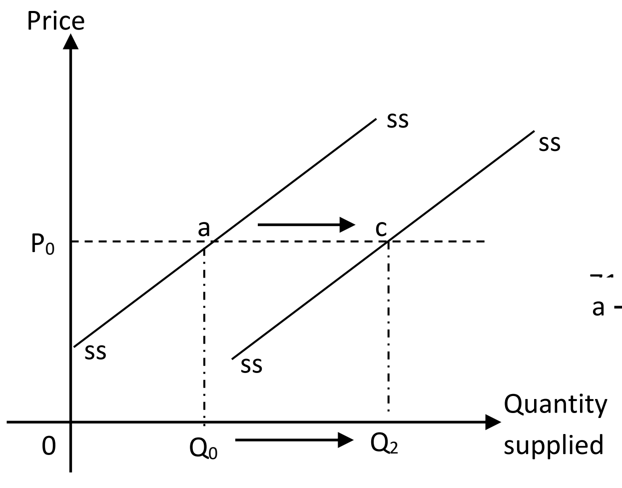
FACTORS THAT CAUSE A CHANGE IN SUPPLY

1. Change in the level of technology. An improvement in the level of technology enables the producers to increase the speed at which they produce goods and services. This leads to increase in production and supply. However a <u>decline</u> in the level of technology leads to a <u>decline</u> in the level of output hence causing a <u>decrease</u> in supply.
2. Change in the size of the market.
3. Change in government policy in taxes and subsidies.
4. Change in the number of producers or suppliers.
5. Change in the level of development of infrastructure.
6. Change in the political state of the country.
7. Change in the length of the gestation period.
8. Change in the climatic conditions.
9. Change in the price of a jointly supplied good.
10. Change in the price of a competitively supplied good.
11. Change in the objective of the firm.
12. Change in the cost of production.
13. Change in the availability of raw materials.

INCREASE IN SUPPLY / EXTENSION IN SUPPLY

This is the increase in the amount of goods supplied due to favourable change in other factors affecting supply and the price of the commodity in question being constant.

Illustration



a ⟶ i increase in supply

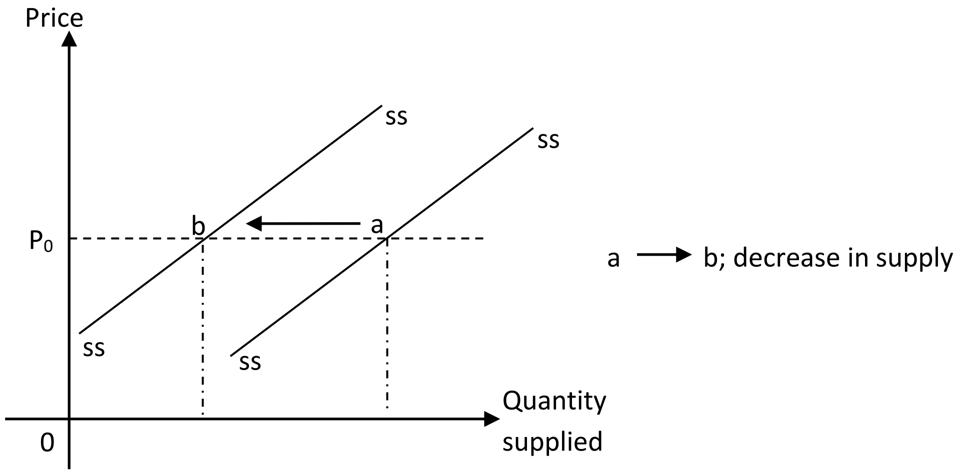
FACTORS THAT CAUSE INCREASE IN SUPPLY AT A CONSTANT PRICE

1. A favourable change in the government policy of taxation and subsidization. An improvement in the government policy on taxes e.g. in form of reduced tax rates on producers as well as improved subsidies, motivate many producers to increase the amount they produce. This enables increase in supply at a constant price.
2. Favourable change in the climatic conditions.
3. Increase in the size of the market
4. Decrease in the price of a competitively supplied good.
5. Decrease in the cost of production
6. Increase in the price of a jointly supplied good
7. Favourable changes in political climate
8. Increase in the number of producers or suppliers
9. Increased availability of raw materials
10. Improvement in technology
11. Improvement in infrastructure etc.

A DECREASE IN SUPPLY

This is the decrease in amount of commodities supplied due to unfavourable changes in other factors affecting supply and the price of the commodity in question being constant.

Illustration



FACTORS THAT CAUSE A DECREASE IN SUPPLY AT A CONSTANT PRICE

1. Un favourable change in government policy of taxation and subsidies
2. Unfavourable change in climatic conditions
3. Decrease in size of market
4. Increase in price of a competitively supplied good
5. Increase in cost of production
6. Decrease in price of a jointly supplied good
7. Unfavourable change in political climate
8. Decrease in number of producers or suppliers.
9. Decreased availability of raw materials
10. Break down in infrastructure
11. An unfavourable change in government polity of taxation and subsidization.
12. A decline in the government polity on taxes e.g. in form of increased taxes on producers as well as decreased subsidies discourage many producers to decrease the amount they produce. This leads to decline in supply at constant price.
13. An increase in that cost of production. An increase in the cost of production of a commodity leads to a decrease in the amount of goods produced by the supplier. This leads to a decline in supply at constant price.
14. Decrease in price of a jointly supplied good. A decrease in price of a jointly supplied good e.g. timber leads to a decrease in production of the other jointly supplied goods e.g. saw dust. This leads to a decline in supply of constant price.

Questions

(a) Distinguish between change in demand and change in quantity demanded.

(b) Explain the factors that cause a change in demand for a commodity at constant price.

(a) Distinguish between increase in supply and decrease in quantity supplied

(b) Explain the factors that cause increase in supply.

(a) Distinguish between joint supply and competitive supply

(a) Why is the supply curve positively slopped? Why do producers supply more units at higher prices and less units at lower prices?

- Entry of new firms
- The profit motive is satisfied at high price
- The ease of diverting resources from the production of one commodity whose price is falling to another commodity whose price is increasing.
- The ease of meeting the cost of production when price increases
- The substitution effect in supply.

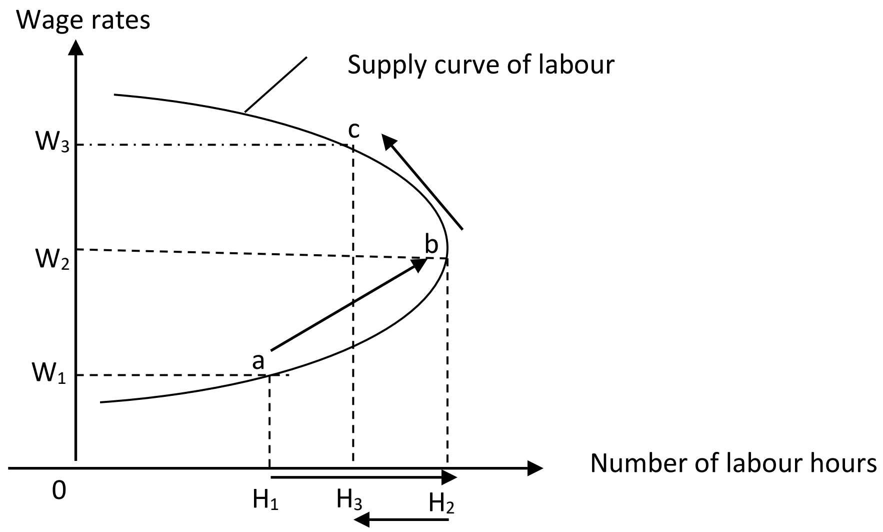
THE ABNORMAL / REGRESSIVE SUPPLY CURVES.

An abnormal supply curve is one that does not conform to the conventional law of supply

Examples of regressive supply curves

The backward bending supply curve of labour.

Illustration



The supply curve of labour slopes upwards up to a certain point beyond which it bends backwards. It does not conform to the conventional law of supply. In the above case, as wages increase from QN, OWs, labour hours are increased from OH1 – OH2. However, if wages are made to increase further to OW3, labour supply falls to OH3 i.e. H2 is greater than H3 in terms of hour.

NB: labour supply refers to the number of hours labourers are willing and able to offer for work at alternative wage rates with a given time range.

Question

Give reasons why the supply curve for labour is backward bending (causes of the regressive supply curve of labour).

Strong preference for leisure at high wages. As wages increase, some workers prefer leisure to work as they supply less hours hence the backward bending supply curve.

Presences of target worker. Some individuals get employed to accomplish their targets. Such targets are attained within a short period of time when wages are increased. This makes such individuals to supply less hours of work at high wages.

Increased levels of progressive taxation. NB: A progressive tax whose tax rate increases with increase in tax pay income. Therefore as wages increase, the amount paid as tax increases. This reduces the willingness to offer more hours to work as wages increase.

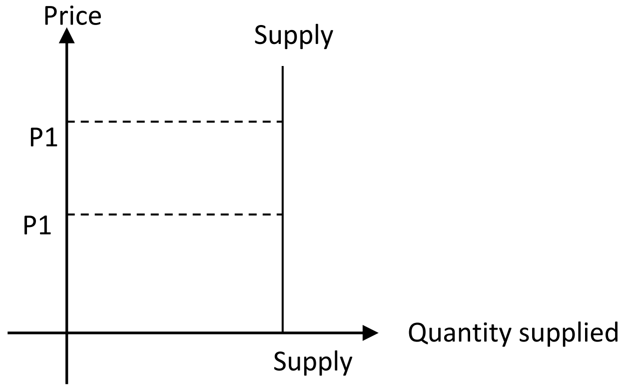
Reduction in the real income due to high rates of inflation.

The effect of old age and sickness

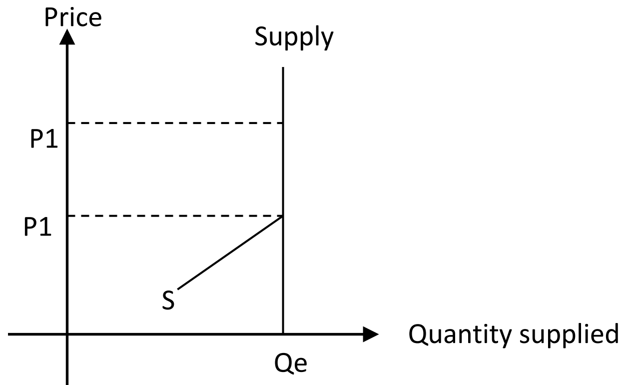
The effect of worsening political situation

The effect of worsening working conditions

The perfectly inelastic supply curve for commodities and fixed supply. Some commodities have fixed supply and dispute charges in the amount supplied remains the same.



The supply curve with capacity constant or restriction.



Existence of commodities that are subsidized by the government. In this case, even when prices increase or reduce, supply does not change. The amount supplied depends on the government.

Scarcity of raw materials in the short run in this case even when there is an increase in prices; the amount supplied may not increase because the producers call the faire raw materials.

In case of supply on special order i.e. even when the price falls, the seller does not reduce the amount supplied because he is supposed to supply the amount agreed upon with the buyer.

CONCEPT OF ELASTICITY

Elasticity of Demand

Elasticity of demand refers to the measure of the degree of responsiveness of quantity demanded of a commodity due to any change in the major determinants of demand. The major determinants of demand include;

- Price of the commodity in question

- Income of the consumer
- Price of related goods

Therefore, there are three major types of elasticity of demand;

- Price elasticity of demand (PED)
- Income elasticity of demand (YED)
- Gross elasticity of demand

PRICE ELASTICITY OF DEMAND (PED)

This is the degree of responsiveness of quantity demanded of a commodity due to a change in the price of the commodity in question. It is computed using the formula;

$$\text{Price elasticity of demand} = \frac{\text{change in quantity demanded}}{\text{Change in price of the commodity in question}}$$

$$\frac{\text{Change in quantity demanded}}{\text{Change in price of the commodity in qn.}} \times \frac{\text{Original price}}{\text{Original quantity}}$$

$$\text{P.E.D} = \frac{\text{change in quantity} \times \text{P0}}{\text{Change in price} \times \text{Q0}}$$

$$\text{P.E.D} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price of commodities in question}}$$

$$\frac{\Delta Q\ (Change\ in\ Q)}{\Delta P\ (Change\ in\ P)} \begin{matrix} = Q1 - Q0 \\ = \theta P1 - P0 \end{matrix} \quad = \quad \frac{\Delta Q}{\Delta P}\ x\ \frac{\Delta P}{\Delta Q}$$

$$\text{\% change in Q} = \frac{Q_1 - Q_0}{Q_0}\ x\ 100$$

$$\text{\% change in price} = \frac{P_1 - P_0}{P_0}\ x\ 100$$

$$\text{P.E.D} = \frac{\frac{Q_1 - Q_0}{Q_0}\ x\ 100}{\frac{P_1 - P_0}{P_0}\ x\ 100}$$

P.E.D $= \dfrac{\dfrac{Q_1 - Q_0}{Q_0}}{\dfrac{P_1 - P_0}{P_0}}$

$= \dfrac{\Delta Q}{Q_0}$ $\quad = \dfrac{\Delta P}{P_0}$

$= \dfrac{\Delta Q}{Q_0} - \dfrac{\Delta P}{P_0}$ $\quad = \dfrac{\Delta Q}{Q_0} \; x \; \dfrac{P_0}{\Delta P}$

$= \left| \dfrac{\Delta Q}{\Delta P} \; x \; \dfrac{P_0}{Q_0} \right|$

NB:

Price elasticity of demand is always negative implying the negative slope of the demand curve. It is therefore multiplied y -1 to make the final answer positive and meaningful.

Example 1

Given that the price of commodity n decreased from shs. 500 to shs 400 and as a result the amount demanded increased from 10 units to 12 units. Calculate the price elasticity of demand.

P1 = 400

P0 = 500

Q1 = 12

Q2 = 10

P.E.D $= \dfrac{\Delta Q}{\Delta P} \; x \; \dfrac{P0}{Q0}$

= ΔQ = 12 - 10

= 2

= ΔP = 400 – 500

= -100

= P.E.D = $\frac{2}{-100}\ x\ \frac{500}{10}$

= $\frac{1000}{-100}$ = -1 x -1 = 1 Unitary

NB: Elasticity has no units because they cross out during the process;

OR

Using formula 2

P.E.D = $\frac{\%\text{ change in quantity demanded}}{\%\text{ change of price of commodity in question}}$

% change in Q = $\frac{Q1 - Q0}{Q0}\ x\ 100$

= $\frac{P_1 - P_0}{P_0}\ x\ 100$

= $\frac{12 - 10}{100}\ x\ 100$

= $\frac{400 - 500}{500}\ x\ 100$

= $\frac{2}{10}\ x\ 100$

= $\frac{-100}{500}\ x\ 100$

= $\frac{2}{10} \div \frac{-100}{500}$

= $\frac{2}{10}\ x\ \frac{500}{-100}$

= $\frac{1000}{-1000}$

= -1 x 1

= 1 Unitary

Example 2

Given that the price of a commodity rose from shs. 1500 to shs. 2000 and as a result, the amount demanded fell from 20kg to 15kg. Calculate the price elasticity of demand.

Price elasticity of demand = $\frac{\Delta Q}{\Delta P} X \frac{P_0}{Q_0}$

P_1 = 2000

P_0 = 1500

Q_1 = 15

Q_0 = 20

$$= \frac{15-20}{2000-1500} \times \frac{1500}{20} = \frac{-5}{500} x \frac{1500}{20} = \frac{-7500}{10,000}$$

$$= \frac{-75}{100} x -1 = \frac{75}{100} =$$ 0.95 inelastic

Using method 2

Price elasticity of demand = $\frac{\text{\% change in quantity demanded}}{\text{\% change in price of the commodity}}$

$$= \frac{Q_1 - Q_2}{Q_0} x\ 100 = \frac{P_1\ x\ P_0}{P_0} x\ 100 = \frac{15-20}{20} x\ 100$$

$$= \frac{2000-1500}{1500} x\ 100 = \frac{-5}{20} x\ 100 = \frac{500}{1500} x\ 100$$

$$= \frac{-23\%}{33.33\%}$$

= -0.75 x -1

= 0.75 Inelastic.

Given that the price of commodity is decreased from shs. 10,000 to shs. 8000. As a result, the quantity demanded increased by 25%. Calculate the price elasticity of demand.

P1 = 8000

P0 = 10,000

% change of quantity demanded = 25%

$$\text{P.E.D} = \frac{\text{\% change in quantity demanded}}{\text{\% change in price of commodity}}$$

$$\text{\% change in price} = \frac{P_1 - P_0}{P_0} \times 100$$

$$= \frac{8000 - 10,000}{10,000} \times 100$$

$$= \frac{2000}{10,000} \times 100$$

$$= -20\%$$

$$\text{P.E.D} = \frac{20\%}{20\%}$$

$$= \frac{-5}{-4}$$

= 1.25 Elastic.

Given that the price of a commodity fell by 30% and as a result of quantity demanded of the same commodity increased to 45 units from 30 units. Calculate the price elasticity of demand.

P1 =

P0 =

Q1 = 45

Q2 = 30

$$\text{P.E.D} = \frac{\text{\% change in quantity demanded}}{\text{\% change in price of a commodity}}$$

$$\text{\% change in quantity demanded} = \frac{Q_1 - Q_0}{Q_0} \times 100$$

$$= \frac{45 - 30}{30} = 100$$

$$= \frac{15 \times 100}{30}$$

$$= \underline{50\%}$$

$$\text{P.E.D} = \frac{50\%}{-30\%}$$

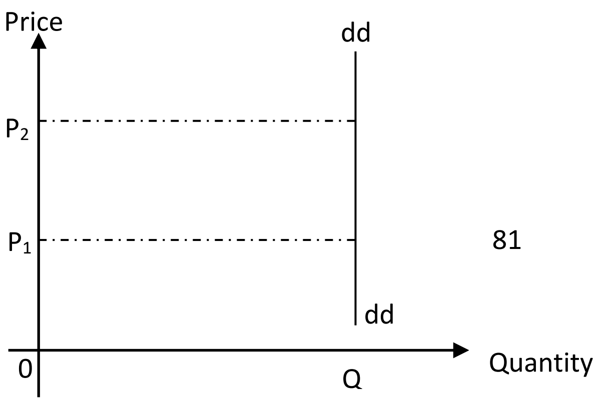
$$= \frac{5 \times -1}{-3} = \frac{-5}{-3} = \frac{-5}{3}$$

$$= 1.667 = 1.67 \text{ Elastic}$$

INTERPRETATION OF PRICE ELASTICITY OF DEMAND

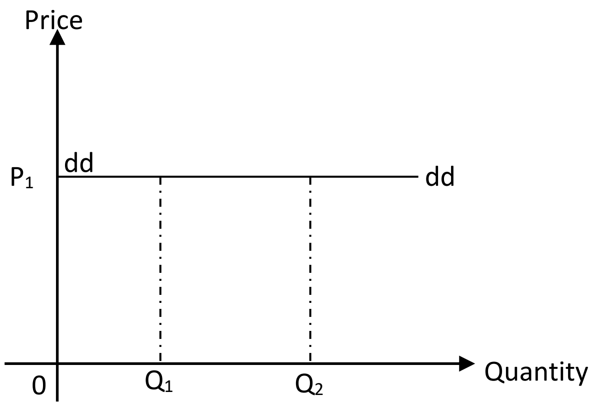
Perfectly Inelastic Demand

Illustration



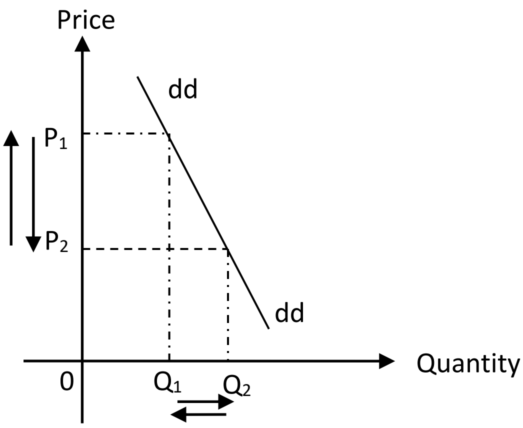
This is when an increase or decrease in price does not affect the quantity demanded. It is common with necessity goods like salt and soap. In this case, the price elasticity of demand is zero (0).

Perfectly Elastic Demand
Illustration



This is when an increase or decrease in quantity demanded is not due to changes of the price of the commodity but changes in the other factors that affect that demand. Therefore at the same price, more or less is demanded; in this case the price elasticity of demand is equal to <u>infinity.</u>

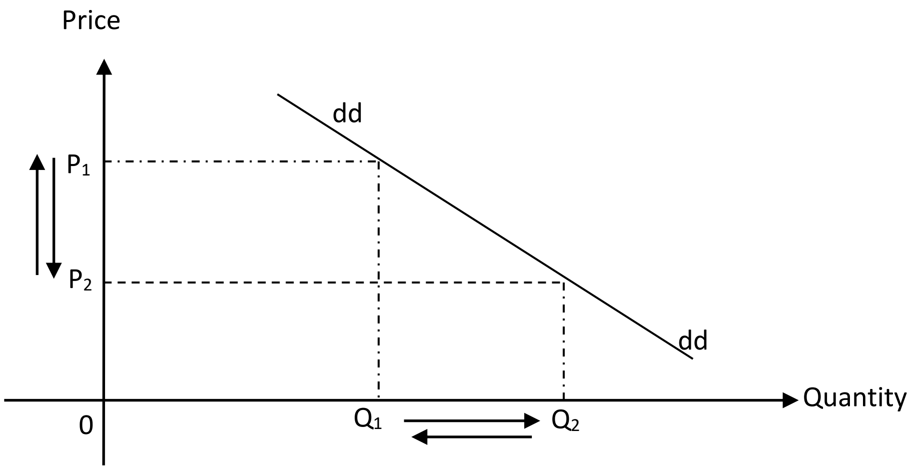
Inelastic Demand (Low Elasticity of Demand)
Illustration



This is when the price elasticity of demand is greater than 0 but less than 1. A big change in price leads to a small change in quantity demanded. The response of quantity demanded to changes in price is low.

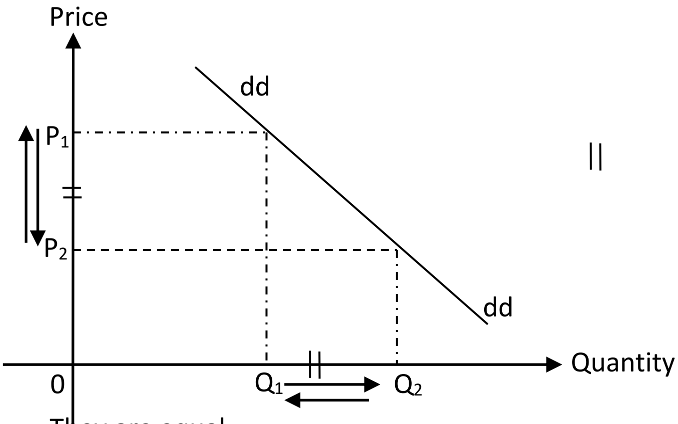
Elastic Demand (High Elasticity of Demand)

Illustration



This is when a small change in price levels to a big change in quantity demanded. In this case, the price elasticity of demand is greater than the 1 but less than infinity. The response of quantity demanded to changes in price is high.

Unitary Elasticity



They are equal

This occurs when a change in price brings about an equal change in quantity demanded. In this case, the price elasticity of demand is equal to 1 i.e. the proportionate change in quantity demanded is due to an equal change in price. (when asked degree, refer there)

If elasticity = I; unitary elasticity

O; perfectly inelasticity

00; perfectly elastic infinity

0 < e < 1 ; inelastic (between zero and 1)

1 < e < 00 ; (between 1 and infinity)

FACTORS THAT INFLUENCE PRICE ELASTICITY OF DEMAND.

1. **The income of the consumer.** High income consumers have inelastic demand because even when price increases, they are able to buy almost the same quantity on the other hand, low income consumers have elastic demand because when price increases, most of them cannot afford to buy and quantity demanded by a great margin.

2. **Presence or availability of substitutes**. Goods with close substitutes have elastic demand. This is because the consumer has many alternatives to choose from when price increases. However, goods with no close no substitutes have inelastic demand.

3. **The degree of necessity of a commodity**. Necessities or essential goods like salt and soap have inelastic demand. However, luxuries have elastic demand because consumers can easily stop buying them / choose to buy less when price increases.

4. **The degree of people's addition to a commodity**. The demand for addictive items like cigarettes and alcohol is inelastic demand. This is because such items form a habit in the consumer that even when price increases, he or she can not buy less, however non addictive items have elastic demand.

5. **The nature of the commodity.** Durable goods like furniture tend to have inelastic demand because even if there is a fall or rise in price, the consumer does not purchase additional unit. However perishable goods have elastic demand i.e. any slight fall in price makes the consumer to buy more units.

6. **The number of uses to which a commodity can be put constant to which a commodity is composite.** Commodities with several uses have elastic demand. This is because an increase in price makes consumers cut down or reduce the number of uses to which a commodity is put e.g. elasticity on the other hand, commodities with few uses have inelastic demand.

7. **The proportion of income spent on the commodity.** Commodities that take a very small proportion of the consumers income e.g. safety pins, match box etc have inelastic demand. However commodities that take a big percentage of the consumer's income have elastic demand.

8. **The period taken by a consumer to change his or her spending habits**. The shorter the time period, the more elastic demand is and the longer the time period, the more inelastic demand is.

9. **The level of advertising.** Goods that are advertised well or persuasively have inelastic demand. However, those that are less or poorly advertised have elastic demand.

10. **The convenience or comfort in getting the commodity**. Goods that are easily increased convenience in buying and have inelastic demand. However, commodities which are not conveniently accessible have elastic demand.

11. **The level of price stability**. When prices are stable, demand tends to be elastic. However when there price instabilities, demand tends to be inelastic. This is because, the consumers get used to the changing prices.

12. **The time period (short run or long run).** Demand tends to be inelastic in the short run. This is because in the short run, the time is not enough for the consumer to find alternatives. However in the long run, demand becomes inelastic because the comers can easily access alternatives / substitutes.

FACTORS RESPONSIBLE FOR THE LOW ELASTICITY OF DEMAND FOR A PRODUCT (INELASTIC DEMAND)

1. Presence of high income consumers
2. Presence of goods with no close substitutes
3. Presence of necessity or essential goods
4. Consumption of addictive items
5. Presence of durable goods
6. Presence of commodities with few uses
7. Presence of commodities that take up a small portion of the consumers
8. Taking of a long time to change his or her spending habits
9. Persuasive advertising of commodities
10. Presence of goods that are easily accessed.
11. Instability of price s
12. Short run time period.

sample

High income of the consumer. High income earners have inelastic demand for the commodity. This is because the high income earners continue buying or consuming a commodity when prices increase, they continue to buy almost the same quantity.

FACTORS THAT MAY LEAD TO ELASTIC DEMAND FOR A PRODUCT (FACTORS FOR HIGH ELASTICITY OF DEMAND)

1. Presence of low income consumers

2. Presence of goods with close substitutes
3. Presence of luxurious goods
4. Presence of non-addictive items
5. Presence of perishable goods
6. Presence of commodities with several uses
7. Presence of commodities that take up a large portion of the consumers
8. Taking of a short time by a consumer to change his or her spending habits
9. Dull or poor advertising of commodities.
10. Presence of commodities that are not conveniently accessed
11. Stability of price or prices being stable

    Long run time period.

sample

Presence of luxurious goods. Luxurious goods have elastic demand because consumers can easily stop buying them or buy less when their prices increase. Presence of commodities with several uses. Goods with several uses have elastic demand because increase in prices makes consumers cut down in the uses to which a commodity is put.

CROSS ELASTICITY OF DEMAND

This is the degree of responsiveness of quantity demanded of one commodity due to a proportional's change in the price of another commodity. It measures the degree of responsiveness of quantity demanded of a commodity due to a proportional change in the price of another commodity.

x and y (assume commodities x and y)

Cross elasticity of demand can be written as; $\frac{C.E.D = \%\ \Delta qty\ (x)}{\%\Delta p(y)}$

$$C.E.D = \frac{\%\, change\ of\ quantity\ demanded\ of\ x}{\%\ change\ of\ price\ of\ y}$$

OR

$$C.E.D = \frac{change\ of\ quantity\ demanded\ of\ x}{change\ of\ price of\ y} \ x \ \frac{original\ price\ of\ y}{original\ quantity\ demanded\ of\ x}$$

$$= \frac{\Delta qty\ (x)}{\Delta P_1(y)} \ x \ \frac{P_o(y)}{Q_o(x)}$$

Calculate the cross elasticity of demand if the price of commodity m falls from shs. 1,000 to shs. 800 and the quantity demanded of commodity z increases from 10 units to 20 units.

P_o m = 1000
P_1 m = 800
Q_o z = 10 units
Q_1 z = 20 units

C.E.D = $\frac{\Delta Qty\ of\ (2)}{\Delta\ P\ of\ (m)}\ x\ \frac{P_o\ of\ \ (m)}{Q_o\ of\ (z)}$

= $\frac{20-10}{800\ -1000}\ x\ \frac{1000}{10}$

= $\frac{10}{-200}\ x\ \frac{1000}{10}$ = $\frac{10000}{-200}$

= C.E.D = -5

Given that the price of commodity T increased from shs. 50,000 to shs. 80,000 and the quantity demanded of commodity P increased by 10%. Calculate the cross elasticity of demand.

P_0 T = 50,000
P_1 T = 80,000
Q_o P =
Q_1 P =

C.E.D = $\frac{\%\,change\ in\ quantity\,demanded\,(p)}{\%\ change\,in\ \ price\,of\ \ (T)}$

% change in quantity = 10%

% change in price of T = $\frac{P_1 - P_0}{P_o}\ \ x\ 100$

= $\frac{80{,}000\ -\ 50{,}000}{50{,}000}\ x\ 100$

= $\frac{30{,}000}{80{,}000}\ x\ 100$

= <u>60%</u>

Given that the price of commodity y decreased from shs. 15,000 to shs. 10,000 and the quantity demanded of another commodity remained constant at 2,000 kg. calculate the cross elasticity of demand.

C.E.D = $\dfrac{\Delta qty\ (x)}{\Delta P\ (y)}$ x $\dfrac{P_o(y)}{Q_o(x)}$ x $\dfrac{Po\ of\ \ (y)}{Qo\ of\ \ (x)}$

= $\dfrac{2000 - \ 2000}{10000 - \ 15000}$ x $\dfrac{15{,}000}{2000}$

= $\dfrac{0}{-5000}$ x $\dfrac{15000}{2000}$

= $\dfrac{0}{-10{,}000{,}000}$

= 0. y and x are not related.

INTERPRETATION OF CROSS ELASTICITY OF DEMAND

When the answer is positive, the two commodities are substitutes.
When the answer is negative, the two commodities are complements
When the answer is zero, the two commodities are not related.

INCOME ELASTICITY OF DEMAND

This is the degree of responsiveness of quantity demanded of a commodity due to a proportionate change in the income of the consumer.

Y.E.D = $\dfrac{\text{percentage change in quantity demanded}}{\text{Percentage change in income of the consumer}}$

OR

Y.E.D = $\dfrac{\Delta Qty}{\Delta Y}$ x $\dfrac{Yo}{Qtyo}$

Y represents or means income

Example

Given that the consumer's income increased from shs. 10,000 to 30,000 and the quantity demanded of commodity m decreases from 50 units to 20 units. Calculate the income elasticity of demand for commodity m.

Y.E.D = $\frac{\Delta Qty(m)}{\Delta Y} x \frac{Yo}{Qtyo(m)}$

= $\frac{20 - 50}{30{,}000 - 10{,}000} x \frac{10{,}000}{50}$

= $\frac{-30}{20{,}000} x \frac{10{,}000}{50}$

= $\frac{300{,}000}{1{,}000{,}000}$

= -0.3 (inferior goods)

The commodity is an inferior good.

Given that the consumer's income increased by 20% and his demand for commodity z increased from 15 units to 30 units. Calculate the income elasticity of demand.

Y.E.D = $\frac{\Delta Qty(2)}{\Delta Y} x \frac{Yo}{Qo(2)}$

= 30 - 15

Y.E.D = $\frac{\text{Percentage change in quantity demanded (2)}}{\text{Percentage change in income of consumers}}$

% change in quantity = $\frac{Q1 - Q0}{Qo} x \ 100$

= $\frac{30 - 15}{15} x \ 100$

= $\frac{15}{15} x \ 100$

= 100%

= $\frac{100}{20}$

= <u>5 (normal good)</u> It is a normal good

Given that the consumer's income is shs. 25, 000 and the consumers' demands 600 units of commodity I. however, when the consumer's income is increased to 30,000shs. He still demands 600 units of commodity x. calculate the income elasticity of demand for commodity x.

Y.E.D = $\frac{\Delta Qty(x)}{\Delta Y} x \frac{Yo}{Qty_0(x)}$

= $\frac{600 - 600}{30{,}000 - 25{,}000} x \frac{35{,}000}{600}$

$$= \frac{0}{5000} \times \frac{25{,}000}{600}$$

$$= \frac{0}{3{,}000{,}000}$$

= 0 (necessity goods) It is a necessity good

Interpretation of income elasticity of demand

When the answer is negative the commodity is inferior
When the answer is positive, it is a normal good
When the answer is zero, it is a necessity good.

PRACTICAL USES OF THE CONCEPT OF ELASTICITY

To the producer

1. It guides employers when **determining wages for their workers**. The employers pay higher wages to employees, such high wages through increasing price with limited decline in quantity sold. However, employers pay low wages to employees who help them make commodities with elastic demand.

2. Guides in **setting of prices in order to maximize profits**. A producer who deals in a commodity with inelastic demand sets a high price to maximize the revenue per unit sold in order to maximize profits. However, a producer who deals in a commodity with elastic demand sets a lower price to maximize the number of units sold in order to maximize profits.

3. **Guides producers' reaction to competition in the market**. Producers dealing in commodities with inelastic demand charge high prices and are reluctant to change their actions in the market. However, those dealing in commodities with elastic demand always respond to competition by charging lower prices, improving the quality of their products and engaging in persuasive advertising.

4. **Helps the producer to determine tax incidence**. Tax incidence. Is the final resting place of a tax charged by government. A bigger percentage of the tax charged on the producer is paid by the buyers for commodities with inelastic demand. However, for commodities with elastic demand, the bigger percentage of the tax is paid by the producer.

5. **Guides monopoly producers in price discrimination.** Price discrimination. Is the selling of a similar commodity at different prices to different buyers (market) regardless of the cost of production. Monopoly producers charge high prices in the markets where buyers have inelastic demand for their products. However, they charge lower prices in the markets where buyers have elastic demand.

6. **Guides producers on how much to produce and supply in order to maximize profits.** A producer whose commodity has inelastic demand produces less and supplies less on the market in order to maximize the profits. However, one dealing in a commodity with elastic demand produces a lot and supplies large quantities in order to maximize sales and profits.

To the government

1. **Guides government in its taxation policy**. Taxes are imposed to raise government revenue. In order to maximize the tax revenue, the government sets a low tax rate for commodities with elastic demand and a high tax rate for commodities with inelastic demand.
2. **Guides government when pricing public utilities electricity and safe water.** The government sets a low price to business firms and industrialists that use public utilities. This is because such utilities can afford alternatives and therefore have elastic demand for public utilities. However, domestic assets like households are charged high prices because their demand for such utilities is inelastic i.e. they cannot afford the substitutes like generators or solar electricity.
3. **Guides government when discouraging the production and consumption of undesirable commodities.** For commodities with inelastic demand, the other means of controlling trade like quotas, total ban or licensing are more effective compared to the taxes while for commodities with elastic demand, taxes are increased to effectively control their production and consumption.
4. **It helps government when determining the tax incidence**. It guides government in its privatization and nationalization policies. The government nationalizes firms dealing in commodities with inelastic demand in order to check consumer exploitation by the private sector. However, it privatizes its firms dealing in commodities with elastic demand in order to improve their efficiency through competition in the private sector.
5. **It guides government when determining the benefits from international trade.** Counties exporting commodities with inelastic demand but importing those with elastic demand benefit more from international trade compared to those countries exporting goods with elastic demand and importing goods with inelastic demand.
6. **It guides government in its devaluation policy**. Devaluation is the official polity to reduce the exchange value of a country's currency in relation to other countries currencies. Devaluation makes imports expensive and exports cheap. It therefore discourages the importation of goods but promotes exports. However this is only successful when the elasticity of demand for exports and imports is elastic.

To the consumers

Guides consumers when planning their expenditures. Consumers plan to spend more money on goods with inelastic demand and less money on goods with elastic demand e.g. they .... to spend more money on fuel and other necessities and less money on sugar and other luxuries.

Question

Distinguish between income elasticity of demand and cross elasticity of demand.
Explain the practical uses of the concept of price elasticity of demand to;
(i) Producers
(ii) Government
(iii) Consumer
(iv) Account for price inelastic demand

ELASTICITY OF SUPPLY

This is the degree of elasticity of quantity supplied of a commodity due to a proportional change in any of the determinants of supply.

PRICE ELASTICITY OF DEMAND

This is the degree of responsiveness of quantity supplied of a commodity due to a proportionate change in price of the commodity in question. It is computed using;

$$\text{P.E.S} = \frac{\text{percentage change in quantity supplied}}{\text{Percentage change in price}}$$

$$\text{P.E.S} = \frac{\Delta\, qty's}{\Delta\, Px} \; x \; \frac{Pxo}{Qoss}$$

Example

Given that the price of a commodity increased from shs. 800 per kg to shs. 1200 per kg and the quantity supplied changed from 100kg to 400kg.
Calculate the price elasticity of supply.
State the degree of the price elasticity of supply

$$\text{P.E.S} = \frac{\Delta Qtys}{\Delta\, Px} \; x \; \frac{Pxo}{Qoss}$$

$$= \frac{400 - 100}{1200 - 800} \; x \; \frac{800}{100}$$

$$= \frac{300}{400} \; x \; \frac{800}{100}$$

$$= \frac{240{,}000}{40{,}000}$$

= 6

b) Elasticity supply (1 < e < 00) between 1 and infinity e < 00 - elastic supply

between 0 and 1 0 < e < 1 = inelastic supply

e = 1 unitary supply

e = 0 perfectly inelastic supply.

The quantity supplied of a commodity increased by 50%. This was due to an increase in its price from shs. 30,000 to shs. 60,000. Compute the price elasticity of supply and comment on its degree.

$$\text{P.E.S} = \frac{\text{percentage change of quanity supplied}}{\text{Percentage change of price}}$$

$$\%\text{ change of price} = \frac{P1 - Po}{Po} \ x \ 100$$

$$= \frac{60{,}000 - 30{,}000}{30{,}000} \ x \ 100$$

$$= \frac{30{,}000}{30{,}000} \ x \ 100$$

= <u>100%</u>

$$\text{P.E.S} = \frac{50}{100}$$

= 0.5 (inelastic supply)

Given that the price of a commodity decreased to shs. 2500 from 5000 per kg and the quantity supplied decreased by 50%. Calculate the price elasticity of supply and state the degree of elasticity.

$$\text{P.E.S} = \frac{\%\text{ change in quantity supplied}}{\%\text{ change in price}}$$

$$\%\text{ change in price} = \frac{P1 - Po}{Po} \ x \ 100$$

$$= \frac{2500 - 5000}{5000} \; x \; 100$$

$$= \frac{2500}{5000} \; x \; 100$$

= <u>-50%</u>

$$\text{P.E.S} = \frac{50}{-50}$$

= 1 (unitary supply)

$$\text{P.E.S} = \frac{\text{\% change in quantity supplied}}{\text{\% change in price}}$$

$$\text{\% change in price} = \frac{P1 - Po}{Po} \; x \; 100$$

$$= \frac{2500 - 5000}{5000} \; x \; 100$$

$$= \frac{-2500}{5000} \; x \; 100$$

= <u>-50%</u>

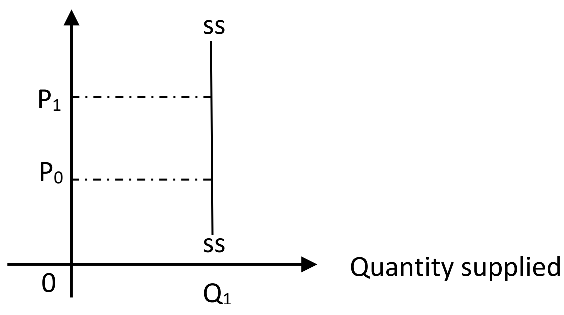
$$\text{P.E.S} = \frac{-50}{-50}$$

= 1 (unitary supply)

INTERPRETATION OF PRICE ELASTICITY OF SUPPLY

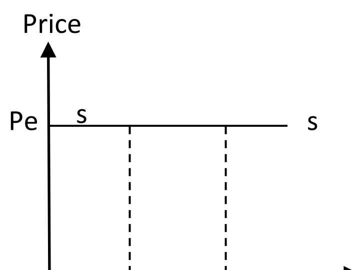
Perfectly inelastic supply

Illustration



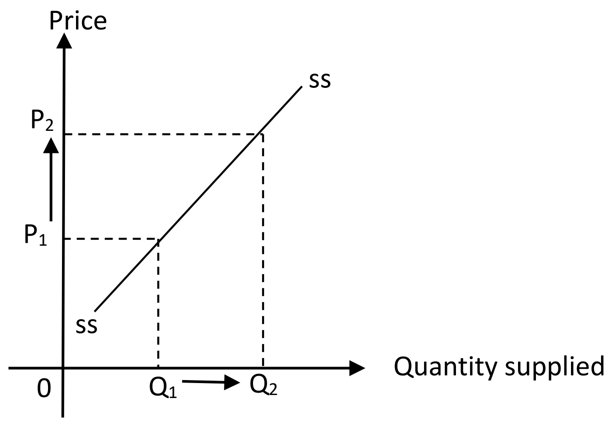
This occurs where an increase or decrease in the price of the commodity in question does not affect the amount supplied. The quantity supplied does not change when the price changes in this case the coefficient of the elasticity of supply is zero (0).

Perfectly elastic supply



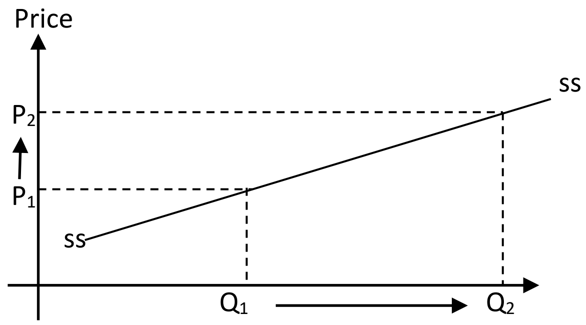
This occurs where at the same price of the commodity in question, more or less is supplied. This may be due to the other factors that affect the amount supplied. The coefficient of elasticity of supply is infinity.

Inelastic supply



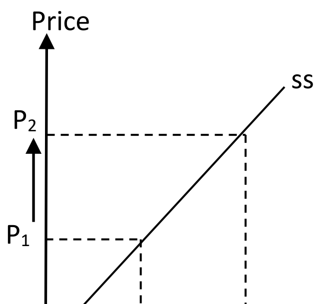
This occurs where a big change of the price of the commodity in question leads to a smaller change in the amount supplied of the commodity in question. The co-efficiency of price elasticity of supply is greater than this but less than one.

Elastic supply



This is one where a small change in the price of the commodity in question leads to a bigger change in the quantity supplied. The price elasticity of supply is greater than one but less than infinity.

Unitary supply



=

This is where the price elasticity of supply is equal to one (1) e = 1. A given percentage change in the price brings about an equal change in the quantity supplied.

CROSS ELASTICITY OF SUPPLY

This is the degree of responsiveness of quantity supplied of a commodity due to a proportionate change in the price of another commodity. It is computed using;

$$C.E.S = \frac{\text{Percentage change in quantity supplied (x)}}{\text{Change in price of (y)}}$$

$$C.E.S = \frac{\Delta Qty\,supplied\ (x)}{\Delta\, price\ of\ (y)} \ x \ \frac{Po(y)}{Qo(x)}$$

Example 1

$$C.E.S = \frac{\text{\% change in quantity (z)}}{\text{\% change in price (y)}}$$

$$\text{\% change in quantity (y)} = \frac{Y^{0}{}_{1} - Po}{Po} \ x\ 100$$

$$= \frac{500 - 300}{300} \ x\ 100$$

$$= \frac{200}{300} \ x\ 100$$

$$= 66.67$$

$$C.E.S = \frac{66.67}{25}$$

= 2.67

= z and y are jointly supplied goods.

Example 2

Given that the amount of a commodity supplied of commodity n decreased by 3 units from 5 units. This was due to an increase in the price of another commodity m by shs. 2500 from shs. 2500. Calculate the elasticity of supply and identify the relationship between commodities m and n.

$Q_o(n) = 5$

$Q_1(n) = 2$

$P_o(m) = 2500$

$P_1(m) = 500$

$$C.E.S = \frac{\Delta Qty(n)}{\Delta P(m)} \; x \; \frac{Po\ (m)}{Qo\ (n)}$$

$$= \frac{2-5}{5000-2500} \; x \; \frac{2500}{5}$$

$$= \frac{-3}{2500} \; x \; \frac{2500}{5}$$

$$= \frac{7500}{12500}$$

= -0.6 (competitively supplied goods)

NB:

If the cross elasticity of supply a positive then the commodities are jointly supplied.
If the cross elasticity of supply is negative, then the two commodities are competitively supplied.
If the cross elasticity of supply is zero (0), the two commodities are not related.

FACTORS THAT DETERMINE THE ELASTICITY OF SUPPLY

1. **The more readily available the factors** are, the more elastic supply becomes, and however, once the factors of production are scarce, supply becomes inelastic.

2. **The length of the gestation period.** A long gestation period implies inelastic supply e.g. agricultural products have inelastic supply because of their long gestation periods. However, a short gestation period makes supply to be elastic i.e. the supply of bread is elastic because it takes a short time to produce bread.
3. **The ease of entry of new firms in the industry**. Free entry of new firms in the industry implies that any increase in the price can attract new firms leading to a big change in supply hence elastic supply. However, restricted or blocked entry of new firms into the industry leads to inelastic supply.
4. **The cost of production**. Commodities that have very high risks of production have inelastic supply while those with low costs of production have elastic supply
5. **The nature of the product.** Durable commodities have elastic supply while perishable items have inelastic supply.
6. **The method of production or technology used to produce**. Commodities produced with the help of simple and efficient technology have elastic supply while these are produced with the help of complicated and expensive technology has inelastic supply.
7. **The production period (the short run and long run)**. In the short run, supply is basically inelastic because the period is short and some factors of production remain fixed while in the long run, supply is basically elastic because all the factor inputs become variables (can be changed).
8. **The law of returns to scale. (The law of variable proportions).** It states that as more and more units of variable factors are added to a given quantity of a fixed factor the marginal output first increases, it reaches a maximum and it decreases in case of increasing returns, supply is elastic an in case of losing returns supply in inelastic.

Factors determining low elasticity of supply of commodity

P – a

600 - 450 x 4

400 x 4 – 600

1800 – 600

GNP = NNP

Low elasticity of supply of a commodity

1. Availability of factors of production
2. Long gestation period
3. Blocked or restricted entry of new firms
4. High costs of production
5. Perishable of the commodity
6. Expensive or complicated methods / technology used

7. Short run period
8. Decrease in returns to scale.

PRICE MECHANISM AND RESOURCE ALLOCATION

Define the term price mechanism

It is a system in a free enterprise economy where prices and resource allocation are determined by the inter – play of forces of demand and supply. Price mechanism is also known as the price – profit mechanism.

How does price mechanism operate?

To understand the concept of price mechanism, we need to note the following;

1. Demand dictates what is to be supplied by the produces
2. Consumer's expenditure is equal to sellers' venture
3. Consumers are regarded as voters. It follows that whenever a consumer buys a product, he or she is casting a vote in favour of its production and supply.
4. Consumers take an upper hand in deciding what is to be produced i.e. there is consumer sovereignty where a consumer takes a leading role in determining allocation of resources.
5. The greater the demand for a commodity the grater the incentive for a producer to supply more of that commodity. However, when consumers demand less of a commodity, it means that fewer votes are being cast in favour of that commodity. As a result, producers tend to supply less on the market.

Adam Smith referred to price mechanism as an invisible hand which guides the allocation of resources and the conduct of business.

ASUMPTIONS UNDERLYING PRICE MECHANISM.

1. Consumers are regarded to be rational i.e. they are assumed to be of a calculating mind.
2. It assumes no wastage of resources because producers only supply what consumers want at a particular time.
3. There is no government intervention as far as pricing and output policies of the producers are concerned.
4. Some firms are assumed to be more efficient than others hence price mechanism assumes competition in the market.
5. It assumes free mobility of factors of production, both occupationally and geographically.
6. Consumer sovereignty prevails in the market
7. Production is profit – motivated i.e. producers aim at profit maximization
8. Existence of a free enterprise economy or system where resource allocation is determined by the interaction of forces of demand and supply.

WHAT PRICE MECHANISM FOCUSES AT:

Price mechanism responds to the basic economic questions by providing answers to these questions. These questions are as follows.

1. **What is to be produced?** This question is answered depending on the preferences of the consumers because they influence what the consumers can buy or demand. This gives a signal to the producers to determine produce.
2. **For whom to produce?** This question is answered by considering the purchasing power of consumers. Normally producers tend to supply goods to those consumers with a greater purchasing power in order to maximize profits.
3. **How to produce the needed goods**? This is determined by the efficiency of the technique of production used. Therefore, the producers always desire to use cheaper but efficient techniques of production. The aim is to maximize profits through minimizing costs.
4. **When should the output be produced?** This is answered by considering the appropriate time of producing the commodity. A decision can be made to produce during the present time or to produce in the future depending on the existing market conditions.
5. **Where to produce from?** This question is answered by locating a firm in an area where market is readily available (where consumers' demand is high) some entrepreneurs decide to locate their business firms in areas with the lowest costs of production in order to maximize profits.

THE ADVANTAGES / ROLES OF PRICE MECHANISM IN RESOURCE ALLOCATION

1. It leads to efficient allocation of resources. Price mechanism is used by producers to distribute the scarce resources in the production of those goods needed by the consumers. Producers allocate more resources to those goods whose demand is high and fewer resources are allocated to those goods whose demand is low.
2. It answers the question of how much to produce (it provides automatic adjustment between supply and demand). When there is an increase in aggregate demand, prices increase. This attracts more firms into the industry and supply increases. Therefore, price mechanism sends a signal to the producers to increase supply in order to respond to the increase in aggregate demand. This created an automatic response between demand and supply.
3. It helps to reward the various factors of production. Price mechanism applies in the factor market. Efficient producers earn more profits than the inefficient producers. At the same time, other factors of production are demanded for and supplied. Those who demand for factors of production pay factor prices for example labour is paid wages / salaries by those who hire its services.
4. It ensures efficiency of firms. High prices lead to high profits. Producers are encouraged to produce more output of better quality. This enables producers to expand their scale of production and become more efficient.

5. It promotes consumer sovereignty i.e. it helps in deciding whom to produce for. Producers tend to supply to those consumers who are willing to buy . the consumers influence what is to be produced and this promotes consumer sovereignty in production. NB: the consumers send a signal regarding what is to be supplied to them.

6. It determines where to produce from or where to locate the production unit. Production units are located in those areas where market is readily available and where the consumers are willing to pay the price charged by the producers. Hence price mechanism gives a signal of where production is to take place.

7. It determines income distribution / it distributes income. This is achieved when producers buy resources from the resource owners. At the same time the consumers buy goods and services supplied by the producer. This enables the producers to receive income from consumers. Hence income is distributed in the economy through price mechanism.

8. It helps producers to determine when to produce. Production always takes place at such a time when consumer's demand is high. (this is common with seasonally demanded and supplied goods. the high demand forces producers to increase supply. Producers make a judgement of when to produce by looking at demand and supply forces in the market.

9. It determines what is to be produce. When the price of a certain commodity is high, the producers supply more of it in order to gain higher profits. On the other hand, the producers normally supply less of a commodity whose price is low. Hence the decision of what is to be produced is influenced by the price signals.

10. It determines the type of technology to be used in production. (It answers the question of how to produce). High demand for goods calls for an increase in supply to respond to that demand. This requires producers to apply better techniques of production in order to increase supply of goods.

11. It encourages flexibility in production. Producers use the price and products signals to change from less profitable to more profitable economic activities. For example, a coffee farmer may divert from growing of coffee to growing of vanilla should the price of vanilla become higher than that of coffee.

12. Consumers are availed with a variety of goods and services. Price mechanism generates competition among producers. This gives rise to a greater variety of goods and services in an economy. Consumers are able to exercise choice when improving their standards of living.

13. It promotes or encourages innovation and invention. Due to competition, producers tend to design new and better ways of production, distribution, branding and marketing of goods and services. This is done so that producers are able to supply what consumers need.

EXPLAIN THE DEMERITS OF PRICE MECHANISM WHEN ALLOCATING RESOURCES IN AN ECONOMY.

1. It promotes or accelerates income inequality. Efficient producers whose goods are highly demanded receive higher incomes than the inefficient producers. Therefore, the efficient producers get access to most of the resources in the economy. This creates income disparity in the economy.

2. Emergence of monopoly power. Price mechanism creates private monopoly since inefficient firms leave the industry and efficient firms monopolise the market. The monopoly firms restrict output in order to charge high prices. They also supply low quality goods due to the absence of competition in the industry.

3. There is consumer exploitation due to ignorance (1 distorts consumer choice through persuasive advertisements). Price mechanism assumes that a consumer has perfect knowledge about the market conditions. However, many consumers are not aware of price changes and new goods on the market. As a result, consumers are exploited through persuasive advertisements and other forms of malpractices by profit – hungry traders.

4. There is a divergence between private benefit and public interests. Price mechanism does not consider the negative effects inflicted on the public when products exploit the natural resources. Much emphasis is put on private benefit of profit maximisation without taking into account public interest. For example, when forest trees are cut down to get timber; there is a danger of deforestation and its negative impact on the environment. Unfortunately, this is not considered under price mechanism.

5. It results into unemployment. Firms which cannot make profits automatically go out of production. Therefore, labour which would have been employed in such firms remains idle and this creates unemployment in an economy.

6. Misallocation of resources is likely to occur. Price mechanism creates resource wastage and excess capacity in certain cases. Producers abandon production of those goods which are not highly demanded. This leaves some resources to be idle or underutilized. At the same time, excessive competition among producers leads to resource wastage.

7. It does not respond to rapid structural changes in an economy. Price mechanism fails to adjust to those structural changes which are desired in an economy. For example, price mechanism (market forces of demand and supply) cannot be used to repair destroyed infrastructure after a war because such structural change calls for government intervention and involvement.

8. Resource wastage / resource duplication due to competition among private investors.

9. It breeds economic instabilities. for example traders who are interested in making business gains may hoard goods so that they create artificial shortages with motives of selling those goods at higher prices.

10. Failure to allocate resources to the provision of public goods.

NB: Other structural changes to which price mechanism may not adequately respond to include; modernization of agriculture, liberalization of trade, privatization of public enterprises etc.

LIMITATIONS OF PRICE MECHANISM (FACTORS THAT LIMIT EFFECTIVE OPERATION OF PRICE MECHANISM IN AN ECONOMY

NB: The focus is on those factors that slow down or hinder or distort the allocation f resources through price mechanism.

1. Limited entrepreneurship. Poor organization of factors of production and failure to take risks limits producers from responding to the demand of the consumers. Producers fail to supply those goods needed by consumers due to poor organization of factors of production and this slows down the operation of price mechanism.

2. Limited capital / inadequate capita. The use of inadequate capital by producers causes low output. Producers supply less than what the consumers actually demand for. This creates shortages of goods on the market hence limiting the operation of price mechanism.

3. Limited skilled labour. The use of unskilled labour leads to low output. This makes supply not to respond to the demand of consumers because low volumes of goods are being supplied. This limits the use of price mechanisms in resource allocation.

4. Poor infrastructure. Poor road network limits the supply of goods to those areas where they are needed. Consumers may desire to buy goods but cannot get them in time due to poor transport and distribution network.

5. Existence of monopolies. (Monopoly power). Many monopolists are price makers. They always restrict output or supply in order to charge high prices and exploit the consumers. They do not supply goods according to the demand by the consumers and this distorts the use of price mechanisms in the allocation of resources.

6. Immobility of factors of production. Some factors of production do not move with ease form one occupation or geographical area to another. Therefore, producers may fail to increase output since factors of production are immobile. Hence supply does not respond to demand and this limits the operation of price mechanism.

7. Government interference / regulation. Government actions like the fixing of a maximum price (Price ceiling) discourage some producers. Producers finally reduce the amount of goods supplied on the market. In this case, supply does not match with the consumers' demand and price mechanism is distorted.

8. Inability to forecast the future trends. Some procures fail to anticipate increased demand for their goods in the future. This gives rise to low output and consequently there is a scarcity of goods on the market. This creates a gap between demand and supply hence the use of price mechanism in allocation of resources is distorted.

9. Ignorance of the producers and consumers. In some cases, producers supply goods without judging the conditions in the market. Likewise, some consumers are not aware of the availability of some products and the prices at which they are sold. This creates a slow response between demand and supply hence limiting price mechanism.

EXPLAIN THE OBJECTIVES FOR GOVERENMNT INTERFERENCE IN OPERATION OR PRICE MECHANISM.

Due to the defects or weaknesses of price mechanism, government interferes in the allocation of resources through the forces of demand and supply for the reasons below;

1. To control economic instabilities like unemployment and inflation i.e. to stabilize the economy.

2. To control or check monopoly power in an economy. The aim is to fight the dangers associated with private monopolists.

3. To minimize or reduce income inequality

4. To check or control consumer exploitation by the profit – hungry business community. The profit – hungry traders exploit consumers through over – charging, sale of fake products, product adulteration, sale of expired goods etc. such trade malpractices call for government intervention by using various laws to protect consumers.

5. To ensure optimal resource allocation in a country. The intention is to avoid wastage of resources by ensuring that resources are used to producer those goods needed by the consumers.

6. To cater for the rapid structural changes which are desired in an economy but cannot be attained through market forces of demand and supply, for example rehabilitation of basic infrastructure after periods of war calls for government interference because price mechanism alone does not create such a structural change.

7. To control or minimize social costs which arise when private individuals or private investors are pursuing their private gains. Such social costs include pollution of environment, over fishing; deforestation etc. this objective is being pursued through enacting laws geared at protecting the environment.

8. To provide public goods like public roads and national security which are not catered for by the price mechanism (market forces of demand and supply). The government cannot leave the maintenance of national security and defence to the market force of demand and supply.

9. To encourage production and consumption of merit goods such as safe water, medical care and education (a case in Uganda is the funding of universal primary and secondary education by the government).

10. To provide goods needed by the poor. In some cases government subsidizes such goods so that they become affordable to the poor people in an economy. The aim is to improve the quality of life of the poor people.

EXPLAIN THE DIFFERENT WAYS THROUGH WHICH GOVERNMENT INTERFERES WITH PRICE MECHANISM.

1. Use of progressive taxation. Progressive taxes help in re – distributing income in an economy because the higher the income earned the higher the tax rate on that income and the lower the income earned the lower the tax rate. This narrows the gap between the rich and the poor.

2. Controlling / discouraging monopoly power (use of anti – monopoly legislations). Government enacts laws aimed at checking monopoly powers of private produces or investors. This is aimed at reducing consumer exploitation associated with monopoly firms.

3. Setting up and strengthening bureau of standards. A bureau of standards is in charge of inspecting goods being produced to ensure that certain quality specifications are fulfilled before goods are put on market. A certification mark is given for goods that fulfill the required quality standards and this protects the health of consumers.

4. Encouraging the setting up of consumer associations and consumer co-operative societies. These help in sensitizing the consumers about the ways in which they can be exploited by profit – hungry traders. The consumers are educated on how they can safe guard themselves against buying expired goods and adulterated goods as well as other forms of exploitation by traders.

5. Subsidization of firms especially those providing essential and merit goods. the government offers subsidies to firms which produce essential services so that the consumers are able to get such services at lower prices.

6. Setting up regulatory bodies to protect the environment / enacting environment protection laws. The National Environment and Management Authority (NEMA) in Uganda ensures that laws are put in place to govern the exploitation of resources, to protect wetlands and to enforce proper disposal of industrial wage.

7. Licensing of business enterprises / control of licensing. The government puts certain restrictions on the licensing of traders such that licenses are given to only those traders or enterprises approved by the licensing department. This checks the carrying out of illegal or illicit trade.

8. Planning for the economy. Economic development plans are drawn up by the government to guide the allocation of resources in both the private and public sector. The aims are to guide the allocation of resources in both the private and public sector. The aim is to avoid misallocation of resources associated with price mechanism.

9. Controlling (fighting) inflation.

10. Rationing of goods. It involves direct action by the government to distribute the scarce commodities to the public at fixed prices in limited quantities. This is done in periods when goods are scarce in order to reduce consumer exploitation by the traders. For example, in 1986 – 1987, the government of Uganda used this policy by rationing the supply of essential goods like sugar, soap, salt to consumers through local councils.

11. Nationalization of economic enterprises. Nationalization is where the state takes over ownership of enterprises formerly privately owned. This is done to ensure that all people have access to those essential goods and services which the private sector could not adequately provide to the public.

12. Use of buffer stocks. A buffer stock is one which is built up by accumulating stock of agricultural products in times of plenty and then releasing it to the market in times of shortage. This buffer stock is stored and it is by sold by government to the consumers in times of scarcity. Therefore, price mechanism is interfered with by the government.

13. Provision of public goods by the government. For example the provision of better transport network in form of roads helps in the movement of goods of areas where they are in plenty to those areas where goods are scarce. Hence shortages created through market forces of demand and supply are solved or checked.

14. Price controls by the government. This involves the legislation of minimum price (price floor) to protect producers and a maximum price (price ceiling) to protect consumers from being exploited.

AGRICULTURE IN RELATION TO DEMAND AND SUPPLY

Agriculture price fluctuations

Price fluctuation refers to the persistent risk and fall in prices of commodities. There instabilities are common with the prices of agriculture and primary products.

CAUSES OF PRICE FLUCTUATIONS IN THE AGRICULTURAL SECTOR.

1. The long gestation period of agricultural products. Agricultural products have a long gestation period and therefore before harvest there is shortage on the market and this increases prices. However, as the harvest session approaches, supply increases and this leads to a fall in the prices of agricultural products.
2. Bulkiness of agricultural products. Most agricultural products are bulky and heavy e.g. bananas, maize, sugarcane. They are therefore not easy to transport from areas of plenty to areas of scarcity. Prices therefore increase in the areas of scarcity and they reduce in the areas of supply.
3. Variations in climatic conditions. Agricultural products largely depend on nature. During bad climatic conditions, the agricultural output is low forcing prices upwards. However, during favourable climatic conditions, the supply of agricultural products increases leading to a fall in their prices.
4. The perishability of agricultural products and the difficulty of storage. Agricultural products are highly perishable e.g. Milk and tomatoes cannot be kept for a long period of time because they easily get bad. Therefore, during the harvest period, prices fall because farmers produce and supply a lot (little or nothing is stored).
5. However, after the harvest period, prices increase because there is little or limited supply (little or limited was stored for the future).
6. NB: The above factors are also referred to as supply rigidities for agricultural products / factors responsible for the inelastic supply of agricultural products.

Questions

Outline the factors responsible for the inelastic supply of agricultural products.

1. Poor surplus disposal systems. There is a poor system of managing surplus out puts form firms. This is due to poor infrastructure in form of poor roads and storage facilities. Therefore during seasons of high procures the surplus produced is sold at low prices and part of it is exported.
2. Changes or variations in the costs of production. Agricultural producers incur several costs of production e.g. when buying fertilizers, when hiring tractor services or when paying wages to their workers. Such costs fluctuate with time. Therefore a fluctuation upwards of such costs increases prices of agricultural products and a fluctuation downwards of such costs leads to a decrease in the prices of agricultural products.
3. Divergence between planed output and actual output. It is difficult to predict the actual output is greater than planned output; there is a supply of the market leading to a fall in the prices of agricultural products. However, in seasons where the actual output is less than the planned output, there is a shortage on the market and prices increase.

4. The price inelastic demand for agricultural products. The demand for agricultural products is price inelastic. A big change in the price causes a very limited change in the quantity demanded. Therefore, in seasons of high supply, prices fall because buyers do not increase the amount they buy significantly. However, in seasons of low supply, prices increase because the buyers do not significantly decrease the amount they buy.
5. Income inelastic demand for agricultural products. The amount demanded of food and other agricultural products is not non responsive to changes in people's income. The amount demanded changes by a very small percentage when the consumers' income changes. Therefore during seasons of high supply, prices fall because the excess output is not bought and during seasons of low supply prices increase because the consumer whether rich or poor buy almost the same units.
6. The poorly planned output or poor planning by farmers. In seasons when producers enjoy high prices for the agricultural products many farmers are attracted to produce and this increases supply in the next season leading to a fall in prices. However, in seasons of low prices, most farmers plan to produce less and this leads to scarcity in following season hence forcing prices upwards.
7. The poor or weak bargaining position on the international market. The major buyers of agricultural products form LDCs are MDCs (more developing countries) sometimes MDCs set high prices and sometimes they set low prices. During seasons of low supply, MDCs set high prices for agricultural products from LDCs to attract supply, however during seasons of high supply, they reduce the prices.
8. Competition with synthetic fibres / artificial fibres. Some agricultural products like cotton face stiff competition from the artificially manufactured substitutes like nylon, silk, polyester. In seasons when there is high supply and demand for the natural fibres, the demand for cotton reduces leading to a fall in price. However, in seasons when the supply of the artificial fibres is low, the demand for cotton increases leading to an increase in its price.

EFFECTS / CONSEQUENCES OF AGRICULTURAL PRICE FLUCTUATIONS.

1. It leads to unstable export earnings. In seasons when agriculture exports are sold at increasing prices, the export earnings increase. However in seasons when agricultural exports are sold at low prices, the export revenue declines.

2. It leads to unstable incomes to farmers. During seasons of high prices, farmers get high incomes and they improve their wellbeing. However in seasons of low prices, farmers earn low incomes and their standards of living decline.

3. It leads to unstable balance of payment position. During seasons of increasing prices for agricultural exports, the balance of payment position improves. However, during seasons of reducing prices of agricultural exports, the balance of payment problem worsens.

4. Unstable terms of trade. When the prices of agricultural exports increase, the terms of trade improve. However, during times of reducing price for agricultural products, the terms of trade worsen.
   NB: terms of trade is the ratio of the export price index to the import price effect.

5. It results into fluctuation of exchange rates. Increase in export prices of agricultural products makes the country to earn more foreign currency. This reduces the exchange rate in the country. However, during seasons of declining prices for agricultural exports, the supply of foreign consumers reduces and this raises the exchange rate.

6. Planning based on expected earnings is made difficult. The country gets problems in planning especially where the plans are finances by incomes from the exports of agricultural products. Sometimes plans have to be adjusted because of the fluctuating incomes earned.

7. The unstable prices frustrate the peasant farmers. Since the farmers earn unstable incomes, they are likely to lose the interest in farming. Some of them abandon their farms when prices are falling and re-organize them in seasons when prices are increasing. This leads to unstable output from the agricultural sector.

8. It accelerates / encourages rural urban migration with its associated problems.
As incomes from the agricultural sector become unstable, many people especially the young migrate from rural areas to urban centres looking for employment opportunities with more stable rewards. However this migration is associated with a number of evils like over population in urban areas, decreased labour in rural areas etc.

9. It leads to seasonal unemployment. Some farmers decide not to produce in given seasons because they fear the miserable prices. Such farmers become seasonally unemployed i.e. they are employed when price are high and unemployed when they don't produce because of low prices.

10. It worsens income inequality. When prices of the agricultural products decline, the farmers earn less from their activities. This creates an income gap between the farmers and those in the other occupations with stable incomes.

11. It leads to unstable tax revenue to government. Increase in prices of agricultural products increases government tax revenue. This is because most of the farmers become able and willing to pay the taxes levies on them. However, when the prices of agricultural products fall, the government tax revenue reduces because most of the farmers fail to raise the money to pay the taxes.

12. It encourages speculation which leads to poor allocation of resources. The farmers are forced to always predict the prices for the following seasons before they plant. However, where the prediction becomes wrong, the farmers lose their resources leading to wastage.

POSSIBLE MEASURES OF REDUCING PRICE FLUCTUATIONS OF AGRICULTURAL PRODUCTS.

1. Use of buffer stocks. This is where stock of agricultural products is accumulated in times of plenty and it is released to the market in time of shortages / scarcity. Buffer stocks stabilize supply of agricultural products leading to more stable prices.

2. Improvement in transport facilities. This involves the development of a good network of roads to enable the movement of agricultural products from areas of plenty to areas of scarcity. This can help to keep the prices stable in the different areas which lead to stable incomes for the farmers.

3. Embarking on further diversification of the economy. There is need to encourage farmers to diversify their agricultural activities. The farmers can be encouraged to grow many crops instead of growing one crop. Therefore, if the price of one crop decreases, the farmer may resort to another crop whose price is stable.

4. Promotion of industrialization programmes for the agricultural sector. Agro based industries can be used to buy excess output of agricultural raw materials. At the same time, these industries add value and durability to the agricultural products. This can enable the farmers to get stable incomes from their agricultural activities.

5. Improving storage facilities for agricultural products. Improved storage facilities enable the farmers to store the surplus and releasing adequate amounts as desired by the markets. This can stabilize supply of agricultural products leading to stable prices.

6. Carrying out technological and scientific innovations. This can be done through carrying out research to develop varieties of crops with shorter gestation period and greater resistance to pests and diseases. This enables the stabilization of agricultural output and supply in order to stabilize prices.

7. Strengthening international product / commodity agreements. International commodity agreements like the international coffee agreement can enable the member countries to have better bargaining power on the world market. Through these agreements, supply is controlled through quotas in order to have more stable prices.

8. Granting more subsidizes to the farmers. Government should subsidize the activities of farmers in order to stabilize their costs of production. Once their costs of production are stabilized, prices also become stable.

9. Encouraging farmers to engage in forward market contracts. This involves farmers signing agreements / contracts with the buyers concerning the price(s) at which to sell. Such agreements ensure stable markets and stable prices.

10. Price legislation by government. The government can fix a minimum price above the equilibrium price below which it is illegal to buy from farmers. This helps to stabilize prices at which the farmers sell to the different traders or buyers.

11. Strengthening regional economic cooperation. E.g. the East African customs union and the common market for Eastern and southern Africa. (COMESA). This improves the bargaining power for member countries when dealing with developed nations.

12. Diversification and expanding the market for agricultural products. The government should plan to extend and widen the market for the agricultural produce. This can be through searching for new buyers from the highly developing African countries e.g. United Arab Emirates, Quarter, Indonesia.

Questions

(a) Account for the price instability of agricultural products in your country.
(b) What measures can be taken to stabilize prices of agricultural products in your country?

(a) Explain the effects of agricultural price fluctuations in your country.
(b) What measures have been taken to stabilize agricultural prices in your country?

(a) Why is the supply of agricultural products inelastic?
(b) Explain the effects of agricultural price fluctuations in your country.

PRODUCTION

Production refers to the process of transforming factor in parts into output. I.e. goods services that satisfy human wants.

It refers to the process of creating utility in goods and services to satisfy human wants.

The process can be done by an individual, a firm or the government

The production process involves the following activities:

i. Physically transforming the raw materials into intermediate or finished goods
ii. Storing the goods until such a time when man needs them
iii. Transporting the goods to the destination where man needs them
iv. Changing the ownership through the exchange of goods and services
v. Provision of direct services for example teaching, nursing etc

The process therefore is not complete until goods and services have reached the consumer

TYPES OF PRODUCTION

Production is of two types and these include.

Direct production

Indirect production

Direct production/Subsistence production: This refers to the production of goods and services for one's own consumption for example constructing one's house, teaching one's own child.

Characteristics of Direct production

- Family labour is mainly used
- Simple tools are mainly used e.g. hoes.
- It is carried out on small scale.

- There is limited or no specialization.
- Low quality output is mainly produced.
- It requires less capital.

Demerits

- It limits country's foreign exchange earnings
- Leads to poor standards of living
- Lowers tax revenue
- Low quality output
- Limits employment opportunities.
- Limits economic growth
- Lead to under utilization of resources.

Indirect Production/Commercial production: This refers to the production of goods and services for exchange. It involves use of money to get what you can not produce

Round about production: This refers to the production of goods not for their direct consumption but for further production.

STAGES OF PRODUCTION/LEVELS OF PRODUCTION

Primary production: This involves the extraction of raw materials from nature by man to be used in the production of goods and services. It involves activities such as fishing, lumbering, mining etc. The output from this type of production does not offer direct utility to the consumer in most cases

Secondary Production: This refers to the transformation of the extracted raw materials into finished or semi finished goods ready for use. The industries which carry out secondary production can be classified into processing, manufacturing, construction and assembling industries

Under secondary production there intermediate industries. These are industries that produce goods to be used as raw materials in other industries for example leather turning industries, tyre making industries etc

Tertially Production: This refers to the provision of services to the final consumers. Such services include teaching; banking etc these services are both personal and commercial

Commercial services are those offered during trade e.g. banking, insurance, and transport while personal services include teaching, nursing, etc.

FACTORS OF PRODUCTION/AGENTS OF PRODUCTION

-These are the resources or inputs that are used to facilitate the production of goods and services or are resources or inputs used to produce an output of goods or services from the production process. These factors can be natural or man made

Factors of production are also known as **tools of production** and they include;

(i) Land
(ii) Labour
(iii) Capital
(iv) Entrepreneurship

NOTE:

(i) Factor price is the monetary payment for the factor of price for its contribution to the production process.
(ii) Specificity of a factor of production refers to the degree to which a factor of production is restricted to performing a particular task.

LAND

This refers to the natural resources on, under and below the earth's surface that facilitate the production process e.g. water, air, soil etc. The monetary reward for land is rent.

Characteristics of Land

i. It is subjected to the law of diminishing returns.
ii. It is geographically immobile i.e. cannot be moved from one place to another but occupationally mobile
iii. Its supply is fixed i.e. perfectly inelastic.
iv. It is a free gift of nature. Therefore its supply price is zero.
v. It is not homogeneous i.e. it varies in terms of fertility and value from one place to another.
vi. It has no opportunity cost
vii. Its productivity can be increased by use of other factors like labour and capital

Importance of Land

i. It is a source of raw materials e.g. stones, minerals etc.

ii. It acts as a dumping ground for waste production.
iii. It is a source of energy i.e. Hydro electric production.
iv. It acts as collateral security to acquire loans.
v. Land can be used for recreation in a way that recreational facilities like stadiums are built on land and it also provides a good scenery for tourism
vi. It is a source of revenue to the government i.e. land can be taxed as a property

Ways of improving the quality of Land

- Applying fertilizers
- Reclamation of Swamps
- Using modern methods of production e.g. irrigation

The price for land mainly depends on;

- Location of Land
- Size of Land

NOTE:

The reward for land is rent and more precisely it is economic rent

Rent: This refers to the monetary reward to land for its contribution in the production process as a factor of production.

Economic rent refers to the monetary payment to a factor of production over and above its **supply price.**

.

Economic Rent= Actual earnings (A) – Transfer earnings (T)/supply price

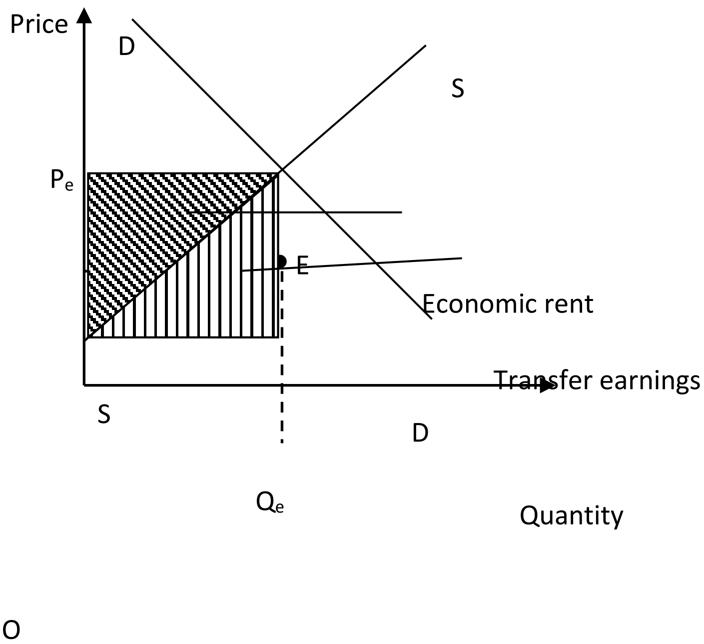
Transfer earnings/supply price refers to the minimum reward necessary to retain or keep a factor of production in its present employment without transferring to the nest best alternative use or employment.

or

Transfer earning: This refers to the minimum monetary reward to a factor of production to retain it in its supply price or transfer earnings.

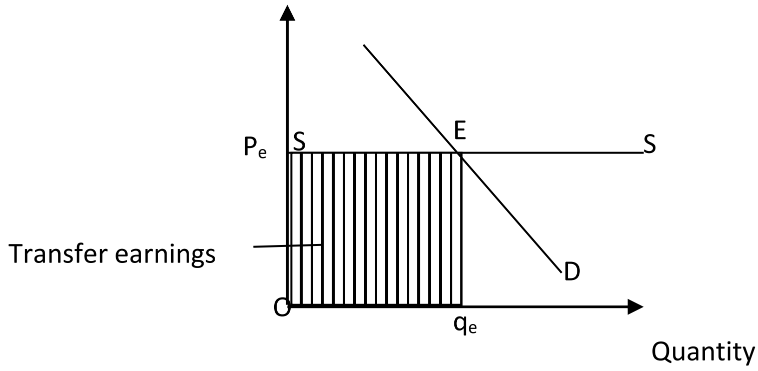
A dual payment = Transfer Rent and transfer Earnings

Graphical Illustration of Economic Rent and Transfer Earnings

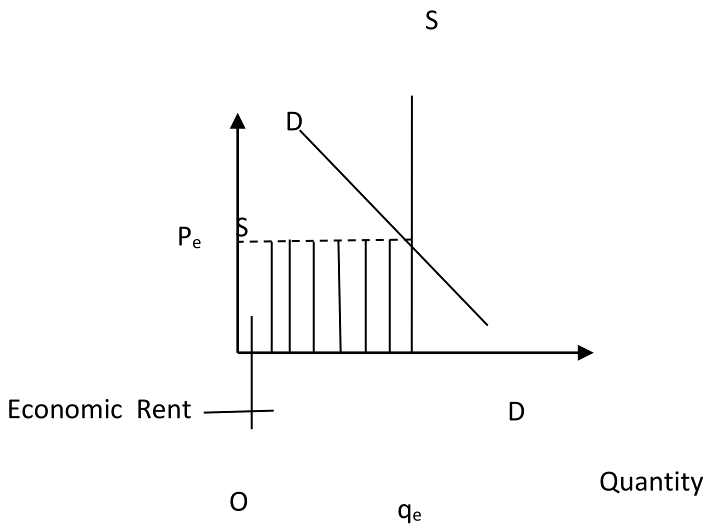


In situations where the supply curve is **perfectly elastic**, economic rent is zero and the whole part opeEqe shows transfer payment as shown below;

Price D



In situations where the supply curve is **perfectly inelastic**, transfer earnings is zero and the whole portion opeEQ gives the economic rent as shown below.



Computation of Economic Rent and Transfer Earnings

Example I

Given that a factor of production receives a total earning of shs. 430,000 ans supply price of 300,000, calculate the economic rent.

Solution

Total earnings = Transfer earnings + Economic rent

430,000 = 300,000 + Economic rent

Economic rent = 430,000 - 300,000

= shs. 130,000

Example II

Given that the factor's transfer earnings is shs. 130,000 and its economic rent is 1½ times the transfer earnings, find the factors actual earnings.

Solution:

Actual earnings = Transfer earnings + Economic rent

= 130,000 + 3/2 x 130,000

= 130,000 + 195,000

= shs. 325,000

Given that supply price of a factor of production is shs. 600,000 and its economic rent is 15% of the supply price, determine the factors actual earnings.

Actual earnings= transfer earnings + Economic rent

= 600,000 + 15% x 600,000

= 600,000 + 90,000

= shs. 690,000

Exercise

Given that the factors transfer earnings is shs.150,000 and its economic rent is twice the transfer earning. Calculate the factors actual earnings.

Solution

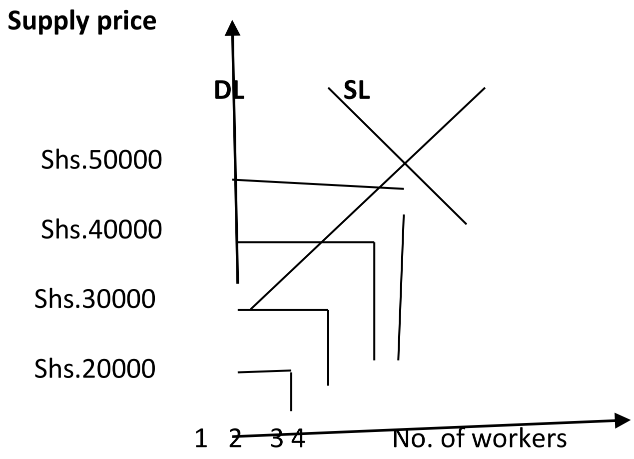
Actual earnings = Transfer earnings + Economic rent

= 150,000 + 2 x 150,000

= 150,000 + 300,000

= shs. 450,000

Read the diagram below and answer questions that follow



If wages are determined by the forces of demand and supply in the labour market, calculate the economic rent received by the 1st, 2nd, 3rd and 4th worker

Reasons why the payment for land is regarded as economic rent.

- It has a zero supply price
- It is a free gift of nature
- It is geographically immobile

It has a fixed supply

Other forms of rent include the following

Commercial rent: This refers to the monetary payment for hiring a durable asset such as building or machine.

Quasi rent: This refers to the monetary payment to a factor of production whose supply is inelastic in the short run but elastic in the long run. There fore, quasi rent is a special kingd of economic rent received by a factor which has a perfectly inelastic supply in the short run and elastic supply in the long run

Ability rent: This refers to the monetary payment to a factor or production trained to handle specific tasks

Or

Is the monetary payment made to factor of production due to its natural ability or talent?

Social rent: is the payment for the use of original property of soil

Differential Rent: This is the payment for land according to its variations in its productivity since land is not homogeneous or is the monetary payment made to a factor of production to its unique qualities

Site rent/ situational rent: is the monetary payment made to a factor of production due to its unique geographical location

Determinants of Economic Rent

Level of demand for a factor of production: High demand for a factor of production leads to a high economic rent while low demand for a factor of production lead to a low economic rent.

Level of supply of a factor of production: Low level of supply of a factor of production results into a high economic rent while a high level of supply for a factor of production leads to a low level of economic rent.

Degree of substitutability of a factor of production: Factors of production which can easily can easily be substituted by other factors lead to a low economic rent while those factors which cannot be easily subtitled have a high economic rent.

Degree of specificity of a factor of production: Those factors of production which are meant to supply a specific task have a high economic rent while, those which are not specific tend to have a low economic rent.

Degree of elasticity of demand for a factor of production: Factors of production whose demand is highly elastic tend to have a low economic rent while those whose demand is highly inelastic tend to have a high economic rent.

Capital; This refers to any man made stock of assets accumulated by an individual or society for the production of other goods and services e.g. machines, buildings etc.

Characteristics of Capital

i. It has an opportunity cost
ii. It has a monetary value
iii. It depreciates over time
iv. It is a man made factor of production
v. It is less subject to the law of diminishing returns
vi. It can be obsolete or out dated e.g. machines.

NOTE:

Capital depreciation/Capital consumption: This refers to the wear and tear of capital assets during the production process.

Capital depreciation allowance: This refers to the amount of money kept aside to cater for the wear and tear of capital assets in the production processes.

Capital maintenance: This refers to the consistent renewal of the existing capital stock.

Capital appreciation. This refers to the increase in the value of existing capital over a specified period of time from the time of purchase to the time of sell

Productivity of capital. Refers to the out put produced per unit of out put employed

Capital mobility is the ease with which capital can be put to various uses

Marginal efficiency of capital. Refers to anticipated monetary returns from an extra unit of capital employed or

It is the additional monetary returns/income expected from an extra unit of capital employed

Marginal productivity of capital refers to extra out put produced as a result of employing an extra unit of capital

TYPES OF CAPITAL

Liquid Capital: This refers to capital inform of cash i.e. coins and notes.

Working capital/Circulating capital: This refers to capital in form of Physical assets that are used in the day to day running of the business. It involves raw materials, fuel etc.

Human capital: This refers to the skills or knowledge that an individual possesses. It is acquired through training.

Fixed capital: This refers to capital which does not change in the course of production. It includes land, buildings machinery etc.

Foreign capital: This refers to capital owned by foreigners in an economy.

Private/individual capital: This refers to capital which is exclusively owned and yields income to the owner.

Public/Social/overhead capital: This refers to capital which is collectively owned and used and it is provided by the state.

Sunk capital. Refers to specialized capital which cannot be easily adapted to an alternative use other than the one for which it was originally designed e.g. a railway line cannot be used for road transport etc

Floating capital. This is capital which can be used for a number of purposes and in a variety of ways e.g. money, land, buildings

Real capital. This is capital in form of physical assets e.g. factories, machinery, vans etc

ROLE OF CAPITAL IN ECONOMIC DEVELOPMENT

1. **Increases output:** Capital increases the level output since it simplifies and makes production quicker. Hence accelerating the rate of economic growth
2. **It facilitates further accumulation of capital.** Capital inform of fixed assets acts as collateral security facilitates borrowing from financial institutions for further production of goods
3. **It improves quality of output.** Capital facilitates research which promotes production of better quality output which improves people's standards of living.
4. **It improves socio- economic infrastructure:** Capital in form of machines helps to improve and construct new roads, extend or generate power which all promote economic development.
5. **It is used to reward other factors of production:** Capital in form of liquid money is used to reward other factors of production such as labour in the production process.
6. **It improves / increases efficiency or productivity of other factors e.g. labour efficiency**; Capital in form of cash is used for further education and training which helps to increase labour efficiency. Further more, use of machines increases out put produced by labour
7. **It facilitates full/optimum utilization of resources:** Capital in form of machines facilitates the exploitation of the world be idle resources. For example uncultivated land, unextracted minerals etc
8. **It monetizes the economy**. It enables producers to change from primitive methods of production (subsistence) to modern methods (commercial production) hence facilitating trade (exchange) for example capital in form of machines
9. **It facilitates technological transfer and development**. For example capital in form of cash enables research which results inn better production techniques. It also enables country/producers to buy more efficient methods of production from other countries from one country to another which improves efficiency in production.
10. **It improves entrepreneurial skills**. It is the strongest weapon of an entrepreneur in mobilizing other factors of production to play their role in economic development
11. **It reduces economic dependence and its consequences**. Liquid capital facilitates research which enables a country to produce what have been imported from other countries

12. **It creates more employment opportunities**. Adequate working capital increases the level of out put and utilizes the would be idle resources which necessitates demand for more labour
13. **It improves the country's BOP position**. This is due to increased exportation of good quality products leading to economic growth and development
14. **It promotes industrial development/facilitates the industrialization process**. Capital in form of heavy machines is employed to establish industrial plants
15. **It widens consumer's choice**. Working capital enables entrepreneurs to produce a variety of goods and services thus enabling them to choose from the variety produced
16. **It promotes specialization** in the production process which helps to improve labour efficiency.

NOTE: Technological transfer refers to the flow of new and more efficient methods of production from one country to another especially from developed to developing countries.

NEGATIVE ROLES

1. It leads to **over exploitation of resources**. The use of capital inform of machines increases the rate at which resources are being utilized i.e. some end up being over exploited
2. Capital leads to social costs like pollution. Most machines pollute the environment by releasing dangerous gases into the atmosphere thereby affecting human beings and aquatic life
3. It causes **technological unemployment**. Machines replace labour in the production process for example ATM cards have substituted labour in banks because the do work which would have been done by workers
4. Capital leads to **over production of goods**. This is because machines work at a high speed and produce goods all the time. They end up producing more than what the market needs leading to wastage of resources
5. Capital inform of machines is **associated with accidents** which leads to loss of life. Property etc

CAPITAL ACCUMULATION:

It is the **process** of increasing the stock of a country's assets in order to improve on its productivity

Or

This refers to the **process** of increasing on the existing capital stock of a given country over a given period of time.

Methods of Capital Accumulation

- **Through investment:** This refers to the process of devoting income to creation of more capital stock.
- **Through saving:** This refers to the act of putting aside part of one's income for future use.
- **Through taxation:** A tax is a compulsory payment by individual and companies to the government.
- **Through borrowing** both internally and externally.
- **Through capital inflows** by foreign investors.

FACTORS DETERMINING THE LEVEL OF CAPITAL ACCUMULATION

1. **Income level:** High income levels increase the level of saving and investment which results into a high rate of capital accumulation while low income levels discourage savings and investment leading to a low level of capital accumulation.
2. **Market size**: A wide internal and external market encourages investment leading to a high out put level, income and saving hence high capital accumulation while a small market size discourages investment which leads to low output levels, income and savings thus limiting capital accumulation.
3. **Population growth rate:** A low population growth rate encourages saving and investment because it encourages producers to save which leads to a high rate of capital accumulation while a high population growth rate discourages saving due to high expenditure leading to a low level of capital accumulation.
4. **Size of the existing capital stock:** A large size of existing capital stock encourages investment which increases out put, incomes and savings leading to a high rate of capital accumulation while a narrow size of existing capital stock discourages investment leading to a low rate of capital accumulation.
5. **Level of capital in flow and out flow:** A high rate of capital out flow in form of profit repatriation discourages investment leading to a low rate of capital accumulation while a high rate of capital in flow by foreign investors encourages investment hence leading to a high rate of capital accumulation.
6. **Government policy regarding taxation and subsidization**; Favourable government policy of subsidization and other incentives like tax holiday, exemptions, reductions etc given to producers encourages investment leading to a high rate of capital accumulation while unfavorable government policy of imposing heavy taxes discourages savings and investment leading to a low level of capital accumulation.
7. **Political climate**: Existence of political instabilities in some parts of the country discourages investment leading to a low rate of capital accumulation since it scares away investors while political stability in the country attracts investment hence a high rate of capital accumulation.
8. **Rate of inflation:** A high rate of inflation in the country discourages investment since it reduces the real value of savings causing a low rate of capital accumulation while a low level

of inflation attracts investment since it increases profits in the businesses leading to a high rate of capital accumulation.

9. **Level of technology:** Advanced technology increases the level of production, income and saving leading to a high rate of capital accumulation while low levels of technology result into low levels of production hence low level of capital accumulation.
10. **Level of infrastructural development:** Well developed infrastructure such as roads, railways, financial institutions like banks etc promote investment in the country since they attract both local and foreign investors leading to high rate of capital accumulation while undeveloped infrastructural network e.g. unstable power supply, undeveloped roads etc discourages investment leading to low level of capital accumulation.
11. **Level of Entrepreneurial Skills:** High entrepreneurial skills promote the level of investment in the country since existence of potential entrepreneurs leads to efficiency in the production of goods which leads to a high rate of capital accumulation while low entrepreneurial skills discourage investment hence low level of capital accumulation.
12. **Level of interest rates:** Low interest rates on borrowed money promote borrowing and investment leading to high rate of capital accumulation while high interest rates discourage borrowing and investment leading to a low rate of capital accumulation.
13. **The demonstration effects in consumption**. This is the copying of foreign consumption habits after having been exposed to them. When such habits are imitated, the level of savings reduces thus leading to low capital accumulation
14. **Level of accountability**. A high level of accountability leads to high capital accumulation i.e. limited corruption and embezzlement because this implies that resources are invested in the planned productive activities but a low level of accountability leads to low level of capital accumulation since resources meant to accumulate capital are channeled to unproductive activities
15. **Time preference.** This is the desire by people to prefer consumption now or in the future. A p[positive time preference leads to low capital accumulation since it reduces saving levels but a negative time preference leads to high capital accumulation since it increases saving levels
16. **Degree of conservatism/Cultural factors**. Rigid cultural factors tend to discourage savings and reduce on the level of capital accumulation for example peoples' failure to transform from subsistence to modern/commercial sector, polygamy etc but a culture that is adaptive responsive to change encourages capital accumulation

Factors limiting capital accumulation

1. **Low income levels:** Low incomes discourage saving and investment which reduces the rate of capital accumulation.
2. **High population growth rate:** High rate of population growth increases the level of consumption which discourages investment.
3. **Existence of political instability:** Political instability income parts of the country discourage investment which leads to low level of capital accumulation.

4. **Small market**: A narrow market discourages production and investment which leads to a low level of capital accumulation.
5. **High level of capital outflow:** High capital out flow discourages investment in the country which leads to a low rate of capital accumulation.
6. **Poor state of social infrastructure:** Poor infrastructure such as poor roads and railways discourage investment which leads to a low level of capital accumulation.
7. **Existence of extended families:** The increases the level of consumption which lowers savings and investment hence leading to a low level of capital accumulation.
8. **Limited entrepreneurial skills:** This discourages investment in the country which results into a low level of capital accumulation.
9. **Low level of technology:** Poor state of technology results into low level of production which limits the rate of capital accumulation.
10. **Low wage level:** Low wages to workers discourage saving and investment which leads to low rate of capital accumulation.
11. **High rate of inflation**: This discourages investment in the country leading to low level of capital accumulation.
12. Unfavourable government policies of imposing heavy taxes
13. This discourages investment in the country leading to a low level of capital accumulation.
14. **High interest rates on borrowed money:** High interest rates discourage borrowing and investment in the country which leads to a low rate of capital accumulation.

Ways of increasing the rate of capital accumulation

1. **Improving social infrastructure:** This promotes investment in the country which increases the rate of capital accumulation.
2. **Improving the state of technology:** This increases the level of production which increases the level of capital accumulation.
3. **Increasing wage levels:** This encourages savings and investment in the country hence increasing the rate of capital accumulation.
4. **Improving entrepreneurial skills:** An Improving entrepreneurial skill through organizing workshops and seminars promotes investment in the country hence increasing the level of capital accumulation.
5. **Adopting anti-inflationary measures:** This promotes investment in the country hence leading to a high rate of capital accumulation.
6. **Setting a minimum wage:** This increases savings and investment into the country leading to a high rate of capital accumulation.
7. **Controlling population growth rate:** Controlling the rate of population growth through family planning reduces the level of consumption which increases saving and investment hence increasing the rate of capital accumulation.
8. **Ensuring political stability through conducting peach talks with rebels**
9. This attracts investments into the country hence increasing the rate of capital accumulation.
10. **Widening the market size:** Widening the market through joining economic integrations encourages investments into the country hence increasing the rate of capital accumulation.

11. **Attracting capital in flow:** Through offering investment incentives, capital in flow increases which promotes foreign investment hence increasing the rate of capital in flow.
12. **Lowering interest rates on borrowed capital**: This promotes borrowing from financial institution for investment which increases the rate of capital accumulation.

NOTE:

(i) **Interest**

This is the monetary reward for capital for its contribution in the production process.

DETERMINANTS OF INTEREST RATES

Length of loan repayment period: High interests are normally charged on loans borrowed for a long period of time while low interest rates are changed on loans with a short repayment period.

Level of demand for loanable funds: High demand for loans leads to high interest rates while low demand for loans leads to low interest rates.

Number o financial institutions: A large number of financial institutions in an area increases the level of completion leading to low interest rates while a small number of financial institution leads to a high interest rate.

Prevailing economic situation: Interest rates tend to be high in periods of economic depressions and recession as compared to periods of economic boom and recovery.

Level of money supply in the economy: High interests are changed in situations where money supply is low while low interests are changed where money supply is high.

Rate of inflation: Interest rates are normally high in periods when the rate of inflation is high while low interest rates are charged where the level of inflation is low.

Marginal efficiency of capital: This refers the anticipated monetary returns from an extra unit of capital employed.

DETERMINANTS OF MARGINAL EFFICIENCY OF CAPITAL

Anticipated level of output: High level of anticipated output leads to a high marginal efficiency of capital while a low level of anticipated output leads to low marginal efficiency of capital.

Level of Taxation: A high tax level leads to low marginal efficiency of capital while a low tax level leads to a high marginal efficiency of capital

Quality and efficiency of other factors of production: High quality and efficient factors of production lead to high marginal efficiency of capital while inefficient factors of production lead to low marginal efficiency of capital.

Availability of excess capacity: Existence of excess capacity leads to a high level of marginal efficiency of capital while absence of excess capacity leads to low marginal efficiency of capital.

NB: Excess capacity refers to a situation where a firm produces at less than its installed potential or capacity.

Rate of depreciation: A high rate of depreciation of capital goods leads to a low level of marginal efficiency of capital while a low rate of depreciation leads to a high rate marginal efficiency of capital.
Size of the market: A wide market leads to a high rate of marginal efficiency of capital while a narrow market size leads to a low rate of marginal efficiency of capital.
Price level: A high price for the final commodities leads to a high rate of marginal efficiency of capital while low prices lead to low rate of marginal efficiency of capital.

Source of capital

- Accumulated personal savings
- Bank loans
- Inherited wealth
- Retained profits
- Dividends from holding shares
- Foreign Aid
- Disposal of personal property.

Explain the factors that lead to a change in the level of capital accumulation

LABOUR

Labour refers to all human efforts both mental and physical that contribute to the production process.
Or
It refers to human effort both mental and physical directed at producing goods and services with a view of obtaining a reward i.e. salary or wage
Labour force is the number of people or proportion of the population that is made up of the working age group or is available for employment in an economy at a given time

FACTORS THAT INFLUENCE/DETERMINE/AFFECT THE SIZE OF LABOUR FORCE

By influencing it means that such factors either increase or decrease the size of labour force
They include the following

1. **Population size.** The larger the population, the bigger the labour force and the smaller the population, the smaller the size of the labour force.
2. **Population structure in terms of age and sex**. The population comprising mainly of the 25-60 age group has larger work force than a population structure dominated by the young and the aged who are economically less productive. Similarly more males imply a larger labour force.
3. **Education/training period.** Where the training period is low, the size of labour force may be low while a sufficient training period avails more productive labour force to an economy.

4. **Government policy in relation to retirement age**. Early retirement reduces the size of labour force while late retirement gives an economy a wider labour force base.
5. **Migration rate**. High immigration rates result into increased population and hence increased labour force while high emigration rates plus cases of brain drain reduce a country's' labour force.
6. **Natural conditions/abilities**. An economy with many physically and mentally able people has more potential for labour force than one with a few naturally able individuals which has less potential labour force.
7. **Traditions and culture**. Certain traditions and culture do not allow women to work and if women constitute a big percentage of the population then the economy will have limited workforce otherwise societies with limited cultural restrictions have a larger labour force base.
8. Working conditions
9. Peoples' attitude towards work
10. Wage offered
11. Social and political conditions in the country
12. Efficiency of other co-operant factors

TYPES OF LABOUR

The following are the types of labour

Productive labour. This is the human effort directed at the production of goods and services that have exchange value and is rewarded

Unproductive labour. This is the human effort that does not produce an out put of goods and services or produce goods and services which have no exchange or market value e.g. house wives, the owner of the school, renting your own house etc

Productive labour can be categorized into three categories i.e. skilled, semi skilled and unskilled labour

Skilled labour. This is one which is well trained and has practical knowledge in a particular field for example doctors, engineers, teachers etc

Unskilled labour. Is that which lack formal education and with no practical experience in any particular job

Semi skilled labour. Is that labour with some little education and little practical experience e.g. s.6 drop outs, s.4 leavers

Characteristics of labour

i. Labour is a very mobile both geographically and occupationally.
ii. Labour cannot be stored i.e. if a worker remains idle for some time, then his labour will be wasted.
iii. Labour cannot be separated from the labourer.
iv. Its quality can be improved upon through education and training.
v. The productivity of labour varies from one individual to another
vi. Labour is interchangeable with capital i.e. it can be substituted with capital

vii. It involves incurring costs for example it under goes training

DEMAND FOR LABOUR

Demand for labour refers to the number of employees that an employer is able and willing to employ and retain in employment at a given wage rate at a given period of time.

The demand for labour is a **derived demand** i.e. it is demand derived from the demand of goods and services labour can help to produce

DETERMINANTS OF DEMAND FOR LABOUR

Level of demand for goods that labour produces; High demand for products that labour produces leads to high demand for labour while low demand for products that labour produces leads to low demand for labour.

Degree of substitution of labour for other factors of production. Where labour can easily be substituted by machines, the demand for labour tends to below while in cases where labour cannot be substituted by machines, demand for labour tends to be high.

Proportion of labour costs to total costs of production; A high proportion of labour costs to total costs leads to low demand for labour since it reduces profits of the firm while a low proportion of labour costs to total costs leads to a high demand for labour

.

Productivity of labour The demand for labour tends to be high for highly productive labour while the demand for labour tends to be low for labour whose productivity is low

.

Level of labour skills; The demand for labour tends to be high where labourers are highly skilled because of being efficient and effective while that of unskilled labour tends to be low because it is less effective and productive

Availability of co-operant factors of production. adequate supply of other co-operant factors of production particularly land, capital and entrepreneurship leads to high demand for labour but inadequacy of such factors leads to low labour demand for example a small piece of land requires less labour, a firm with little capital employs less etc

Factors that lead to low demand for labour.

- Low demand for products that labour produces. leads to low demand of labour because today products produced by labourers not so good like that of the machines hence having less demand
- High wage levels
- High degree of substitution of labour with machines.
- High proportion of labour costs to total of production leads to low demand for labour since it reduces the profits of the firm.
- Low productivity of labour
- Low labour skills. (unskilled labour) most careers today require theoretical knowledge thus, lack of content is likely to be a low demand for labour.

Factors that lead to high demand for labour

- High labour skills
- High productivity of labour
- High demand for products that labour produces
- Low wage levels.
- Low degree of substitution of labour with machines.
- Small proportion of labour costs to total costs of production

Labour supply refers to the number of people who are willing and able to work at a given wage rate at a given period of time.

Supply of labour: This refers to the number of hours that a labourer is willing to offer for work at the ongoing wage rate in a given period of time.

FACTORS THAT DETERMINE/INFLUENCE/AFFECT LABOUR SUPPLY

Population size: A big population size leads to a high labour supply because of the availability of many people to provide labourwhile a small population size leads to low labour supply because of the few existing people willing and able to work.

Wage rate: A high wage rate attracts more people to work leading to high labour supply while a low wage rate discourages people from work leading to low labour supply.

Working conditions: Favourable working conditions attract people to work leading high labour supply for example a clean environment, readily available protective equipment like masks, gloves etc, free lunch and drinking water while unfavourable working conditions for example a dirty environment discourage workers leading to low labour supply.

Age structure of the population: A big proportion of elderly people leads to a low labour supply while a big proportion of people in the working age group leads to a high labour supply.

Level of education and skills: A high level of education leads to a high level of labour supply since education equips individuals with skills to perform certain tasks while a low level of education leads to a low level of labour supply.

Length of training period: Long training periods lead to a low labour supply while short training periods lead to high labour supply.

Retirement age: A high retirement age leads to a high labour supply since it enables strong individuals to serve for quite long before retirement while a low retirement age leads to a low labour supply since it denies labourers a chance to serve for quite long.

Political climate: Areas with political instabilities lead to low labour supply since workers are scared of their lives and property while those which are politically stable experience low labour supply.

Risks involved in a job. Labour supply tents to be low in jobs which are highly risky and high in jobs which do not involve high risks.

Attitude towards work: Labour supply tends to be low where people’s attitude towards work is poor/negative while it tends to be high where people have a positive attitude towards work.

Degree of labour mobility: High mobility of labour leads to high labour supply while low labour mobility leads to low labour productivity.

The rate of emigration. High rate of emigration leads to low labour supply since this leads to loss of energetic and productive people. But low rate of emigration leads to high labour supply

Sex composition of a country's population structure: Countries with more men than women tend to have high labour supply while those with more women tend to have high labour supply while those with more women than men tend to have low labour supply.

Factors that lead to low labour supply

- **High average age of leaving school**
- Low mobility of labour.
- Poor attitude towards work
- Small population size.
- Low wage rates
- Poor working conditions.
- Low level of education and training.
- Long period of training
- Low retirement age
- High risks involved in a job.

Factors that lead to high labour supply

- Short training period.
- High level of education and training.
- High retirement age
- Low risks involve in a job.
- Favorable working conditions
- High wages offered at a job
- Big population size
- Positive attitude towards work.
- High mobility of labour
- Low average age of leaving school.

Measures that can be taken to increase labour supply

- Increasing wage rate
- Promoting education through offering free education.
- Reducing the training period
- Reducing population size through family planning
- Improving working conditions of workers
- Increasing the retirement age

PRODUCTIVITY AND EFFICIENCY OF LABOUR

Labour productivity refers to the amount of out put produced per unit of labour employed during a given period of time
Or
Refers to the quantity of out put produced per unit of labour employed in a given period of time
Labour efficiency. Refers to the measure of quantity and quality of a **commodity** that a unit of labour can produce in a **short period** of time

Average product of labour: This refers to the amount of output per unit of labour employed.

Marginal productivity of Labour: This refers to the additional output resulting from employing an additional unit of labour.

FACTORS THAT DETERMINE PRODUCTIVITY AND EFFICIENCY OF LABOUR

Level of education and training: High level of education and training results into a high level of output leading to high productivity of labour while low levels of education results onto low output levels leading to low productivity of labour.

Working conditions: Poor working conditions result into low output levels leading to low labour productivity for example poor feeding, hygiene, etc while favourable working conditions like a clean work place with safe drinking water, free lunch, protective equipment like gloves lead to high output hence high productivity of labour.

Wage level: High wages encourage workers to produce more output leading to high productivity of labour while low wages discourages labour from producing more leading to low labour productivity.

Degree of specialization: High levels of specialization lead to high output levels hence high labour productivity since it gives workers chance to perform activities that they can do better while low levels of specialization lead to low output levels thereby leading to low to labour productivity.

Quality of management and supervision: Efficient management and supervision results into high output since most workers fear their immediate bosses leading to high labour productivity while inefficient management lowers output levels leading to low productivity of labour since many workers absent themselves from work and others become reluctant.

Attitude of workers towards work: Positive attitude of workers towards work leads to high labour productivity due to high output while a negative attitude of workers towards work leads to low output leading to low labour productivity.

Availability and quality of other co-operant factors of production: Presence of efficient co-operant factors of production like land, capital and entrepreneurship results into high labour productivity while inefficient co-operant factors of production like infertile land, inadequate capital lower output leading to low labour productivity.

Level of experience and seniority: High experience levels result into high output levels hence high productivity of labour while low experience levels lead to low output hence low labour productivity.

Health status of works: Healthy works produce more output leading to high labour productivity while unhealthy workers produce less output leading to low productivity of labour.

Level of technology: High technology levels increases output levels and of a good quality hence high labour productivity and efficiency for example in agriculture use of tractors yields more out put while low levels of technology leads low output levels and of poor quality hence low labour productivity.

Natural ability of workers: Gifted and strong workers produce more output levels leading to high labour productivity while weak ones produce less output leading to low productivity of labour.

Political climate: Workers in politically stable areas concentrate and produce more output leading to high labour productivity and efficiency while those in politically unstable areas produce less output hence leading to high low labour productivity.

Level of innovations and inventions among workers. High level of innovation and inventions among workers lead to high labour productivity and efficiency due to the ability to come up with new methods of productions or to improve on the existing methods/products but low levels of innovations and inventions lead to low labour productivity and efficiency

FACTORS THAT LEAD TO LOW PRODUCTIVITY OF LABOUR

Poor attitude towards work: This lowers the level of output leading to low productivity of labour.

Poor technology: The use of poor technology leads to low output levels hence low productivity of labour.

Low level of education and training: This leads to low output levels hence low productivity of labour.

Low wage levels: Low wages offered discourage workers which results unto low output levels hence low productivity of labour.

Poor management and supervision: This results into low output levels leading to low productivity of labour.

Poor working conditions such as long hours of work: This leads to low output levels hence low labour productivity.

Poor health condition: This also results into low output levels hence low labour productivity.

Limited c-operant factors of production: This results into low output levels hence low productivity of labour.

Low level of specialization: This limits output levels leading to low labour productivity.

Lack of experience: This results into low output levels causing low productivity of labour.

Negative attitude towards work: This results into low output levels causing low productivity of labour.

Political instability in some parts of the country: This causes low output levels leading to low productivity of labour.

Factors that lead to high productivity of labour

- Positive attitude of workers towards work.
- High levels of education and training
- High wage levels
- Use of advanced technology.
- Good management and supervision
- Favourable working conditions
- Good health condition.
- Adequate co-operant factors of production.
- High level of specialization.
- High level of experience at job.
- Existence of political stability throughout the country.

Measures that can be taken to increase productivity of labour

- Further training of workers
- Ensuring political stability
- Increasing wage levels
- Improving working conditions e.g. reducing hours of work.
- Improving supervision and management through organizing workshops and seminars.

Factors that lead to a decrease in productivity of labour

- Decrease in wage rates
- Negative change in workers attitude towards work
- Determination in technology.
- Decrease in supervision.
- Deformation in the level of education.

- Reducing in supply of co-operant factors of production.
- Emergency of political instability in some parts of the

LABOUR SPECIFICITY AND MOBILITY OF LABOUR.

Factor specificity and mobility.

Factor specificity refers to the tendency for a factor of production to be specialized to a particular kind of production.

Therefore, **specific factors** are factors that are specialized in a particular kind of production in such a way that they can not be easily used for any other purpose other than that for which they were designed.

Non specific factors, are factors which can easily be transformed from one use to another like; buildings, farm land and unskilled labour. With regards to labour; it is a long period of training or study that makes it to be highly specific.

Factor mobility. It refers to the ease with which a factor of production can move from one occupation to another or from one geographical location to another.

Labour mobility. This refers to the ease with which labour can move from one occupation to another orone geographical location to another.

Mobility of labour is int two major categories;

1. Geographical mobility of labour.
2. Occupational mobility of labour.

Geographical mobility of labour.

Refers to the ease with which labour can move from one place to another. The inability of labour to move from one geographical area to another is referred to as geographical immobility.

Occupational mobility of labour. Refers to the ease with which labour can move from one occupation/job to another. The inability of labour to move from one job to another is occupational immobility of labour.

Occupational mobility of labour can be vertical or horizontal.

Horizontal mobility of labour. This efers to the ability of labour to move from one occupation to another of the same status e.g a teacher moving from one school to another stil as a teacher.

Vertical mobility of labour. This refer to the ability of labour to move from one occupation to another but of different status e.g from teacher to head teacher .

NB. Immobility of labour refers to the inability of labour to move from one place or job to another.

CAUSES OF GEOGRAPHICAL MOBILITY OF LABOUR.

The movement of labour from one geographical area to another is caused by a combination of factors which include the following.

1. Difference in the cost of living in different areas. Labour moves from areas with high cost of living to ones with low cost of living so as to maintain its standards of living, leading to geographical mobility of labour.
2. Insecurity in some places. Labour moves from insecure places to secure and peaceful areas so as to safe guard life and property thus leading to geographical mobility of labour.
3. Geographical wage difference. Labour moves from places with low paying jobs to area of high paying jobs so as to improve on their welfare e.g. brain drain is a result of this factor.
4. Desire to simply change the environment. Labour moves from one place to another place just to change the environment, join friends and relatives in another place.
5. Out break of epidemics in some places. Labour moves from some places to avoid epidemics in such places. E.g. cholera, Ebola etc
6. Desire to enjoy social amenities in some places. Labour moves from one place to another to enjoy easy or good life e.g. attending to night clubs, sleeping in good hotels most especially in towns.
7. Victimization. Being wrongly victimized eg against indiscipline like murder, rape, theft etc forces people to move to other places.
8. Unfavorable climate. This forces labour to move from one place to another with better climatic condition e.g. extreme hotness, floods, coldness forces people to move to areas with better and favorable conditions.
9. Desire to seek for employment. The unemployed labour moves from one place to another due to failure to speak local language of the area leading to geographical mobility of labour.

BARRIERS TO GEOGRAPHICAL MOBILITY OF LABOUR/ OBSTACLES/CONSTRAITS/FACTORS LIMITING .

1. High costs of transport involved in traveling from one place to another. This makes it difficult for labour to move to other places of work thus remaining in one place of work hence limiting geographical mobility of labour.
2. Strong family ties in the current place of work. Some times it is difficult for labourers to leave behind their families, friends and workmates for other places of work thus remaining in the current place of work hence limiting geographical mobility of labour.
3. Political instability in the alternative place of work. Workers remain in the current place of work due to the fear of alternative places of work which are politically unstable.
4. High costs of living in the alternative place of work. The high costs of living in the alternative place of work implies reduction of real wage. This means as the cost of living raises, labourers afford less and less units of goods and services . This makes labour geographically immobile.
5. Housing shortages/poor housing facilities in alternative places of work. Labour fails to move to alternative places of work that lack decent accommodation especially in rural areas leading to geographical immobility.

6. Poor transport and communication network in alternative places of work. Labour tends to remain in the current place due to the fear of going to other places where transport and communication is poor.
7. Ignorance/ limited knowledge about the existing jobs. Opportunities in other places of work. Due to poor communication, labourers fail to know the existing jobs in other places of work leading tom geographical immobility of labour.
8. Apathy among some groups of people in alternative places of work. This limits labour from going to such areas people practice apathy and remain in their current work places leading to geographical immobility of labour.
9. Old age. Some workers fail to join other jbs due to their old age and prefer remaining to their current job leading to geographical immobility of labour.
10. Poor working conditions in the alternative places of work. These discourage the labourers from moving to such places since they want to maintain their welfare.
11. Heavy and permanent investment in the current place of work. Employees do not move from places where they have fixed investments . This is because of the strong attachment they have in them.

MEASURES THAT CAN BE TAKEN TO IMPROVE GEOGRAPHICAL MOBILITY OF LABOUR.

- Advertising existing job opportunities in other areas. This creates awareness to people of existing job opportunities hence improve labour mobility.
- Developing the infrastructural network in the alternative work place. This makes it easy for people to move from one place to another alternative place of work.
- Improving the political atmosphere in the alternative place of work. Through conducting peace talks with the rebel groups, political atmosphere is improved allows people to move from one place to another.
- Increasing wages in places where they are low. This attracts worker s to go and work in such places hence promotion of labour mobility,.
- Improving working conditions in alternative places of work. This attracts workers to go to such places where there are good working conditions hence promotion of labour mobility.
- Subsiding transport costs to alternative places of work. This lowers transport costs of workers which makes it easy for move to alternative p-laces.

Qn. Account for the geographical mobility of labour.

Explain the causes of geographical immobility ES OF OCCUPATIONAL MOBILITY OF LABOUR..

The following are the reasons why labour may move from one place to another.

1. Differentiation wage/salary differentials. Labour moves from low to high paying jobs in order to get enough money to improve on welfare.
2. Difference in non monitory benefits among different jobs. Some workers leave jobs with no fringe benefits e.g. transport and go where there are such benefits allowances, medical care etc. Thus leading to occupational mobility of labour.

3. Difference in social prestige among different jobs. Labour leaves less prestige jobs to prestigious jobs so as to improve their status in community thus leading to occupational mobility of labour.
4. Old age. Elderly workers develop physical body weaknesses and therefore move to less demanding jobs hence causing occupational mobility of labour.
5. Possibility of promotion in alternative jobs. This makes labour to move to such jobs since promotions promote one's status and are accompanied by monitory rewards hence causing occupational mobility of labour.
6. Social cultural incompatibility. With in a current occupation. This forces labour to change from one job to another e.g. a Muslim changing from being a bar attendant to another job which is more socially accepted by the religion. This leads to occupational mobility of labour.
7. High level of education. This makes labour more flexible because of the position of several qualifications. This enables them to join easily highly paying jobs hence occupational mobility of labour.
8. High level of advertisement. This increases awareness of workers about existing jobs to else where and persuades them leading to occupational mobility of labour.
9. High risks involved in the current job. This forces labour to move to less risk jobsso as to secure life while at work
10. Discrimination at the current job. This forces labour to move to other jobs with out discrimination of labour.
11. Low cost of training in the alternative job. This encourages workers to go for short courses which promotes occupational mobility of labour after completion of such cources they apply for better jobs.
12. Government policy of transferring workers from one job to another. This promotes the movement of labour from one place to another hence causing occupational mobility of labour.]

BARRIERS TO OCCUPATIONAL MOBILITY OF LABOUR./OBSTACLES/CONTRAINTS/CAUSES OF OCCUPATIONAL IMMOBILITY OF LABOUR.

1. High costs of training for alternative jobs. This discourages workers from training for alternative jobs forcing them to remain in heir current jobs hence limiting occupational mobility of labour.
2. Long period of training for the alternative jobs. Workers remain in their current jobs due to fear of the long training period required to acquire skills for alternative jobs.eg training to become a doctor requires a long period of time thus limiting occupational mobility of labour.
3. High degree of specialization in the current jobs. This discourages workers from going for other jobs due to limited skills compared what is required in alternative jobs hence limiting occupational mobility of labour.
4. Low wages in the alternative jobs/better payments offered in the current job. This discourages workers from going for jobs where wages are lower than what is offered in the current jobs thus leading to occupational immobility of labour.

5. Natural inability to do other jobs. People have different natural talents, it is difficult fr an individual to change from one occupation to another because of limitation in talents eg a professional footballer may not become a musician when he is not naturally talented.
6. High financial requirements in changing from one job to another. Changing from one job to another involves costs like transport, typing and photocopying documents and time etc. These constitute financial barriers to occupational mobility of labour.
7. Bureaucratic formalities involved in acquiring a new job(s). Many jobs have stringent formalities that are followed while applying for these jobs. Eg requirement for interview both oral and written while others involve aptitude tests. This limits occupational mobility of labour since many workers don't apply for such jobs.
8. Barrios by trade unions and professional bodies. Some workers faile to get jobs because of the strong barrows brought by professional bodies to non bodies eg to become a teacher you must have been registered by the ministry of education and spotrts and when you join such trade unions, to leave you must seek permission.
9. Ignorance./ limited knowledge about existing jobs opportunities in other areas. Due to poor communication skills, labourers fail to know of existing job opportunities in such areas. They thus remain in the current places of work due to occupational mobility of work.
10. Restrictive social factors within the alternative occupation. Eg restrictive age, sex etc. Some jobs are socially and culturally meant for a particular sex, age group or religion hence limiting workers out of those group to join such jobs leading to occupational immobility of labour.
11. High risks involved in the alternative jobs. Workers tend to remain in their current jobs due to fear of high risks involved in other jobs such as mining hence limiting labour mobility.
12. Prospects of being promoted in the current job. Workers remain in their current jobs due to prospects of being in the near feature hence promoting occupational mobility of labour since promotion is accompanied by monitory and non monitory benefits.
13. Lack of required skills in the alternative jobs. Workers fail to join the other jobs due to lack of relevant skills in such jobs which leads to limiting of mobility of labour.
14. Discrimination of workers in the alternative jobs. Workers remain in their current jobs due to the fear of discrimination in the labour market on the basis of sex, tribe, race etc which limits mobility of labour.
15. Possibility of further training in the current jobs. Labourers who have been promised further training at the current job become reluctant to other jobs leading to occupational immobility of labour.

MEASURES THAT CAN BE TAKEN TO IMPROVE OCCUPATIONAL MOBILITY OF LABOUR.

- Subsidizing training of workers for alternative jobs. This attracts workers to go for training which increases mobility of labour.
- Reduction of the training period. This encourages workers to go for such alternative jobs WHOSE TRAINING PERIODS ARE REDUCED.

- Adopting strict laws against segregation of workers according to sex, age etc which gives equal opportunities to all people in the labour market.

Revision Questions.

1. Explain the causes of labour mobility.
2. Explain the factors influencing labour mobility in your country/ economy.
3. Suggest workable measures that can be taken to promote labour mobility in your country.
4. Explain the causes of occupation mobility of labour.
5. Account for high occupation mobility of labour in your country.

ADVANTAGES OF LABOUR MOBILITY.

1. Reduces unemployment problems. Labour mobility enables workers to move from areas where there are a few jobs to areas where there are more job opportunities.
2. It helps to increase wages of workers. Labour mobility allows workers to move from jobs where low wages are offered to jobs where jobs relatively high.
3. It helps a country to over come labour shortages. Labour mobility allows the inflow of skilled manpower in the country hence over coming a problem of labour shortage.
4. Labour mobility allows workers to enjoy better working conditions by moving from jobs where conditions of work are poor to these jobs with favorable working conditions.
5. Increases labour productivity. It allows workers to move to other jobs where their potential can be fully exploited hence increasing their productivity and efficiency.
6. Creates a sense of international community. Geographical mobility of labour allows people to move from one country to another hence creating a sense of international community.
7. Acquisition of new skills. As workers change from one job to another, they acquire new skills hence increasing their productivity and efficiency.
8. Reduces regional imbalances in economic development since skilled labour is able to move to all regions.
9. Reduces income inequalities among workers. Since all have access to high paying jobs.

DEMERIITS /DISADVANTAGES OF LABOUR MOBILITY.

- Labour mobility may interfere with steady labour supply since workers are ever on move. This disrupts production.
- It encourages brain drain since labour is always hunt for green pastures which exist in developed countries . This renders a country to to shortage of skilled labour.
- It makes it difficult for labour to organize it self into strong trade union since it is on move hence leading to low bargaining power of individual workers.

- Discourages specialization and acquisition of experience in a particular jobs since workers keep on changing jobs for better paying jobs.
- It may lead to erosion of desirable cultural values in a particular area due to mixing of people of different cultural back ground.

FACTORS THAT DETERMINE LABOUR MOBILITY/DETERMINANTS.

1. Skills required. Jobs which require highly specialized skills reduce the mobility of labour but incases where no special skills required e.g. office messengers mobility is high.
2. Cost and period of training. Jobs which involve high costs of training and take long duration leads to low costs of training mobility is high.
3. Degree of job security. Temporary jobs lead to high mobility since there are more chances of being sucked but permanent jobs lead to low labour mobility because workers are satisfied and secure.
4. Degree of advertisement. High degree of advertising existing jobs and comfort places leads to high labour mobility since it increases awareness among people but a low degree of advertising leads to low labour mobility since labourers don't know existing opportunities. Else where.
5. Influence of trade unions and professional associations. In occupations where there are restrictions on the entry into such professions in free entry and exit mobility of labour is increased.
6. Level of education. Highly educated people usually take up permanent jobs leading to low labour mobility but less education people take any job leading to high labour mobility.
7. Nature of the job. Jobs with high occupational hazards like mining sugar cane cutting etc discourages workers join them leading to low labour mobility but jobs with limited occupation hazards leads to mobility of labour.
8. Degree of specialization. Labour which is highly specialized is occupationally immobile because it requires retraining which may be difficult and costly but low level of specialization leads to high labour mobility.
9. Age of worker. Old age discourages labour mobility since labour becomes physically weak to move. But the youth have the ability to move leading to high mobility of labour.

PRODUCTIVITY OF LABOUR AND EFFICIENCY OF LABOUR

Productivity of labour : This refers to the measure of quantity of output produced a unit of labour in a given period of time.

Average product of labour : This refers to the amount of output per unit of labour employed.

Marginal productivity of Labour: This refers to the additional output resulting from employing an additional unit of labour.

Factors that determine productivity and efficiency of labour

Level of education and training: High level of education and training results into a high level of output leading to high productivity of labour while low levels of education results onto low output levels leading to low productivity of labour.

Working conditions: Poor working conditions result into low output levels leading to low labour productivity while favourable working conditions lead to high output hence high productivity of labour.

Wage level: High wages encourage workers to produce more output leading to high productivity of labour while low wages discourages labour from producing more leading to low labour productivity.

Degree of specialization: High levels of specialization lead to high output levels hence high labour productivity while low levels of specialization lead to low output levels thereby leading to low to labour productivity.

Quality of management and supervision: Efficient management and supervision results into high output leading to high labour productivity while inefficient management lowers output levels leading to low productivity of labour.

Attitude of workers towards work: Positive attitude of workers towards work leads to high labour productivity due to high output while a negative attitude of workers towards work leads to low output leading to low labour productivity.

Availability and quality of co-operant factors of production: Presence of efficient co-operant factors of production results into high labour productivity while inefficient co-operant factors of production lower output leading to low labour productivity.

Level of experience and seniority: High experience levels result into high output levels hence high productivity of labour while low experience levels lead to low output hence low labour productivity.

Health status of works: Healthy works produce more output leading to high labour productivity while unhealthy workers produce less output leading to low productivity of labour.

Level of technology: High technology levels increases output levels hence high labour productivity while low levels of technology leads low output levels hence low labour productivity.

Natural ability of workers: Gifted and strong workers produce more output levels leading to high labour productivity while weak ones produce less output leading to low productivity of labour.

Political climate: Worker in politically stable areas produce more output leading to high labour productivity while those in politically unstable areas produce less output hence leading to high low labour productivity.

factors that lead to low productivity of labour

Poor attitude towards work: This lowers the level of output leading to low productivity of labour.

Poor technology: The use of poor technology leads to low output levels hence low productivity of labour.

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Negative attitude towards work: This results into low output levels causing low productivity of labour.

Political instability in some parts of the country: This causes low output levels leading to low productivity of labour.

Factors that lead to high productivity of labour

- Positive attitude of workers towards work.
- High levels of education and training
- High wage levels
- Use of advanced technology.
- Good management and supervision
- Favourable working conditions
- Good health condition.
- Adquate co-operant factors of production.
- High level of specialization.
- High level of experience at job.
- Existence of political stability throughout the country.

Measures that can be taken to increase productivity of labour

- Further training of workers
- Ensuring political stability
- Increasing wage levels
- Improving working conditions e.g. reducing hours of work.
- Improving supervision and management through organizing workshops and seminars.

factors that lead to a decrease in productivity of labour

- Decrease in wage rates
- Negative change in workers attitude towards work
- Determination in technology.
- Decrease in supervision.
- Deformation in the level of education.
- Reducing in supply of co-operant factors of production.
- Emergency of political instability in some parts of the country.

LABOUR SUPPLY

Labour supply refers to the number of people who are willing and able to work at a given wage rate at a given period of time.

Supply of labour: This refers to the number of hours that a labourer is willing to offer for work at the ongoing wage rate in a given period of time.

Factors that determine labour supply

Population size: A big population size leads to a high labour supply while a small population size leads to low labour supply.

Wage rate: A high wage rate attracts more people to work leading to high labour supply while a low wage rate discourages people from work leading to low labour supply.

Working conditions: Favourable working conditions attract people to work leading high labour supply while unfavourable working conditions discourages workers leading to low labour supply.

Age structure of the population: A big proportion of elderly people leads to a low labour while a big proportion of people in the working group leads to a high labour supply.

Level of education and skills: A high level of education leads to a high level of labour supply while a low level of education leads to a low level of labour supply.

Length of training period: Long training periods lead to a low labour supply while short training periods lead to high labour supply.

Retirement age: A high retirement age leads to a high labour supply while a low retirement age leads to a low labour supply.

Political climate: Areas with political instabilities lead to low labour supply while those which are politically stable experience low labour supply.

Risks involved in a job labour supply tents to be low in jobs which are highly risky and high in jobs which do not involve high risks.

Attitude towards work: Labour supply tends to be low where people's attitude towards work is poor while it tends to be high where people have a positive attitude towards work.

Degree of labour mobility: High mobility of labour leads to high labour supply while low labour mobility leads to low labour productivity.

Sex composition of a country's population structure: Countries with more men than women tend to have high labour supply while those with more women tend to have high labour supply while those with more women than men tend to have low labour supply.

Average age of leaving school: Countries where the average age of leaving school is high tend to have low labour supply while those where the average age of leaving school is low labour supply tends to be high.

Factors that lead to low labour supply

- **High average age of leaving school**
- Low mobility of labour.
- Poor attitude towards work
- Small population size.
- Low wage rates
- Poor working conditions.
- Low level of education and training.
- Long period of training
- Low retirement age
- High risks involved in a job.

Factors that lead to high labour supply

- Short training period.
- High level of education and training.
- High retirement age
- Low risks involve in a job.
- Favorable working conditions
- High wages offered at a job
- Big population size
- Positive attitude towards work.
- High mobility of labour
- Low average age of leaving school.

Measures that can be taken to increase labour supply

- Increasing wage rate
- Promoting education through offering free education.
- Reducing the training period
- Reducing population size through family planning
- Improving working conditions of workers
- Increasing the retirement age

DEMAND FOR LABOUR

Demand for labour refers to the number of employees that an employer is able and willing to employ and retain in employment at a given wage rate at a given period of time.

Determinants of demand for labour

Level of demand for goods that labour produces;High demand for products that labour produces leads to high demand for labour while low demand for products that labour produces leads to low demand for labour.

Wage levels;High wages lead to low demand for labour while low wages lead to high demand for labour.

Degree of substitution of labour for other factors of production. Where labour can easily be substulted by machines the demand for labour tends to below while in cases where labour cannot be substituted by machines demand for labour tends to be high.

Proportion of labour costs to total costs of production; A high proportion of labour costs to total costs leads to low demand for labour while a low proportion of labour costs to total costs leads to a high demand for labour

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Productivity of labour. The demand for labour tends to be high for highly productive labour while the demand for labour tends to be low for labour whose productivity is low

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Level of labour skills; The demand for labour tends to be high where labourers are highly skilled while that of unskilled labour tends to be low.

factors that lead to low demand for labour .

- Low demand for products that labour produces.

- High wage levels
- High degree of substitution of labour with machines.
- High proportion of labour costs to total of production
- Low productivity of labour
- Low labour skills.

Factors that lead to high demand for labour

- High labour skills
- High productivity of labour
- High demand for products that labour produces
- Low wage levels.
- Low degree of substitution of labour with machines.
- Small proportion of labour costs to total costs of production.

SPECIALIZATION AND DIVISION OF LABOUR

Specialization: This refers to a situation where an individual, firm or country concentrates on the production of that commodity that it can produce best and get what it cannot produce through exchange.

Division of labour: This refer to the breaking down of the production process into different tasks or activities such that each task is performed by an individual or a group of individuals according to their ability or talent.

Forms/Types of specialization

Specialization by craft: This is the form of specialization where a group of people or family concentrates on the production of a particular craft or activity that they can do best e.g. farming, pot making etc.

Specialization by process: This is where each stage in the production process is carried out by different individuals.

Regional specialization: This is where each region concentrates on the production of what it can produce best and exchange it for what it cannot produce with other regions.

International specialization: This is where each country concentrates on the production of a commodity it can produce best and exchanges it with other countries for what it cannot produce.

ADVANTAGES OF SPECIALIZATION

It saves time: Specialization saves time since an individual does not need to move from one stage of production to another.

It increases efficiency of labour : Specialization leads to an increase in the volume of output which increases efficiency of labour.

It improves the skills of workers: Specialization allows workers to perform a task continuously which helps to improve their skills.

It encourages large scale production: Specialization allows firms to increase on their scale of production thereby enjoying economies of scale.

It improves on the working relationship between workers.

Specialization promotes inter dependence among workers which improve the working relationship among workers.

It increases job opportunities; Specialization calls for different tasks to be performed by different people which helps to create more job opportunities.

It minimizes the costs of supervision; Specialization allows individuals to perform particular asks which helps to minimize supervision and its costs.

It promotes innovation and invention among workers. Specialization allows workers to perform tasks over and over again which leads to discovery of new and more efficient techniques of production.

It increases exploitation of idle resources: Specialization helps to increase the volume of output which promotes exploitation of the would be idle resources.

It reduces fatigue: Through specialization, people perform specific tasks which does not allow hem to move up and down thereby reducing fatigue among workers.

It increases the profit margins of firms: Specialization promotes large scale production which increase the profit margin.

It avoids duplication of tasks: Specialization minimizes duplication of tasks since an individual cannot solely produce a product.

It improves on the quality of output: Through performing a task over and over again workers acquire a high level of experience which improves the quality of output.

DISADVANTAGES OF SPECIALIZATION

It leads to over exploitation of resources: Specialization promotes large scale production which results into over exploitation of the natural resources.

It creates labour shortage: Specialization hinders labour mobility which creates a shortage of labour in other jobs.

Workers cannot asses their efficiency and contribution to the production of a particular product since many workers contribute to its production.

It leads to monitory at work: Repeating the same task over and over again creates boredom and monetary at work which increases risks of accidents at work.

It creates a problem of interdependence among workers such that absence of a given worker of group of workers brings the production process at a stand still.

There is no flexibility in the production process since labour and capital are highly specialized in performing specific tasks.

It leads to loss of craft man ship: Performing a particular task in the production of a commodity leads to loss of one's skills of making a complete item.

It worsens the unemployment problem: Specialization promotes the use of machines which are more efficient than labour there by worsening the unemployment problem.

ENTREPRENEURSHIP/ORGANIZATION:

Organization. This is a factor of production that helps the entrepreneur to combine the other factors of production to produce goods and services. It is mainly engaged in management and administration

Entrepreneurship refers to a factor of production which initiates and finances the production process

An entrepreneur is a person who undertakes risks to start a business with an aim of making profits.

The reward for entrepreneurship as a factor of production is profit.

Functions of an Entrepreneur

- He makes decisions i.e. he makes decisions concerning the running of the business e.g. regarding what to produce where and how to produce is a decision maker in the production process.
- He co-ordinates, supervises and monitors the production process.
- He employs and rewards other factors of production such as labour. Capital and land
- He is an innovator i.e. he is responsible for economic process of the business by discovering better techniques of production.
- He is responsible for the marketing of the product of the firm.
- He bears business risks. The entrepreneur invests his/her capital in the business to earn profits. He invests his/her capital and other resources in the business where there uncertainties

FACTORS DETERMINING THE LEVEL OF ENTREPRENEURSHIP

1. **Level of education and training:** High levels of education lead to lead to high skills hence high levels of entrepreneurship while low levels of education lead to low skills resulting into high levels of entrepreneurship.
2. **Political climate;** Political stability promotes investment in the country which leads to development of entrepreneurial skills while political instability discourages investment hence discouraging entrepreneurs.
3. **Government policy regarding development of entrepreneurship.** Favourable government policies intended to entrepreneurship such as organizing seminars and workshops lead to high entrepreneurial skills while unfavourable government policies towards developing entrepreneurship for example high corporate taxes charged lead to low entrepreneurial skills.
4. **Level of industrialization:** High level of industrialization promotes entrepreneurial development since it encourages potential investors to start businesses while low levels of industrialization discourage development of entrepreneurial skills.
5. **Level of infrastructural development:** Well developed infrastructures such as good roads attract investment activities leading to high entrepreneurial skills while poor infrastructure discourages investment leading to low entrepreneurial skills.
6. **Size of the market**. A large market size attracts more people to set up businesses thus leading to high supply of entrepreneurship. But a small market size discourages investment hence few businesses are set up leading to a low supply of entrepreneurship
7. **Availability of capital and other resources.** Adequate supply of other co-operant factors like capital enables people to set up different enterprises leading to high supply of entrepreneurship but inadequacy of such factors leads to low supply of entrepreneurs due to inability to set up different enterprises
8. **Level of profits earned by existing entrepreneurs.** A high level of profits earned by existing entrepreneurs leads to high supply of entrepreneurs since it attracts investment but low profits earned by already existing entrepreneurs leads to low supply of entrepreneurs
9. **Culture/people's attitude towards work.** A positive attitude towards work encourages innovations and inventions this results in many enterprises being set up leading to high supply of entrepreneurship but a negative culture towards work limits inventions and innovation thus leading to low supply of entrepreneurship
10. **Level of economic development.** High level of economic development leads to high supply of entrepreneurship due to many economic activities carried out in the country but a low level of economic development limits economic activities since it is a disincentive to investment leading to low supply of entrepreneurship

Questions

Explain the factors limiting the supply of entrepreneurship in your country

Account for the small class of entrepreneurs in your country

Explain the factors that lead to a change in the supply of entrepreneurship

Suggest ways of increasing the supply of entrepreneurs in your country
b) Explain the factors limiting the supply of entrepreneurship in your country 16mks

The following are the factors limiting the supply of entrepreneurship in Uganda:

- Poor education system in Uganda limits the supply of entrepreneurs. This is because it is too theoretical with limited emphasis on vocational skills that can increase the supply of entrepreneurs thus producing job seekers rather than job makers
- Low level of economic development. In Uganda there is low level of economic activities which do not attract entrepreneurs from creating more economic activities leading to low supply of entrepreneurs
- The small market size in the country. This limits the supply of entrepreneurs because it discourages many from investing their resources in different economic activities with no market
- Inadequate capital and other resources limit the supply of entrepreneurs. Inadequate capital existing in Uganda limits the level of economic activities because it is used to start a business, paying workers, accessing loans etc. This makes many potential entrepreneurs unable to set up various businesses thus limiting their supply
- Poor government policy in relation to investment. The investment climate in Uganda is associated with lengthy procedures of accessing trading licenses, corruption, high taxes on local entrepreneurs and low subsidies all these limit the supply of entrepreneurship
- Low level of profits earned by the existing entrepreneurs in Uganda. This limits other potential entrepreneurs from investing their resources in Uganda because it is not profitable yet the reward for entrepreneurship is profit thus limiting their supply
- Unstable political climate in Uganda limits the supply of entrepreneurship. This is characterized by constant demonstrations, strikes, riots etc which scare away potential entrepreneurs because they are not certain of the security of their property and lives
- Poor infrastructural development in the country. Infrastructure in Uganda is in poor state for example there is unstable and inadequate power supply, poor transport network especially in rural areas, uneven distribution of banks etc which discourage many potential entrepreneurs from investing in different economic activities
- Negative attitude towards work among Ugandans. This limits the supply of entrepreneurs in the country because many people do not want to work, they have negative culture towards work for example men among the Karamongs are not supposed to work it is the women to work for them

PROFITS

Profit refers to the monetary reward to an entrepreneur for undertaking risks to start a business.

It is the difference between a firms total revenue and the total costs of the firm i.e.

Profits = Total revenue - Total costs

Profit differs from earning to other factors in the following ways:

- Profit may be negative (loss) while other factor payments are usually positive

- Profits are uncertain unlike other factor payments i.e. the entrepreneur is not aware of the amount is going to get from his/her investment
- Profits are non-contractual in that they are only received in future when the business prospers
- It is the only residual payment which remains after all other factors have received their earnings
- They fluctuate more than any other factor payment

Types of profits

Abnormal profits/Economic Profits/super normal/pure/excessive: This refers to the profits made by a firm when average revenue is greater than average cost and attracts new firms into the industry.

Normal profits/Zero profits: This refers to the profits made by a firm at the point where average revenue is equal to average costs and do not attract new firms into the industry. It is a profit which is only enough to maintain entrepreneurship

Subnormal profits/Losses: This is the type made by a firm at the point where average cost is greater than average revenue.

Determinants of profits

Price levels: High prices charged by producers lead to high profits while low prices lead to low profits.

Level of taxation: Heavy taxes imposed on producers by the government leads to low profits while low tax levels lead to high profits.

Level of entrepreneurial skills: High entrepreneurial skills allow efficient organization of other factors of production leading to high profits while low entrepreneurial skills lead to low profits due to failure to organize factors of production efficiently.

Degree of risks involved in the job: Jobs that involve high risks yield high profits while less risky jobs yield low profits.

Level of output: High output levels lead to high profit level while low levels of output produced lead to low profit level.

Market size: A wide market encourages production which lead to high profit levels while a narrow market discourages production leading to low profit level.

Goal of the producers: Producers who aim at profit maximization tend to limit output and increase prices which leads to high profits while producers who aim at sales maximization produce more and charge low prices leads to low profit levels.

Functions of profits

1. **Profits helps in expansion of the firm;** Ploughing back profits helps to expand the firm to increase the level of production.
2. Profits stimulate innovations and invention which increases efficiency of the firm due to use of machines.
3. **Profits guide the government during taxation.** Tax assessment in a firm can be based on the volume of profits. This means that high profits high taxes charged
4. **Profits determine resource allocation:** Producers allocate more resources to production of those commodities which yield high profits and fewer resources to production of commodities that yield less profit.
5. Abnormal profit is an **incentive for production**. It encourages people/firms to increase out put levels. Profits can be re-invested into the business to enable increased production
6. Abnormal profits induce **risk bearing**. It encourages people to take uncertainties as opportunities by committing resources in them
7. Profit indicates whether the business is **growing or expanding**. I.e. a supernormal profit indicates that the business is efficient and expanding while a supernormal profit indicates that the business is declining
8. Profits protect the **firm from competition.** A normal profit or subnormal profit limits the entry of other firms into the industry. This safeguards the existing firm from competition
9. Profit is used to determine what to **produce and not what to produce**. The firms making abnormal profits are encouraged to produce more of those products and those making subnormal profits are encouraged to join other firms thus reducing wastage of resources

Factor Pricing:

Factor price refers to the monetary reward for a factor of production for its contribution to the production process.

Factor prices include the following:

- Wage for labour
- Interest for capital
- Rent for land
- Profit for entrepreneurship.

SUBSISTENCE AND COMMERCIAL PRODUCTIONPRODUCTION

BUSINESS UNITS

LEGAL FORMS OF BUSINESS

A legal business is the one accepted by the regulatory authority in the community to provide goods and services.

The following are legal forms of businesses in Uganda

(i) Sole proprietorship/sole trade.

(ii) Partnership

(iii) Joint stock companies

(iv) Co-operatives

(v) Exchange markets.

SOLE PROPRIATORSHIP/ SOLE TRADE

This type of business started, owned and managed by one person

A sole trader/ proprietor is a person who starts a business, owns and manages it alone.

FEATURES OF A SOLE PROPRIATORSHIP BUSINESS

- Capital is contributed by the owner
- The business is owned and controlled by one person
- The owner enjoys all the profits alone.
- The owner bears all the risks and losses of the business alone
- It requires less capital to be started
- It operates on a small scale ie produces a small volume of goods and services
- At times family labour is employed to assist the owner when he is absent
- The continuity of the business depends majorly on the life of the owner.

EXAMPLES OF SOLE PROPRIATORSHIP BUSINESSES IN UGANDA

Includes Kiosks, Single retail shops, barber shops etc.

ADVANTAGES OF SOLE PROPRIATORSHIP BUSINESSES

- It requires less capital since it operates on small scale which can easily be generated by many people.
- It is flexible .a sole trader can easily change from one line of business to another without seeking for legal requirements/ ideas
- Decision making is easy since it is a one man’s business. This is because there is no need to consult other people in formulating and implementing policies for the business.
- There is a direct contact with his customers which helps the owner to listen to his/her customers and understands their needs
- All profits are enjoyed by one person. A sole trader enjoys all the business profits alone since he is the owner of the business.
- There is close supervision of the business A sole trader can supervise his/her business clearly and closely since he/she operates the business fulltime.
- There is secrecy in sole proprietorship business. A sole proprietor keeps secrecy of the business since the sole trader is the only person who knows the secrets of his/her business.
- It encourages hard work, since a sole trader enjoys all the profits alone, he/she is encouraged to work hard in order to generate profits.
- The owner is independent and self reliant which helps him/her to implement his/her plans quickly.
- The business can easily expand because the profits and capital are not shared by many people.
- Business premises can work as accommodation to the owner hence reducing on the costs of renting.

DISADVANTAGES OF SOLE PROPRIATORSHIP BUSINESSES

The following are the disadvantages of sole proprietorship businesses;

- Lack of continuity. The existence of the business depends on the life of the owner i.e. If the owner dies, the business may come to a standstill because the family members may lack the interest in the business.
- The sole trader also faces the problem of ultimate liability i.e. His/her liability towards the business goes beyond the capital contributed or personal property e.g. if the business fails to settle the debts; his/her personal properties can be confiscated to settle the debts.
- It is tiresome since the trader works for long hours and there is no time to rest.
- The owner may lack skills and experience to conduct the business and this may lead to the collapse of the business.

- Limited capital may not easily carry out market research and advertising to increase sales.

Guiding questions

1 (a) Distinguish between sole trader and sole proprietorship

(b) Explain the advantages and disadvantages of sole proprietorship.

(c) Explain the reasons for the existence of many sole traders.

(d) Explain the challenges facing sole traders in your community

CHALLENGES FACING SOLE TRADERS IN OUR COMMUNITY

- Inadequate capital. When a sole trader doesn't have enough capital, he will not be able to plan for the business.
- Bad debts. Since most of the sole traders sell to low income earners, who eventually do not pay, it will lead to losses in the business.
- Unfavourable government policies like imposing heavy taxes on the goods being sold will also lead to increase in the cost of production.
- High levels of competition from other sole traders also lead to loss of profits in the business.
- Limited market for the goods. If there are few people buying the goods which you sell, it will lead to losses in the business.
- Inadequate business skills. If the sole trader has inadequate business skills like poor handling of customers, it will lead to loss of customers hence bringing low profits to the business.

WHY THERE ARE MANY SOLE TRADERS.

- It is very easy to manage since it operates on a small scale.
- It requires less capital since it operates on a small scale which can easily be generated by many people.
- It requires less labour since it is operated on a small piece of land and it can be managed by one person.
- It operates on a small space which can be accessed by any person
- Secrets of the family are kept safely since the sole trader is the only person who knows the secrets of the business.

PARTNERSHIP BUSINESS

It is a business unit where at least two business people put together their funds or resources in a common enterprise for the purpose of making profits.

OR

This is where two or more people up to the maximum of twenty combine their funds to start a business with the major aim of making profits.

FEATURES OF PARTNERSHIP

Membership ranges from two to twenty

Capital is contributed by the partners with no appeal to the public

Each partner is personally responsible for the profits and losses.

A partnership business can stop at any time due to death or withdraw/ bankrupt /incapacity of any member.

Each partner is responsible for all the debts of the business accept limited partnership

TYPES OF PARTNERSHIP BUSINESS

The following are the types of partnership businesses

1. Ordinary partnership
2. Limited partnership
3. Temporary partnership
4. Permanent partnership..

ORDINARY PARTNERSHIP. (UNLIMITED)

It refers to a partnership in which all members have unlimited liability. This means that all members are answerable to the debts of the business to the extent of selling off their personal property in case the business fails to pay.

LIMITED PARTNERSHIP

This is the one in which liability of members is restricted to the amount of capital they contributed

However, there must be at least one partner whose liability is unlimited.

TEMPORARY PARTNERSHIP

This is a type of partnership formed for a specific period of time expires; the partnership is dissolved or terminated/ ended/ liquidated

PERMANENT PARTNERSHIP

It refers to a partnership formed to operate/ continue indefinitely ie the end time is not known at the time of forming it.

TYPES OF PARTNERS

The following are the types of partners:-

(i) Active partners

These are partners who contribute capital, share profits and losses and are involved in the day to day running of the business.

(ii) Dormant partners (sleeping/silent)

These are partners who contribute capital, share profits and losses but do not take part in the running of the business

(iii) General partners (Unlimited)

These are partners whose liability towards the business's debts and losses is unlimited ie. They are unanswerable to the debts of the business up to the extent of selling their personal property in case the business fails to pay.

(iv) Limited partners

These are partners whose liability towards the business's debts is limited to only the capital contributed. This implies that in case the business incurs losses or debts their personal property is not affected.

(v) Quasi partners (Normal)

These are partners who do not contribute capital, share losses, do not take part in the management of the business but allow their names to be used by the business as partners.

(vi) Minor partners

These are partners below eighteen years of age.

(vii) Major partners

These are partners above eighteen years of age.

FORMATION OF PARTNERSHIP

If people come together to contribute capital and run a business under their names e.g Kazibwe and Musa start up a business and name it KAZIMUSA TRADERS, there will be no need to register it.

However, if their business is to operate under a different name e.g POLOKOTO enterprise, they will be required to register the business and to present a partnership deeds.

PARTNERSHIP DEED

This refers to a written agreement which governs the members of the partnership.

OR

It is a written agreement which states the terms and conditions under which a partnership business is conducted

CONTENTS OF A PARTNERSHIP DEED

- Name of the business of Firm
- Name, address, occupation of each partnership
- Type of each partner ie active, dormant etc
- The capital contributed by each of the partner
- It shows the way profits are to be shared
- It states the rights of each partner
- It indicates the duration of the partnership
- It shows the method of calculating good will at the time of retirement or death of any member.
- It shows the purpose for which the business is established
- It shows the procedures to be taken when dissolving the business
- It lays down the duties and responsibilities of the individual partners
- It shows how the books of accounts should be handled

DUTIES AND RESPONSIBILITIES OF EACH PARTNER

The following are the duties and responsibilities of each partner:-

1. Each partner should display ut most good faith i.e. to be trust worthy and honest in conducting business activities
2. Is a partner has a private business that competes with the partnership, all profits made by him/her should be surrendered to the partnership
3. The business has to refund the partner for the liabilities (losses) incurred by him in the process of conducting business activities

4. No new partners should be admitted without the concern of all other partners
5. No partner should be expelled without dissolving the partnership
6. Every partner has a right to act on behalf of the business from nominal partners' e.g signing documents

DISSOLUTION / LIQUIDATION OF A PARTNERSHIP

Liquidation refers to the bringing the existence of the partnership to an end. It can liquidate or dissolved in the following ways:-

(i) If it is a temporary partnership, it can be liquidated at specific period of time, expiry or stipulated in the partnership deed or after achieving its objective.

(ii) If the partners inform others in writing about the intention to dissolve partnership, they can sit, discuss and agree to dissolve it if reasons are justified.

(iii) If one of the partners becomes insane (mad) or dies, a partnership can be dissolved

(iv) If an event occurs which makes the partnership illegal then it will come to an end

(v) If the business can no longer make profits , it can be liquidated

(vi) If the partners act contrary to the partnership deed and damage the interests of the firm or businesses, the partnership can be liquidated

Questions

State the reasons that can lead to liquidation of a partnership business

Under what circumstances a partnership may be liquidated.

ADVANTAGES OF PARTNERSHIP BUSINESS.

1. More capital is raised in a partnership business compares to a sole proprietorship business. This facilitates the smooth running of the business.
2. Losses and debts are spread or distributed among partners who reduce the burden compared to a sole proprietorship business.
3. Expansion of the business is much easier because of the much capital contributed by different partners. This enables the partnership business to enjoy economies of the (advantages of large scale businesses)
4. Limited liability is enjoyed by limited partners ie incase the business fails to settle the debts, their personal property cannot be sold.
5. There is sharing of ideas because each partner consults another concerning different matters about their business hence producing good quality products.
6. There is privacy which ensures security of the business since affairs are kept privately
7. Partnerships are more flexible compared to joint stock; companies hence can change to any form of business agreed upon by partners.

8. Wise and proper decisions are made due to many ideas generated by different people. There are many chances of success of the partnership business because of different talents and abilities of different partners.
9. A partnership business is simple to form compared to a joint stock company there are few legal documents
10. There is reduced work load for each partner since there is division of labour and specialization.

DISADVANTAGES OF PARTNERSHIP BUSINESS

1. The liability of members/ partners is unlimited except limited partners implying that losses and debts of the business can lead to loss of personal property of general property.
2. Disagreements may arise in a partnership business may lead to its collapse. Partners are most likely to disagree on various matters e.g sharing off profits, leadership in the business etc.
3. There is delay in decision making process which affects the performance of the business. This is because many partners have to be consulted before a policy is passed on/ implemented.
4. Profits are shared by many which lead to the decrease in the amount received by each partner unlike in the sole proprietorship business.
5. A partnership business discourages hard work because if one partner works hard, the profits earned by the business as a result of his/her efforts are shared among the partners equally.
6. Continuity of the business is not certain (Clear) because death or bankruptcy or withdraw of active partners can lead to the collapse of the partnership.
7. If one partner makes a mistake e.g. a poor deal, misuse of funds etc, al partners have to suffer the consequences.
8. There is no withdraw of capital in a partnership business without acceptance or consent of other partners unlike in a sole proprietorship business
9. A partner is a person who agrees to join other members to contribute capital and start up a business with an aim of making profits.

Questions

Why is sole partnership business preferred to a partnership business?

Explain the advantages of a partnership business over a sole proprietorship business

The following are the reasons as to why sole proprietorship business is preferred to partnership business:-

- The sole proprietorship business requires less capital since it operates on a small scale unlike the partnership business which requires large capital
- The sole partnership business is more flexible since it is owned by one person unlike a partnership business which needs consultation from all partners to change to another line of business.
- Decision making is easier in the sole proprietorship business since there are no people to consult unlike the partnership business which slows down the process of decision making since every member has to be consulted.
- In sole proprietorship business, all profits are enjoyed by one person compared to partnership business where profits are shared by many leading to reduce amount by each partner.
- A sole partnership business encourages hard work since all profits are enjoyed by one person unlike partnership business which discourages hard work because all profits made by one person are distributed equally to each partner.
- In sole partnership business, the owner is independent and self-reliant which helps him to implement his plans quickly unlike a partnership where the plans are slowed down since all partners have to first be consulted.
- There is secrecy in a sole proprietorship business since one person knows the secrets of his business unlike in a partnership business where all the partners know the secrets of the business and one partner can spread it out to the non-members.
- A sole proprietorship business can expand easily since the profits are not shared by many people unlike in a partnership business where the profits are shared by many people
- In a sole proprietorship business, a person is free to withdraw capital at anytime without any body's concern unlike in a partnership business, a person has to first get acceptance from the other partners in order to get capital.

JOINT STOCK COMPANIES

It is a co-operate body of persons formed to carry out specific functions with the major aim of making profits.

<u>TYPES OF JOINT STOCK COMPANIES</u>

The following are the types of joint stock companies

(i) STATUTORY JOINT STOCK COMPANIES

These are joint stock companies created by the act of the parliament or formed by the government. The parliament defines the powers and functions of this company

Examples of Statutory joint stock companies

UEB/UMEME

UNEB

UBC

NWSC

(ii) REGISTERED COMPANIES

These are companies which are formed and registered under the companies' act of 1992. These companies are purely private and they are divided into different types namely:-

a) Limited companies. These are companies where the liability of members is limited normally to the normal value of the shares contributed ie personal property can't be sold to settle the debts of the company
b) Unlimited companies. These are companies where the liability of members is unlimited ie private property can be sold to cover the debts of the business
c) Limited by shares registered companies. These are companies where the liability of members is limited to the face value of their shares
d) Limited by guarantee registered companies. These are companies where the liability of members is limited by the amount of money guaranteed ie the amount of money accepted to be contributed towards the debts of a company

NB: Limited by share companies are further divided into two types namely;

Public limited companies

Private limited companies

FEATURES OF A JOINT STOCK COMPANY

Membership ranges 2-50 in case of a private limited company or 7-infinite in case of a public limited company

A joint stock company is separate (legal) entity from the owner implying that it can be sued or sue or it can take anybody in courts of law

Members contribute capital which is divided into small units called shares. Therefore a share is a unit of capital of a joint stock company.

Members buying shares in a joint stock company are called share holders. Therefore a share holder is a person who contributes capital to a joint stock company.

A loan contracted/got/borrowed by a joint stock company is called a debenture. Therefore a debenture is a unit of a loan of a joint stock company

NB: A debenture holder is a person who lends money to a joint stock company.

PRIVATE LIMITED COMPANIES

These are companies which constitute 2-50 share holders who put their capital together with the major aim of making profits

FEATURES OF A PRIVATED LIMITED COMPANY

1. It constitutes of members who range from 2-5- share holders excluding workers.
2. Its shares are not freely translated i.e. Members are not allowed to sell their shares to the general public or to another person.
3. It is not required to publish books of accounts to the public e.g. showing the performance of the company in a given period/time
4. The liability of members is limited to the capital contributed implying that personal property cannot be sold to settle the debts of the business
5. The size of the business is usually small and therefore share holders have direct contact with clients.
6. The founder members normally have majority shares in the company
7. A private limited company can start operating after getting a certificate of incorporation

Questions

(a) Explain the salient features of a joint stock company

b) State the features of a private limited company.

FEATURES OF A PUBLIC LIMITED COMPANY

1. A public limited company is a company formed by a minimum of seven members and no maximum numbers of share holders who put their resources together to run a business with the major aim of making profits
2. Its membership ranges from 7-infinity
3. The company's capital is raised by selling shares to the public and it's called the share capital
4. It starts operating after receiving a certificate of trading/trading licenses
5. Shares are freely transferable in a public limited company ie share enables the public to know the performance of the company
6. The owners of the company are called share holders.
7. It is managed by the board of directors
8. The liability of members is limited
9. There is continuity

DIFFERENCES BETWEEN PUBLIC LIMITED COMPANIES AND PRIVATE LIMITED COMPANIES

Membership in a public limited companies range from 7 to initiating share holders whereas membership in private limited companies range from 2-50 shareholders

In a public limited company, share holder is freely transferable whereas in a private limited company, shares are not freely transferable

A public limited company operates after receiving a certificate of trading license whereas a private limited company operates after receiving a certificate of incorporation

In a public limited company, there is publishment of its books of accounts to the annually whereas in a private limited company, there is no publishment of its books of accounts to the public.

In a public limited company capital can be got from the public whereas in a private limited company capital is only contributed by the share holders.

A public limited company is managed by the Board of Governors whereas a private limited company is managed by share holders

In a public limited company, employees are allowed to buy shares from the company whereas in a private limited company, employees are not allowed to buy shares from the company

In a public limited company, there is no direct contact between the share holders and clients whereas in a private limited company there is contact between the share holders and clients

SIMILARITIES

- Both need legal documents to start operating e.g trading license etc
- The liability of members in both companies is limited
- Both aim at making profits
- Both consist of more than one share holder
- If both companies, founder members normally have more shares.
- Their capital is divided into units called shares
- In both companies dividends are shared according to capital contributed

ADVANTAGES OF PUBLIC LIMITED COMPANIES

- Share holders enjoy limited liability which means that private property can't be sold to cater for the company's debts
- More capital can be raised from the public by selling more shares. This facilitates the smooth running of public limited companies

- Public limited companies operate on a large scale hence enjoy economies of the scale advantages of large scale industries
- Public limited companies find it easy to obtain loans from banks due to large collateral security (large capital contributed by share holders
- Public limited companies attract great entrepreneurs since they are managed by experts i.e. Board of Directors thus less risks are expected
- Shares are freed transferable. This enables share holders to sell off their shares at high prices during the period of economic boom hence earning high.
- Employees are allowed to buy shares in public limited companies. This gives them an added incentive to work harder. This encourages hard work among employees
- Publicity of the company’s book of accounts safe guard share holders against fraud, corruption and embezzlement of the company’s funds
- Continuity of the business is assured since the absence or death of one member doesn’t affect the business
- The public limited company may issue different shares to suit investment habits of different types of people

DISADVANTAGES OF A PUBLIC LIMITED COMPANY

- They are costly and difficult to establish since they require a lot of legal documents which is too expensive
- Most share holders tend to have a little say about the day to day business activities since they are in hands of Directors.
- There is delayed decision making in public companies due to many procedures involved in passing and implementing any policy
- Too much expansion of the company may lead to diseconomies (disadvantages resulting from operating on a large scale)
- There is no privacy in public limited companies since they are required to publish books of account of the public
- Directors of the company may have their own interest that may conflict with the interests of the company and the public
- There is a poor relation between customers and owners of public limited company since there no direct contact between the owners and customers

ADVANTAGES OF A PRIVATE LIMITED COMPANY

- Share holders enjoy limited liability hence their private property cannot be sold to settle the company’s debts

- It allows the owners to have direct control over its affairs since the size of the business is often small
- It is recognized as a separate legal entity. This means that in case of mistakes done by the share holders, the company can take them to courts of law. Similarly if the company makes mistakes, share holders can take it to courts of law
- Continuity of the company is assured since the absence or death of one share holder cant lead to the collapse of the company unlike in sole trade
- Dividends are paid to share holders depending on the capital contributed
- There is privacy in privacy limited companies since final accounts are not published in the public news papers
- More capital is raised under private limited companies since its membership ranges from 2-50 share holders
- Share holders elect their directors democratically. This builds team work in private limited companies

DISADVANTAGESOF PRIVATE LIMITED COMPANIES

- They are very difficult to form since they involve a lot of documents
- Private limited companies do not appeal to the public for share capital. This limits the growth and expansion of these companies
- Transfer of shares is not free since it is limited to approval to all members.
- There is no personal contact between the employees and the owners of the company
- Sharing of profits reduces the amount of dividends received by each partner
- There is lack of personal initiative (self drive) as compared to sole proprietorship business.
- The directors of private limited companies may have personal interests that conflict with the company

Sample questions.

1. (a) Explain the advantages of a private limited company over a public limited company

   b) Explain the advantages of a public limited company

   1(a)

There is privacy in the private limited company since final accounts are not published in the public unlike in a public company where there is no privacy since final accounts are published in the public

It is very easy to manage a private limited company because of the small number of share holders compared to a public limited company which is very difficult to manage since it has no maximum number of share holders

b)

In a public limited company, share holders are safe guarded against corruption, and embezzlement because the books of account are published to the public unlike in a private limited company where share holders are not safe-guarded against corruption and embezzlement of funds because the book of account are not published to the public

More capital is raised under public limited companies by selling shares in the public unlike in a private limited company where share holders are not allowed to sell shares to the public to raise more capital

Employees are allowed to buy shares in public limited companies which encourage them to work harder unlike employees in private limited companies who are not allowed to buy shares and this discouraged them to work harder.

Public limited companies have more accessibility to loans due to large collateral /security contributed by many members unlike in private limited companies where the membership is limited to some share holders hence limited the collateral security.

There is free transfer of shares from one person to another under public limited companies unlike in private limited companies where shares are not freely transferable

Public limited companies attract great entrepreneurs since they are managed by experts unlike in private limited companies with limited number of share holders and limited ability to employ experts.

FORMATION OF JOINT STOCK COMPANIES

For a joint stock company to be formed there must be people who develop the business idea. Such founder members are called promoters

To form a private limited company, two promoters and to form a public limited company, 7 promoters are required.

Promoters are required to submit the registrar of companies for the following documents;

1. Article of association
2. List of directors
3. Certificate of incorporation
4. Prospectus
5. A statement signed by directors showing that they have accepted to undertake a business
6. A declaration that all the requirements are fulfilled
7. Memorandum of association

MEMORANDUM OF ASSOCIATION

It refers to a document which governs the relationship of the company with outsiders or other companies. This document lays down and dentins the power and the limitations of the company while dealing with other companies.

It has 6 contents /clauses which include the following.

(i) The name clause

(ii) Situation clause

(iii) Objective clause

(iv) Capital clause

(v) Liability clause

(vi) Declaration clause

The name clause: It shows/ states the name of the company with the world limited at the end

Situation clause: It states the location of the company ie the name of the country and town in which the registered company is found/located.

Objective clause: It outlines the objective and aims for which the company is formed ie. Objectives of the company must be smart

Capital clause: This shows the share capital the company is supposed to have ie. The total amount of capital needed the value of its shares and the type of shares.

Liability clause: This states that the liability of share holders shall be limited to their capital contributed.

Declaration clause: It states/reveals the desires of people to form a public/private limited company

NB: This document has to be signed between a minimum of 2-7 members

ARTICLE OF ASSOCIATION

It refers to a document that lays down the rules and regulation of the internal control of the company; it is prepared by the founders of the company and issued to the registrar of companies.

It includes the following:-

(i) The time of share holders

(ii) Rights of the share holders

(iii)How share holders are transferred from one person to another

(iv)Direction of share holders ie their qualifications, duties and powers in the company

(v) Internal borrowing

NB: Before the registrar of companies give out the certificate of certification, the founders of the company have to list the following

(i) A list of Directors and these must have names and addresses of those people who have elected and proved to act as company Directors

(ii) Stationary declaration of compliancy with all existing and future company acts(law)

CERTIFICATE OF INCORPERATION

It refers to a document issued by the registrar of companies giving illegal acceptance of the company

OR

It is a document that allows the company to start operation in case of a private limited company

OR

It is a document which certify that the company is existing illegally

At this stage, the company freely formed and it is because a separate entity from its founders implying that it can sue.

A private company after given s certificate of incorporation can start the business but for a public limited company it starts operating a prospectus.

A PROSPECTUS

It refers to an invitation/ advertisation/ an offer to the public to subscribe / buy shares in a newly formed company

CERTIFICATE OF TRADING

This is a document issued by the registrar of companies allowing public limited companies start business. It is issued after a company getting enough share capital

Sample questions

1. (a) Describe the procedures of forming joint stock companied

   (b) Explain the steps involved in registering a company

2. (a) Distinguish between the name clause and a capital clause as used in the memorandum of association

   (b) Write short notes on the following:-

   (a) A prospectus

   b) Certificate of incorporation

   c) Article of Association

   d) Certificate of trading

SHARES

A share refers to a unit of capital of a joint stock company

People who own shares in a joint stock company are known as share holders

TYPES OF SHARES

There are two types of shares namely:-

(i) Ordinary shares

(ii) Preference shares

ORDINARY SHARES

These are shares that do not carry a fixed rate of dividends (profits)

NB: **A dividend** is a reward / profit earned by share holders. These dividends are paid to the share holders according to the performance of the companies ie. If the company performs well/gets profits, the ordinary share holders are paid higher profits (dividends) but if the company doesn't make profits, the ordinary share holders are not paid dividends.

PREFERENCE SHARES

These are shares that carry a fixed rate of profits /dividends. This means that whether the company makes profits or not, the preference share holders are not paid dividends.

Preference shares are of different categories and these include:-

(i) Accumulative preference shares

(ii) Non accumulative shares

(iii) Redeemable preference shares

(iv) Irredeemable preference shares

ACCUMULATIVE PREFERENCE SHARES

These are shares which are entitled to a fixed rate of profits (dividends) until they are paid ie If there are no profits made in a particular trading year, the profits are carried forward until they are paid

NON ACCUMULATIVE PREFERENCE SHARES

These are shares which are entitled to a fixed rate of profits/dividends only when the company has made profits. In a trading year where the company has not made profits, the profits are not carried forward.

REDEEMABLE PREFERENCE SHARES

These are shares that can be bought back by the company from share holders after a given period of time.

IRREDEEMABLE PREFERENCE SHARES

These are shares that cannot be bought back by the company from share holders after a given period of time.

SHARE CAPITAL

This refers to the initial amount of money that a company invests in a business. This money is normally raised by selling shares

The following are the major types of share capital,

Authorized /normal/registered share capital. This is the maximum amount of money that a company can raise by selling shares

Minimum share capital

This refers to the amount of money stated by promoters when applying to the registrar of companies as a minimum requirement to start the business.

Called up share capital

This is the actual amount of money that the share holders have been asked to pay.

Paid up share capital

This is the actual amount of money that has been received from share holders.

Issued share capital.

This is the total number of shares issued to the public

Un issued up share capital

It refers to part of normal share capital that is not issued out for resale to the public

Uncalled up share capital

This is the capital that is not yet needed i.e it is the capital which directors have not yet called for.

DEBENTURES

It refers to a unit of loan borrowed by a joint stock company

A company can borrow money from the public as part of its capital and it is supposed to pay a fixed rate of interest of the loan to the debenture holder after a given period of time.

TYPES OF DEBENTURES

Debentures are categorized into two major categories namely:-

- Naked debentures
- Secured debentures

NAKED DEBENTURES

These are debentures which have no security or property declared against them. This means that if the company fails to pay the debenture holder has no powers to take over the company's property or sued.

SECURED / MORTGATED DEBENTURES.

These are debentures which have security tied to them ie. If the company fails to pay, the debenture holder can sell off the company's property to recover the loan.

REDEEMABLE DEBENTURES

These are debentures that can be paid back by the company after a specific period of time ie the money borrowed is returned by the company within a given period of time.

IRREDEEMABLE DEBENTURES

These are debentures which are never paid back by the company until it is liquidated or ended i.e. the money borrowed remains outstanding or unpaid until the company winds up.

DIFFFERENCE BETWEEN SHARES AND DEBENTURES

A share is a unit of capital while a debenture is a unit of loan of a joint stock company.

A share holder earns dividends whereas a debenture holder earns interests

Dividends of a company depend on the profits made by the company whereas interests by a debenture depend on its interest rate agreed upon.

Debenture holders are creditors of the company while share holders are the owners of the company.

Share holders have aright to participate in the day to day activities in a company while debenture holders are outsiders ie do not participate in the day to day affairs of the company.

GENERAL ADVANTAGES OF JOINT STOCK COMPANIES

Share holders enjoy limited liability hence their property can't be sold to settle the company's debts

More capital is raise since its membership ranges from 7 to infinite.

There is continuity of the business since the absence or death of one member doesn't affect the business.

The larger the capital raised by the company enables it to employ high skilled workers thus improving the productivity and efficiency of the company.

Losses suffered by the business are shared by many members hence it is easy to overcome / solve them.

Companies have a greater chance of improving on the capital since the shares can be sold to the public.

They operate on a large scale hence enjoy economies of the scale.

Companies attract greater entrepreneurs since they are managed by experts and this is in case of public limited companies.

Companies enjoy economic scale inform of reduced average costs as a result of operating on a large scale.

Employees are given chance to buy shares in public limited companies. This gives them added incentives to work harder.

Publicity of the company's book of account safe guard share holders against corruption and embezzlement of the company's funds in case of a public limited company.

It is easy to obtain loans from banks due to large collabouration security in case of a public limited company.

GENERAL DISADVANTAGES OF JOINT STOCK COMPANIES

There is lack of personal initiative(self drive) which discourages hard work since the person knows that even though he/she didn't participate in the day to day running of the business, he is supposed to get his/her share.

They are costly and difficult to establish since they require a lot of legal documents which is too expensive

There is delayed decision making due to many procedures involved in passing and implementing any policy in case of public limited companies.

Transfer of shares is not free since it is limited to approval of all members in case of a private limited company.

There is no personal contact between the employees and the owners of the company in case of a private limited company which makes them relax while doing work.

Revision questions

1. (a) Distinguish between a limited liability company and a private limited company

   b) Explain the advantages and disadvantages of a limited liability company

2. (a) Distinguish between shares and debentures

   b) State the difference between shares and debentures

CO_OPERATIVE SOCIETIES

It refers to a voluntary organization set out by a group of people who come together to achieve a common goal e.g. people can come together for a purpose of supplying themselves with commodities at low prices.

Co-operative societies can be formed by farmers, producers, lawyers, teachers and other groups of people who have common interests.

Members who form co-operative societies are called co-operators.

FEATURES /CHARACTERISTICS OF CO-OPERATIVES

The minimum number of people to register a co-operative is 10

Any person can join a co-operative society regardless of his/her sex, political ideologies, tribe, race etc.

Co-operative societies in Uganda are managed by an elected management committee must be co-operative.

Each member is entitled to one vote irrespective of the number of shares that person has in a co-operative society.

Shares of co-operatives are not freely transferable ie transfer of ownership of shares is not possible.

A co-operative society can issue as many shares as possible.

Voting by proxy is limited ie. Voting on some ones' behalf is restricted.

PRINCIPLES OF CO-OPERATIVES.

Co-operatives operate on the following principles or guidelines

i) Open membership. Anybody regardless of sex, tribe age ,political, social and economic status is free to join the society.

ii) Democratic control/election: Every member is entitled to one vote and can stand for any office if he/she is capable of serving ie. One can contest for any post on the management committee.

iii) Distribution of profits: Members are entitled to the share of profits made during the year inform of dividend or payments.

Payment of dividends depends on member's contribution or volume of business he/she has transacted with the co-operative e.g. with agriculture and producers or producer co-operative , dividends are shared according to the amount of produce a member has sold to the society whereas with consumer co-operatives, it will depend on the member's purchase from the society.

iv) Co-operation with other co-operatives. This principle states the extent to which the co-operative should relate with other co-operatives at local and international level since they have a lot in common and can learn from one another.

v) Promotion of unity. Members in co-operatives should be neutral to avoid social, political and economic differences so as to promote inner unit within the society.

vi) Limited interest: The main purpose of setting up a co-operative society is not about getting profits or investment but to encourage members to participate in activities of co-operatives. Therefore the return on capital should not be considered as a priority in this co-operative society.

vii) Promotion of education. Every member should have real knowledge of the objectives of his /her society and this is done by educating the members

THE CO-OPERATIVE MOVEMENT IN UGANDA

This constitutes the structure of co-operatives in Uganda

The structure has the following levels:-

i) Primary co-operative societies

This constitutes all co-operative societies at village level e.g consumers and producers co-operative societies

ii) Secondary co-operatives: This constitutes all district co-operative unions ie. All co-operative societies in a district come together and form a co-operative union eg. Wholesaler co-operative societies.

iii) Uganda co-operative alliance.

It constitutes of members from both secondary and primary co-operative societies. The Uganda co-operative alliance is the top most co-operative responsible for controlling and co-coordinating all national affairs of co-operative movements

MAJOR TYPES OF CO-OPERATIVES IN UGANDA

The following are the major types of co-operatives in Uganda:-

i) Growers or producers co-operative societies

ii) Consumer co-operative societies

iii) Transport co-operative societies

iv) Savings and credit co-operative societies

v) Wholesale co-operative societies

Growers or producers co-operative societies

It is a co-operative formed by producers or farmers to enable them acquire farm inputs at subsidized /reduced prices, collect and stabilize prices.

Objectives of growers/ producers co-operative societies

- To assist farmers acquire farm inputs e.g. garden tools, fertilizers improved seeds etc.
- To provide financial assistance inform of loans to farmers or members of the society.
- To collect farmers' produce from the gardens and transport it to where it is needed.
- To store farmers' products until when the market is available.
- To establish prices of the farmers' produce.

CONSUMER CO-OPERATIVE SOCIETIES.

These are co-operative societies formed by final consumers with the major aim of purchasing and distributing goods amongst members at a minimum price possible.

FUNCTIONS/ OBJECTIVES OF CONSUMER CO-OPERATIVES

- To provide members with goods at reduced price.
- To protect members against exploitation by middlemen
- To encourage members to save by keeping part of their profits with the co-operative society
- To reduce on excessive profits which would have been enjoyed by middlemen
- To acquire goods from remote areas where individual members may be afraid to reach.

WHOLESALE CO-OPERATIVE SOCIETIES.

These are co-operative societies usually formed at a district level whose membership is made up of consumer co-operatives, with the major aim of controlling production and distribution of goods for the benefit of consumer co-operatives.

OBJECTIVES/FUNCTIONS OF WHOLESALE

They control all the activities of small consumer co-operatives.

To extend credit facilities to consumer co-operative society members.

To supply goods to its members on wholesale basis.

To import and provide storage facilities for various types of goods.

SAVINGS AND CREDIT CO-OPERATIVE SOCIETIES

They are co-operative societies formed to encourage the saving of money among members who may be consumers or producer or a group of people

OBJECTIVES OF SAVINGS AND CREDIT CO-OPERATIVE SOCIETIES

- To encourage members to save part of their income by opening up an account with them.
- To give loans to members of the society loans at a low interest rate.
- To conduct training programmes regarding savings and investment.
- To share profits amongst members according to the amount each member has saved and got from the society.

TRANSPORT CO-ORPERATION SOCIETIES.

These are societies formed to ease transportation facilities of other co-operative societies.

ADVANTAGES

They provide low costs of transport for members of the co-operative societies.

THE ROLE OF CO-OPERATIVE SOCIETIES IN THE DEVELOPMENT OF UGANDA (ADVANTAGES)

They provide revenue to the government inform of taxes charged on their activities. Revenue collected enables the government to provide social services to the people.

They provide employment opportunities e.g drivers and conductors in transport co-operative societies hence improving on their standards of living.

They provide credit facilities to people/members inform of loans, credit supplies etc. e.g. credit and saving co-operatives.

They promote community development programmes/ improve on infrastructural development in their communities. eg. Constructing roads, sponsoring sports programmes. Etc

They stabilize prices of the commodities through negotiating with different buyers from different areas.

They promote savings and investments by encouraging members to save part of their income. This enables them to set up different business activities.

They provide extension facilities to farmers by setting up demonstrational farms which teach farmers better methods of farming.

They protect consumers from over exploitation by middlemen through selling goods to members at a relatively low price eg. Consumers' co-operatives

They provide transport and storage facilities for their members produce

They provide market for their members produce through carrying out market research in different parts of the country.

They provide farmers with farm inputs inform of incentives, pest sides, tools like hoes, pangas etc. this facilitates agricultural development.

THE THEORY OF A FIRM.

A firm can be defined as a single unit of production in an industry which is under one control management that is involved in production of goods and services.
Alternatively, it is a production unit under unified control and management.

Examples of firms.

- Uganda breweries company ltd.
- Uganda batteries,
- New vision publishing company,
- Roofing's limited Uganda,
- Uganda clays, among others.

An industry refers to a group of firms engaged in production of a given commodity using similar or related in put. OR,
It is a collection or group of firms producing similar or related goods e.g bread industry with firms like hot loaf, tip top and others.

OBJECTIVES OF A FIRM.

1. To maximize profits by producing the level of out put at a point where marginal cost = marginal revenue.(MC=MR).
2. To maximize sales revenue that is, to people especially family members and good working environment.
3. To bring about proper utilization of resources and also helping to check on duplication of resources.
4. To provide essential goods and services at fair prices.
5. To protect the national interests and ensure economic security to the nationals.
6. To ensure long run survival for continued existence in production and on the market.

QNS. a) Give four objectives of a firm.

Firms are of different sizes in that some are categorized as large and others as small. The size of the firm **may be measured by any of the following**.

1. Amount of inputs used like, capital. Large amount of inputs used by a firm implies that a firm is large and small amount of inputs imply that the size of the firm is small.
2. The productive capacity of the firm in terms of volume of the output. A high level of output produced implies that a firm is large but a low level of output produced implies that the size of a firm is small.
3. The size of the market served by the firm. A firm that employs a large number of people is considered to be large in size compared to a firm that employs a small number of people. This firm is considered to be small in size.
4. Annual profits earned by a firm. Large firms earn high profits annually compared to small firms that earn low profits annually.
5. Number of people employed by a firm. A firm that employ a large number of people is considered to be large compared to a firm that employs a small number of people this firm is considered to be small.

6. Area occupied by the firm.

FACTORS THAT DETERMINE / AFFECT THE SIZE OF A FIRM.

The following are factors determining the size of a firm.

1. Availability of factors of production. Adequate supply of factors of production enables firms to operate on large scale thus becoming large in size but inadequate supply of factor inputs e.g. capital, labour, land etc limits expansion of firms thus remaining small in size.
2. Market size available. A large market size enables firms to expand easily since they produce large volume of out put to satisfy existing market hence becoming large in size but small market size limits funds to expand since they produce only what is demanded thus remaining small in size.
3. Objective of a firm. Firms whose objective is to operate on a large scale and expand their market sales are big in size unlike firms whose objective is to operate on a small sale and to just attain long run survival, such firms are small in size.
4. Freedom of entry into the industry or nature of the market structure in which the firm is operating. Free entry of firms into the industry enables a firm to expand easily due to existence of supplementary firms which facilitate activities of the main firm but limited or blocked entry into the industry limits firms from expanding hence remaining small in size.
5. Level of technology used. Firms that employ advanced technology produce on a large scale thus expanding easily but firms that employ rudimentary technology produce less output and remains small in size.
6. Level of management. Good quality management favors firms to operate on a large scale due to clear objectives and policies set and implemented but firms with poor quality management dominated by unskilled and inexperienced administrators remain in small size.
7. Possibility of merging. Merging of firms leads to easy expansion which enables the merging firm to become large in size compared to limited possibility of merging which makes the existing firms to remain small in size.
8. Nature of output produced by the firm. A fir that produces high quality products has a high demand for its products which enables it operate on a large scale compared to a firm which produces low quality products which operates on a small scale and remain small.
9. Government policy on industrialization. Favorable government policy on industrial development i.e. high subsidies and low taxes levied enables firms to expand easily but unfavorable government policy of high taxes and low subsidies limits firms to expand thus remaining small in size.

QN. Examine the factors affecting the size of a firm.

Trace the factors limiting the size of a firm.

Why firms of different sizes exist in the same industry

The following are reasons for the existence of firms of different sizes:

1. Difference in entrepreneurial skills. Firms with good quality entrepreneurs expand easily due to the ability of the owners to mobilize resources hence becoming large in size but firms that have low quality entrepreneurs operate on a small scale
2. Difference in the amount of capital employed. Firms with large amount of capital buy the necessary facilities in large quantities hence operating on a large scale but firms with limited capital operate on a small scale due to inability to access all factor inputs needed for expansion
3. Difference in the size of the land owned/occupied by the business. Firms with large pieces of land expand easily hence operating on a large scale but firms with limited land operates on a small scale due to inability to expand
4. Difference in market size available. A large market size enables firms to expand easily since they produce large volume of output to satisfy existing market hence becoming large in size

but small market size limits funds to expand since they produce only what is demanded thus remaining small in size.

5. Difference in objective of firms. Firms whose objective is to operate on a large scale and expand their market sales are big in size unlike firms whose objective is to operate on a small sale and to just attain long run survival; such firms are small in size thus leading to a difference in the size of firms
6. Difference in freedom of entry into the industry or nature of the market structure in which the firm is operating. Free entry of firms into the industry enables a firm to expand easily due to existence of supplementary firms which facilitate activities of the main firm but limited or blocked entry into the industry limits firms from expanding hence remaining small in size.
7. Difference in the level of technology used. Firms that employ advanced technology produce on a large scale thus expanding easily but firms that employ rudimentary technology produce less output and remain small in size.
8. Difference in the level of management. Good quality management favors firms to operate on a large scale due to clear objectives and policies set and implemented but firms with poor quality management dominated by unskilled and inexperienced administrators remain in small size.
9. Difference in accessibility to possibility of merging. Merging of firms leads to easy expansion which enables the merging firm to become large in size compared to limited possibility of merging which makes the existing firms to remain small in size.
10. Difference in the quality of output produced by the firm. A firm that produces high quality products has a high demand for its products which enables it operate on a large scale compared to a firm which produces low quality products which operates on a small scale and remain small.

REASONS FOR THE PREDOMINANCE OF SMALL SCALE FIRMS IN YOUR COUNTRY

The following are reasons for the dominance of small scale firms in my country:

1. Fear of managerial problems. Entrepreneurs fear the challenges associated with managing large scale firms hence setting up small scale firms which can easily be managed
2. The need to maintain personal contacts with customers. Businessmen prefer to have a close contact with their customers and supply accordingly hence the predominance of small scale firms in the country
3. Limited market for products produced. This scares producers from producing on a large scale due to fear of losses thus operating on a small scale
4. Limited raw materials to produce on a large scale. Some raw materials are scarce and therefore difficult to get which makes producers to operate on a small scale thus causing predominance of small scale industries
5. Limited capital for expansion. Many entrepreneurs in Uganda have inadequate capital to set up large scale firms. This explains the predominance of small scale firms in Uganda
6. Interdependency of firms for example sweet making firms on sugar cane processing firms leads to dominance of small scale firms. This is because big firms like sugar processing determine the output of small scale firms like sweet making firm
7. Under developed infrastructure/poor infrastructure. These include poor roads, under developed banking system, unstable power supply etc. These hinder the movement of goods from production places to market areas which causes business losses. T his makes producers to operate on a small scale
8. Political instability in some parts of the country scares entrepreneurs from large scale investment in such areas due to fear of losing large sums of money thus operating on a small scale

9. Some small scale firms act as branches for the main firms e.g. some firms act as branches for Cocacola Company as distributors/agents. This leads to predominance of small scale firms
10. Some small scale firms act as supplementary firms to other big firms. For example they provide raw materials to other large scale firms like sugar cane out growers providing sugar cane to Kakira processing firm
11. Some small scale firms are complementary firms to large scale firms i.e. they provide market to products produced by large scale firms
12. The favourable government policy of encouraging small scale firms. The government provides support in form of capital, land, tax exemptions etc to small scale firms for their growth and expansion
13. Small scale firms are easy to start due to limited legal procedures required. This attracts many entrepreneurs to set up small scale firms
14. Fear of heavy taxes imposed on large scale firms. Owners of small scale firms do not wish to expand their scale of production because they fear to pay heavy taxes imposed on large firms
15. Fear of diseconomies of scale associated with large scale firms. Owners of small firms fear to expand due to increasing average costs associated with large scale firms
16. The need to provide employment opportunities to family members. Many small scale firms are set up to provide jobs to family members therefore they see no need to expand

Account for the survival of small scale firms alongside large scale firms in your country

1. Small scale firms provide goods at fair prices to customers compared to the high prices charged by large scale firms leading to their survival alongside the large scale firm
2. Small scale firms have close contact with customers hence ready market for their products. They easily get to know their customer's complaints and needs thus surviving alongside large scale firms
3. Small scale firms are easy to manage due to small scale operation. This leads to effective monitoring and supervision thus their survival
4. Small scale firms are flexible; they easily change from one line of business to another in case of losses thus surviving alongside large scale firms
5. Small scale firms act as branches for large scale firms for example they act as distribution ground for the goods produced by large scale firms
6. The favourable government policy of encouraging small scale firms. The government provides support in form of capital, land, tax exemptions etc to small scale firms for their growth and expansion
7. Some small scale firms act as source of raw materials to large scale firms for example palm growing firms providing palm fruits to BIDCo Uganda limited
8. Small scale firms are easy to start due to limited legal procedures required. This attracts many entrepreneurs to set up small scale firms
9. The need to provide employment opportunities to family members. Many small scale firms are set up to provide jobs to family members therefore they see no need to expand

ADVANTAGES OF SMALL SCALE FIRMS

- Create many job opportunities in the country. This stimulates peoples' income levels hence improving on standards of living

- They act as training ground for local entrepreneurs hence promoting self sufficiency in the country
- They increase on the GDP and national income of the country by producing many goods and services. Hence promoting economic growth and development
- They encourage the development of infrastructure/promotion of infrastructure development e.g. the road net-work and storage facilities, power supply since they facilitate business activities
- They reduce income inequalities in the country. Small and medium firms enable low income earners to set up their own businesses and get employed in them
- They promote/promotion of technological development. Small and medium firms act as a basis for the development of indigenous technology like iron smelting, pottery etc (they promote innovation and invention). Which in the long run lead to technological development
- They produce/production of affordable goods and services for the poor and this improve the well being of the poor.
- They improve on the balance of payment position of the country through promoting exports and reducing importation of commodities
- They promoting economic diversification. Small and medium firms engage in a variety of goods and services hence reducing the danger of relying on hone line production
- They enable workers to acquire practical skills. This improves on labour efficiency and productivity
- Provision of government revenue through taxes. This enables the government to extend social services to its people
- They promote self sufficiency or self sustenance. Since many people are employed in their own businesses
- They promote backward and forward linkages. This leads to leads to balanced growth and development since each sector supports the other
- They utilize the would be idle resources in the country. This accelerates economic growth and development
- They widen consumers' choice since they produce a variety of goods and services
- Reduce regional imbalance in economic development since many small and medium firms are scattered in all most all parts of the country
- Provision of market for other people's produce. Employees of small and medium firms buy consumer goods from the local communities

Negative role

- They worsen congestion in semi-urban areas
- They waste resources through unnecessary competition
- They have a limited contribution to employment
- They under utilize the locally available resources
- They cause pollution which reduces the quality of life
- They have a low contribution to government revenue
- They produce poor quality goods.
- They produce low out put

GROWTH OF A FIRM

Firms can grow in two major ways.

i. Natural / internal growth.
ii. Artificial / external growth.

Natural growth; is where a firm grows through re-investing the profits it makes or by engaging in production at all stages all by producing a variety of goods and services.

Artificial growth/ integration / amalgamation; is where two or more firms producing similar or related products join to form one bigger firm to enjoy economies of scale.
NB. **Mergers** are firms that have pooled their assets and operate jointly as one production unit.
CATEGORY / TYPES OF MERGING.

Horizontal merging/ integration. This is the union of two or more firms in the same line of production and at the same stage to form one large firm e.g. Uganda Breweries merging with Nile Breweries. The major aim of horizontal merging include;

- To reduce the competition among firms.
- To enjoy the monopoly power over the market.
- To enjoy economies of scale by reducing on costs of production.
- To reduce excess capacity in order to produce to optimum level.

Vertical merging. This is the union of two or more firms in the same line of production but at different stages of production e.g. a tea growing firm merging with tea processing firm.
OR, it is where a bigger firm at a higher stage of production merges with a small firm at lower stages of production with the major aim of getting raw materials or towards the source of supply (raw materials).
Vertical merging takes two forms; Bark ward and forward merging.
Backward /vertical merging, This is where the merging of two firms is about the source of raw materials like coffee processing firm merging with coffee farmers.
Reasons for backward merging.

- To ensure a good supply of quality materials.
- To consider and receive a constant supply of raw materials.
- To enjoy more profits by eliminating middle men.
- To reduce competitors of raw materials by having suppliers of such raw materials as full members of such companies.

Forward merging.
This is where the merging of two firms is towards market out lets. Or, It is where a small firm at lower stages of production merge with a big firm at higher stages of production toward market outlets.
Reasons for forward merging.

- To increase on the number of market outlets so as to expand the market share.
- To reduce competition for market with other firms.
- T o ensure proper product distribution.

Lateral merging.
This is the merging of two or more firms producing different but related products which are not competing but can be marked together. The major aim in this case is to achieve market economies of scale. E.g. a tea producing company joining with a sugar producing company.
Other examples include; a shoe producing company with a shoe polish producing industry.
Conglomerate merging.
This is the joining of two or more firms producing completely different and unrelated products with a major aim of diversifying their activities so as to reduce risks of over depending on one product. E.g. a firm producing fertilizers merging with another one producing ice cream.
Cartel merging.
Merging of two or more firms with the major aim of selling the commodities/ products through a central selling agency at uniform prices.
NB. The combination of firms can also be judged on its degree and outcome. At times these are referred to as methods or forms of merging.
FORMS / METHODS OF MERGIN.
Compete merging/ amalgamation. This involves the dissolution of two or more firms intending to merge to create a new firm like, if firm A joins firm B and a new firm C is formed.

Absorption amalgamation / take over. This involves one firm buying off all the assets of the other firm for example Barclays bank took over Nile bank, airtel took over warid, that is to say, one company retains its entities and the owners of the other liquidating become share holders of the company buying / take over company.

Holding and subsidiary firms. This is where two or more firms join with each other firm retaining its existence but one firm acquires major controlling shares in the other. In this case, the bigger firm is known as holding firm and the other subsidiary firm. E.g. New vision over Bukedde.

Reasons for merging.

- To attain monopoly power.
- To improve on the quality of output produced.
- To promote efficiency in production.
- To effectively or optimumly utilize the resources.
- To diversify production activities.
- To reduce competition for market.
- To improve the ability to access capital.
- To enjoy economies of scale through increasing output.
- To access better technology.
- QNs. Why is it necessary for firms to merge?
- Of what necessity is merging in your country?
- Justify the need of merging in your country.

ADVANTAGES OF MERGING OF FIRMS.

1. It improves on the quality of output produced.
2. It improves efficiency in management. Merging makes it easy to hire skilled and experienced manpower by bigger firms due to sufficient funds which results into managerial efficiency.
3. It reduces on competition. The merging of firms especially when producing similar products and at a similar stage eliminates wasteful competition for raw materials and market
4. It reduces costs of production. After merging, different firms begin using similar facilities, same manpower and spending at once like on advertisement there by reducing costs and maximizing profits.
5. It minimizes duplication of products after merging of firms (horizontal merging), Firms begin producing commodities in agreed quantities and quality hence reducing wastage of raw materials and duplication of products.
6. It enables firms to access better technology. After merging, the bigger firm is in position to perform better methods of production which results into increased quality and quantity of produce.
7. It widens the market of the merging firms. Merging of firms makes the merging firm or the new firm created to monopolize the market or increase on market share.
8. It promotes full utilization of resource. This is because after merging, the firm has more chances of serving a bigger market, access skilled labour and fertilities required to produce at optimal level of output.
9. It results into low prices of commodities. After merging, the new firm created operates and a large scale and enjoys economies of scale in form of reduced average cost hence charging low prices for commodities

10. It enables the merging firms to access financial facilities. After merging, firms easily access loans easily from financial institutions because of adequate collateral security acquired by merging firms. This facilitates easy expansion of merged firms.
11. It promotes research in the merging firms. After merging, the merging firms (new created firm) are in better position to facilitate research activities intended to improve on the quality of products.

It enables the merging firms to share risks, After merging, all risks involved in production become less felt because the new bigger firm is able to safe guard ageists such risks e.g. by undertaking new insurance policies, diversify the production activities, etc

QNS. Explain the merits of merging of firms.

Trace the benefits of horizontal and vertical merging of firms.

DISADVANTAGES OF MERGING.

1. It leads to unemployment. Because workers of the company being absorbed lose their jobs to the workers of the main company.
2. After merging, new firm can maintain the same number of workers which means that workers of the other firms remain unemployed.
3. It results into monopoly tendencies and their adverse effects e.g. exploiting customers in form of high prices, poor quality products etc. Due to lack of these substitutes of their products.
4. It results into managerial problems. This is because after merging, the firm becomes too big to be properly supervised.
5. It limits the independence of the merging firms and this retards their expansion.
6. It leads to over exploitation of resources which makes the future generation vulnerable to scarcity of resources. This is due to skilled workers and increased capital obtained by the merging firm.
7. Merging reduces competition in production which results in production of poor quality goods and services.
8. It attracts higher taxes from the government which reduces the profitability of the merging firms.
9. It leads to loss of customers of the merging companies hence reduction in the market.

FACTORS LIMITING THE MERGING OF FIRMS.

1) Fear of diseconomies of scale. Firms may be reluctant to merge with others in order to avoid the disadvantages of operating on a large scale e.g. marketing diseconomies, welfare diseconomies, transport diseconomies and managerial diseconomies.
2) Fear of losing personal contacts. Some firms may prefer remaining independent In order to maintain close contact with their customers.
3) Fear of complicity in management. Some firms fear to unite with others because of the managerial problems associated with large scale firms e.g. conflicts over power, role conflicts etc.
4) Fear of becoming unemployed. Some firms fear to merge with others because they fear to make their employees unemployed since after merging some employees may not be accommodated in the new firm created.

5) Desire to become independence. Some firms fear to loose their identities after merging with others and therefore decide to remain independent hence making merging of firms difficult.
6) Difference in objective of firms. Firms with different objectives i.e. some aim at profit maximization while others aim at improving on their employees' welfare or maximizing sales thus making it difficult for such firms to merge.
7) Existence of anti-monopoly laws. Government laws against merging of firms make it difficult for different firms to merge e.g. the high lump sum and specific taxes changed on profits of monopoly firms.
8) Difference in the level of development of merging firms. Firms at advanced level of development may fail to merge with those at low level of development since there is advantage from their merging.
9) Ignorance of firms about the advantages of merging such see no value of merging and they stay separate hence limiting merging.

QNS.

a) Examine the consequences of merging of firms.
b) Explain the advantages of and disadvantages of merging.
c) Under what circumstances may firms fail to merge?
d) Trace the consequence of amalgamation of firms.

FACTORS THAT DETERMINE THE GROWTH AND SIZE OF A FIRM.

The following factors determine the growth and size of a firm.

1) Size of the market. Firms with a large market are encouraged to produce large out put in order to satisfy their customers which enables them to expand easily, but firms with a small market produce less out put end have limited growth.
2) Size of the existing capital stock. Firms with a large capital are able to operate on a large scale and make large sales which enables them to grow very fast in size compared to firms with limited or inadequate capital such firms operate on a small scale and have limited growth.
3) Level of technology. Firms using modern and efficient technology are able to produce high level of out put and of a good quality which increases their market share and sales revenue while firms with rudimentary technology produce low level of out put and power quality which limits their growth.
4) Level of supply of raw materials are able to produce on large scale hence growing very fast and able to produce on large scale compared to firms with inadequate and un reliable sources of raw materials.
5) Size of existing land for expansion. Firms with very large piece of land for expansion are able to grow very fast because space is enough to cater large scale operation while firms with limited land / space operate on a small scale thus limiting their growth.
6) Level of supply of workers. Firms with a large number of skilled workers grow very fast because they use workers to produce high level of out put however firms with limited supply

of skilled labour have limited growth since it is hard for them to produce on a large scale and high quality output.

7) Government policy of subsidization and taxation. Favorable government policy inform of low taxes charged on firms and subsidies granted for given to firms to enable them retain a big percentage of the profits made for re-investment however, unfavorable government policies towards the growth of firms inform of high taxes and low subsidies limit the growth of firms since they reduce profits which would have been used to expand such firms.
8) Level of entrepreneurship. Firms with highly skilled and trained entrepreneurs register high growth because such people are able to mobilize and supervise other factors of production for increased out put but, firms with poor entrepreneurship skills have limited skills due to inability to mobilize factors of production to operate on a large scale.
9) Existing economic atmosphere/ level of economic stability. Economic stability in form of low level of inflation, limited fluctuations in exchange rates etc creates a favorable investment climate for different firms. This enables them to grow very fast however, economic instabilities such as high level of inflation, foreign exchange shortages etc , limit firms forms from further investments.

LOCATION AND LOCALIZATION.

Location refers to the setting up of a firm in an area irrespective of whether there are other firms in that area or not.

OR, It refers to a particular place where a firm is established.

When choosing the location of a firm, the producer makes sure that the costs have to be minimized so that profits are maximized.

Since the major aim of firms is to maximize profits, firms will try to locate establishments at the lowest cost. locations where firms can easily get the factors of production at a low price.

FACTORS DETERMINING THE LOCATION OF FIRMS.

1. Availability of power and energy. Many firms that make use of heavy machinery equipment have to be located in areas where there is adequate energy and power but those that don’t need power are widely spread.
2. Availability of market. Some firms have to be established in a place where there is market. This is especially true to those firms whose goods are perishable or fragile. But those other firms that produce commodities that are neither perishable nor fragile can be located far from the market.
3. Availability of raw materials. Firms are usually located at the source of raw materials and this is true for those firms that use materials that are bulky and perishable. But for those firms which use inputs which are neither perishable nor bulky tends to be widely spread.
4. Availability of transport and communication system for easy transportation of inputs and final output. Firms tend to concentrate in areas with good and adequate transport routes e.g. roads.

5. Availability of water especially for those firms that use water main input e.g. breweries. Water is also used in the cooling machines and as a media through which industrial waste is disposed off.
6. Availability of auxiliary /supportive services like transport, banking, insurance name it. Firms mainly locate in areas where such services are.
7. Availability of land like those firms involved in agriculture. Some firms tend to locate in suburbs and in rural areas where the cost of land is low and there is room for expansion.
8. Political climate. Many entrepreneurs would wish to establish their firms in areas which are politically stable. The government policy regarding location.
9. The government policy regarding location of firms i.e. providing employment to people, provision of essential goods and services etc. firms are located in places encouraged by the government
10. Location of firms especially those that provide inputs for the firm in question.

QNS.

1. Distinguish between location and industrial inertia.

Industrial inertia refers to the tendency of an industry to locate /continue surviving in an area where there are other industries / where other industries exist even when factors which led to location in that area no longer apply.

REASONS WHY GOVERNMENT SHOULD INFLUENCE THE LOCATION OF AN INDUSTRY.

- To provide employment opportunities to people.
- To promote balanced regional development and therefore check on problems associated with rural urban migration.
- To fulfill the political obligations.
- To ensure proper utilization of resources i.e. exploit the resources that would other wise remain idle.
- To minimize the advanced effects of localization e.g. pollution, congestion, high costs of living, accidents etc.
- To control monopoly tendencies.
- To avoid unnecessary duplication and wastage of resources.

Qns.

Define location.

Give three reasons why government should influence the location of the firm in your country.

- To transform country’s economy from subsistence to commercial.
- For strategic reasons like defense.
- For regional balance development.
- To reduce social costs.

LOCALISATION OF AN INDUSTRY.

It refers to the concentration of industries in a given area/region. This implies that all firms that deal in production of a given commodity allocated in a particular area. This may be as a result of availability of market for the products in the area availability of adequate power.

ADVANTAGES OF LOCALIZATION.

1. It creates employment opportunities to people in that area. Job opportunities are generated through various linkages.
2. Promotes the development of infrastructure e.g. power and energy, transport communication network. These develop as for the industries to effectively to their work, they must be available.
3. Promotes the development of subsidiary industries in an area. That is they provide inputs to the industry.
4. Leads to the development of institutions that provide auxiliary services like banking, insurance, and institutions. Etc.
5. Improves on the quality of the products of the industry due to competition in the area.
6. It increases the availability of skilled labour needed by the industry which is of benefit to the new firms that may come up.
7. It promotes linkages i.e. forward and back ward linkages in the firms and industries.

NB.

Back ward linkage is where existence of an industry leads to setting up of a new industry to supply the existing industry with inputs/raw materials.

Forward linkage; Is where setting up of an industry results into emergence of another industry with a newly established plant/industry creating market for the product of the already existing industry.

DISADVANTAGES OF LOCALIZATION.

1. It leads to over exploitation of resources in the area.
2. It leads to rural-urban migration and its associated consequences like prostitution.
3. It leads to environmental degradation in an area due to pollution.
4. It leads to income inequality in the country and the people in localized area and other areas.
5. It leads to imbalances in regional development as the industries are only concentrated in that particular areas therefore they tend to develop more than other areas.
6. The country's economy becomes highly dependant in that particular thus incase of any danger the entire economy is likely to suffer.
7. It leads to over straining of the existing infrastructure because it is use over and over again.

DELOCALIZATION/DECENTRALIZATION OF INDUSTRIES.

This refers to disconnection or the deliberate government policy of spreading industries country wide. It can also be defined as the policy of dispersal of industries whereby industries are scattered in different regions of the country.

It may be deliberately undertaken by the government to minimize the problems associated with localization.

FACTORS THAT MAY FAVOUR DELOCALIZATION OF FIRMS.

- Availability of raw materials in the alternative area/region.

- Exhaustion of raw materials in the current location.
- Government policy delocalization of firms.
- Availability of enough land in the alternative area.
- Political stability on the alternative region.
- Presence of enough labour in the alternative region.

ARGUMENTS IN FAVOUR OF DELOCALIZATION.

- To create and fairly distribute jobs. This would help to utilize the cheap surplus labour in rural areas.
- To reduce a problems of rural urban migration hence minimizing the bad consequences of rural urban migration.
- To ensure balanced regional development hence reduce unfair distribution of resources.
- To facilitate development of infrastructure.
- To attain economic diversification all over the country.
- It is one way of encouraging commercial production in rural areas i.e. it helps in transforming a subsistence production into a commercial production.

QN; Differentiate between footloose industries and rooted industries.

TYPES OF INDUSTRIES

Foot loose industries; These are industries whose establishment or location in particular areas is not due to particular pull factors.

Rooted industries; Are industries whose establishment in a particular area is due to particular pull factors (location factors)

Cottage industries; These are small scale industries established to produce mainly consumer goods or for consumption. Like bakeries, grain milling, brick laying industries.

Service industries; These are industries that provide non-tangible economic products e.g. banking, transport, tourism etc to satisfy human needs.

Weight gaining industries; These are industries located near the market because their final products are bulkier and more perishable than the raw materials used to make them.

Weight loosing industries; These are industries located near raw materials because they are heavier or more perishable than the final processed products e.g. diary industries.

Industrial inertia; It refers to the tendency of an industry(s) to remain located in a given area even after the advantages of location of the industry are no longer significant.

Forward linkages; This is where the existence of an industry results into the establishment of another industry or other industries which provide market for the product and bi-products of the already existing industries e.g. an existing fruit growing firm leading to setting up of a fruit canning factory.

Backward linkages; This is where an existing industry0 leads to setting up of new industries to supply the existing industry with inputs (raw materials) e.g. a cigarette industry creating a tobacco farm, tea processing industry creating a tea growing farm.

PRODUCTION PLANNING PERIODS OF A FIRM

Production planning periods are lengths of time in which the firm comes to its production decisions. They are also referred to as runs. Production periods also mean the time required to transform a given level of inputs into out puts

These periods are broadly grouped into four periods namely,

THE VERY SHOR RUN PERIOD

This is a period that is short that, supply cannot be increased through. Should there be an increase in demand, and the only possible way of increasing supply in this period is by running down stocks from the stores there fore the supply is perfectly inelastic

THE SHORT RUN

This is the period of time in which at least one factor is variable while others are fixed such that ,the firm can only vary its out put by changing the variable factor e.g. labour, raw materials etc

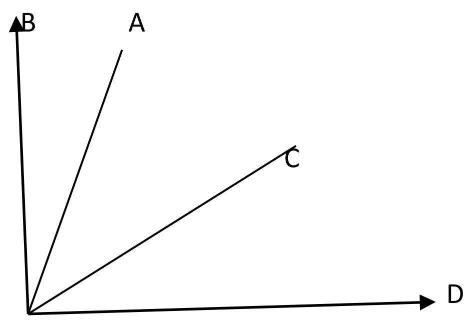
LONG RUN PERIOD. This is a period of time long enough for a firm to change its productive by varying/changing all its factors of production so as to supply what is demanded or necessary

It is in this period or run that the firm is able to expand its scale of production by building new plants

VERY LONG RUN PERIOD (SECULAR)

This is the period of time that is so long that a firm not only varies all factors of production but also changes production techniques hence the firm can produce new products due to the technology developed through research. In this situation, supply is perfectly elastic

AN ILLUSTRATION OF PRODUCTION PERIODS



A= very short run period

B= short run period

C= long run period

D= very long period

THE PRODUCTION CONCEPT OF A FIRM (OUT PUT)

The term product/output refers to the final return that a firm realizes after employing a given amount of inputs. In order for a firm to maximize returns/profits, it combines factors of production in the most desirable proportions and this is best explained by **the production function** which is the mathematical relationship between the inputs and output for example quantity is a function of labour. Q= (L)

A variable factor is a factor which varies with the level of output produced i.e. as output increases, it also increases

A fixed factor is a factor which does not vary with the level of out produced' its supply is inelastic/fixed e.g. land

The product of a firm can be looked at as total product (TP), Average Product (AP) or Marginal Product (MP)

TOTAL PRODUCT (TP). This is the total amount of goods (out puts) produced by the firm after using a given amount of inputs in a given time period

AVERAGE PRODUCT (AP). This refers to output produced per unit of the variable factor employed. It is got by dividing the total output by the units of variable factor employed

$$AP = \frac{TP}{\text{Units of a variable factor i.e. labour/ raw materials}}$$

or

$$\text{Average product} = \frac{\text{Total Product}}{\text{Total variable factor}}$$

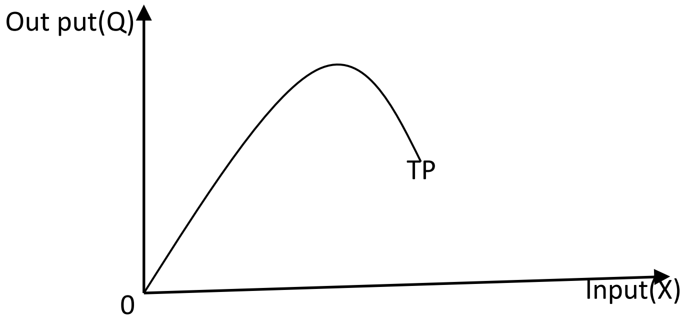
Marginal product: This is the additional output that results from employing an additional unit of the variable factor of production i.e.

$$\text{Marginal product} = \frac{\text{Change in total product}}{\text{Change in variable input}}$$

In put output relation. This shows the relationship between factors of production (input) and output (commodities). This depends on the planning periods discussed above

The input-output production process can be expressed in the following ways:

1. As a statement i.e. Q=Q(L) assuming other factors are held constant
2. It can be expressed as an equation i.e. Y=a+bx, where y is the output, x is a variable input, assuming other factors are fixed
3. It can be expressed as a graph. The production part on the graph may be linear, parabolic or hyperbolic depending on the nature of the planning period



HYPOTHETICAL EXAMPLE OF THE RELATIONSHIP BETWEEN INPUT(LABOUR) AND OUTPUT (TP,AP,MP)

land	No. of men	TP	AP	MP
1	1	10	10	10
1	2	24	12	14
1	3	39	13	13
1	4	52	13	9
1	5	61	12.2	9
1	6	66	11	5
1	7	66	9.43	0
1	8	64	8	-2

EXERCISE

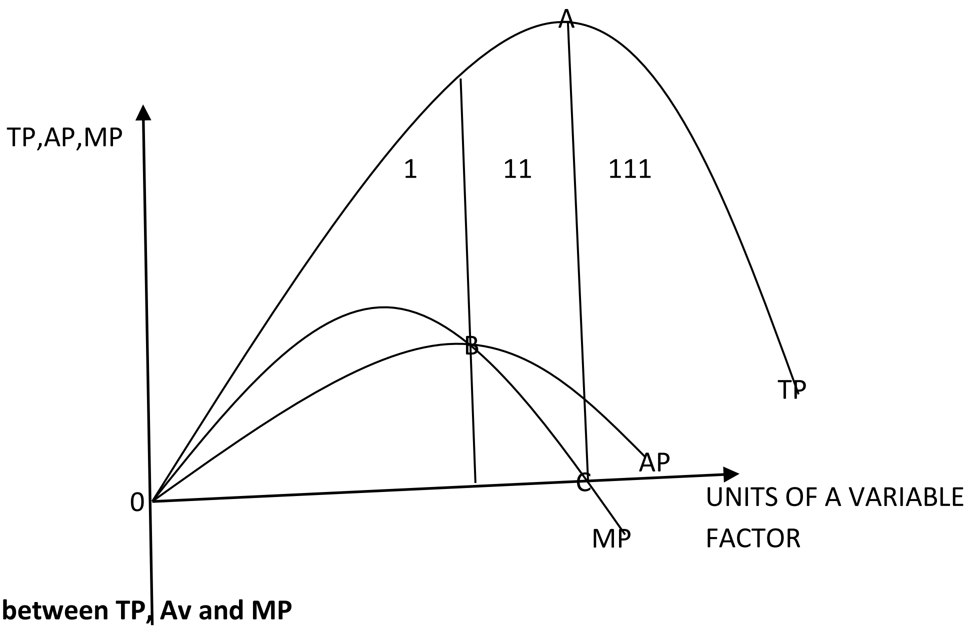
Complete the table below

Derive the TP, AP and MP curves and explain the relationship among these variables

land	No. of workers	TP	AP	MP
2	1	5	-	-
2	2	15	-	-
2	3	45	-	-
2	4	73	-	-
2	5	86	-	-

2	**6**	**91**	**-**	**-**
2	**7**	**91**	**-**	**-**
2	**8**	**87**	**-**	**-**

Relationship between total product, Average product and managerial cost.



Relationship between TP, Av and MP

In the short run, Total product, average product and marginal product are all increasing.

When marginal product is at maximum, both average product and marginal product are increasing but at a reducing rate. When total product is at maximum marginal product is zero. When total product is declining but positively, marginal cost is decreasing negatively.

Production stage.

Stage 1: state of increasing returns to scale. It starts from the origin to B where MP=AP (where AP is at its maximum) In this stage, total product, average product and marginal product are increasing. In this stage fixed factors are too much compared to the variable factor. Any increase in the variable factors causes an increase in total product, average product and marginal product hence increasing returns to scale

The fixed factor is extensively used hence this stage sometimes is referred to as an extensive region

The elasticity of production in this region is greater than 1

Ep=<u>%Δ in Q =</u>

%Δ in L

$$= \frac{\Delta Q \backslash Q}{\Delta L \backslash L}$$

$$Ep = \frac{\partial Q}{\partial L} \cdot \frac{L}{Q}$$

Where, $=\frac{\partial Q}{\partial L}$ **is MP** $\frac{L}{Q}$ **is 1/AP**

Ep = MP\AP

In stage 1: MP\AP>1

$\Rightarrow$ **MP>AP**

Stage II: state of diminishing returns. it starts at point B where MP=AP i.e. AP is at maximum to the zero point of MP at point C. under this stage TP is at its highest. Addition of more variable factors onto the fixed factor leads to decreasing returns to scale due to over utilization of the fixed factor.

This stage is sometimes referred to as the economic regional production. This is because profit maximization takes place with in this region

The profit maximization is that the wage rate given to a variable factor must equal to the value of MP

The elasticity of production is less than 1

Ep = MP\AP<1

$\rightarrow$ MP<AP

Stage III: This is also known as the stage of negative returns. It starts from the point where marginal product is zero. Additional of more variable factors results into negative returns due to over utilization of the fixed factor and under utilization of the variable factor.

Elasticity of production in this stage is less than zero

Ep<0

The law of Diminishing Returns /The law of variable proportions

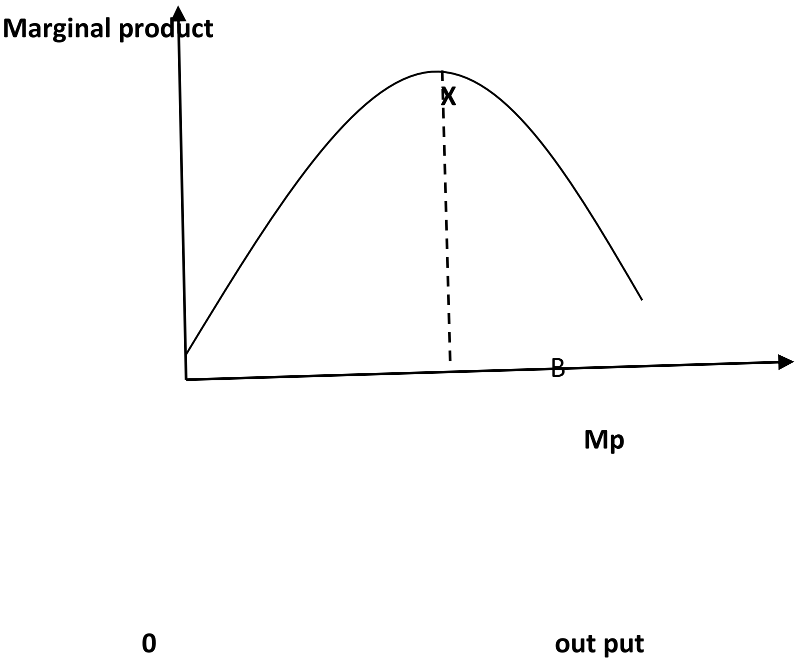
T I called the law of variable proportions because it tries to explain the effect of varying the proportions in which factors of production are used

The law states that "as more successive units of a variable factor are applied to a fixed factor at constant technology, the marginal product first increases ad then diminishes."

Or

The law states that "As more and more units of a variable factor are applied to a given quantity of a fixed factor, the marginal product first rises, reaches a maximum point and then diminishes". This law arises due to the fact that, as more and more units of a variable factor are applied to a fixed factor, the variable factor will have less and less units of a fixed factor to work with

AN ILLUSTRATION OF THE LAW OF VARIABLE PROPORTIONS/DIMINISHING RETURNS



OX **portion of the MP shows increasing returns; here mp arises because the fixed factor is still more than the variable factor**

At point X, MP is at maximum because the fixed factors is fully utilized by the variable factor

Point XB of the MP curve shows diminishing returns because the fixed factor is being over utilized by the variable factor

Assumptions of the law

- Units of the variable factor are homogenous/equally efficient
- It assumes existence of a fixed factor
- It assumes existence a variable factor
- It assumes the level of technology is constant
- It assumes a short run period of production.
- It assumes constant factors prices i.e. wages, rent etc

IMPORTANCE OF THE LAW OF VARIABLE PROPORTION

It helps the producers to determine optimum factor ratios

It is a basis for population control to reduce population pressure on a fixed factor (land)

It helps a firm to determine the profit maximizing out put i.e. a point where mp is at maximum

It helps the firm to determine the optimum size of the plant i.e. where Total product is at is maximum and MP is zero

LIMITATIONS OF THE LAW OF DIMINISHING RETURNS

Note: Returns to scale refers to the net output resulting from increasing units of both fixed and variable factors.

THE THEORY OF COSTS

In order to generate an output of goods and services, a firm has to employ factors of production which must be paid for normally in monetary terms. This constitutes a cost

COST OF PRODUCTION

Refers to what the firm incurs in the production process to produce goods and services.

Costs are monetary expenses a firm incurs in order to produce an output of a commodity.

Costs of production can be categorized into social costs and private costs

Social costs. These are opportunity costs foregone by the society due to production of a particular commodity instead of the other

Private costs. Refer to monetary expenses incurred by a firm in production of a given amount of a commodity. Private costs are further divided into:

Implicit costs.

Explicit costs

Implicit costs. These are costs of self owned, self employed resources used in the production process and neglected while calculating/computing the costs of a firm.

Examples of implicit costs

- Use of personal property in production
- Services provided by a house wife
- Use of family labour in the business
- Services of the owner

Explicit costs. Are costs or expenditure on resources hired by a firm to use in the production and they are included in the computation or calculation of the firm's costs

Examples of explicit

Wages, rent, costs of raw material, transport etc

Explicit costs are further subdivided into:

i. Fixed costs
ii. Variable costs
iii. Total costs

FIXED COSTS/OVER HEAD/UN AVOIDED/INDIRECT/SUPPLEMENTARY COSTS/INESPENSIBLE COSTS

These are costs which do not vary with the level of output or
Costs incurred by the firm irrespective of the level of output produced. They are incurred even if the level of output is zero

Examples of fixed costs

i. Rent
ii. Interest on loans
iii. Insurance
iv. Depreciation costs
v. Salaries of top managers

VARIABLE COSTS(FC)/PRIME/DIRECT/AVOIDABLE/OPERATING COSTS/RUNNING

These are costs that vary directly with the level of output produced i.e. they increase with the increase in the level of out put

Examples of variable costs

i. Cost of raw materials
ii. Costs of advertising
iii. Transport costs
iv. Wages for labour
v. Electricity costs

It should be noted that at zero output, V.C are equal to zero

TOTAL COSTS. These are overall expenses incurred by a firm in the production of a given level of output or

Are total expenses incurred by a firm in the production of a given level of output on both fixed and variable factors

Hence, TC=VC+FC

When output is zero, TFC=TC

The relationship between TFC,TVC and TC can be illustrated in the table

OUT PUT	TFC	TVC	TC
0	300	0	300

1	300	300	600
2	300	450	700
3	300	500	750
4	300	600	800
5	300	750	900

EXERCISE

Given the table below

OUT PUT	TFC	TVC	TC
0	100	0	100
1	100	50	150
2	100	100	200
3	100	150	250
4	100	200	300

Compute total variable costs at 3 units of out put

Total costs at 4 units of out put

Use the information above to derive the TFC, TVC and the TC curves

Explain the relationship between TFC, TVC and TC

RELATIONSHIP BETWEEN TFC, TVC AND TC

- When TVC is zero, TC is equal to TFC
- When output is zero, TVC is equal to zero which means that TVC starts from the origin
- As a firm increases its level of output, the TVC increase and as output reduces, the TVC reduce hence the variable cost curve begins from the origin and it has a positive slope
- As a firm increases its level of output, the total fixed costs remain constant hence the fixed cost curve of a firm is represented by a horizontal straight line
- As the firm increases its level of output, the total costs also increase and as it reduces the level of output, total costs also reduce. But when output is zero, the total costs are equal t the fixed costs
- Therefore the TC curve of a firm has got a positive slope and must have the same slope as the variable cost curve but it begins at a point where the fixed cost curve meets the y-axis
- When output is zero, TC is equal to TFC and as output increases, the costs and total variable costs increase

- The TC increases at the same amount of TVC. This is because the TFC is fixed for all levels of output in the short run

SHORT RUN VARIATION IN COSTS

To analyze the relationship between costs and output, we use average and marginal costs instead of totals in the short run period. Therefore costs can be described as:

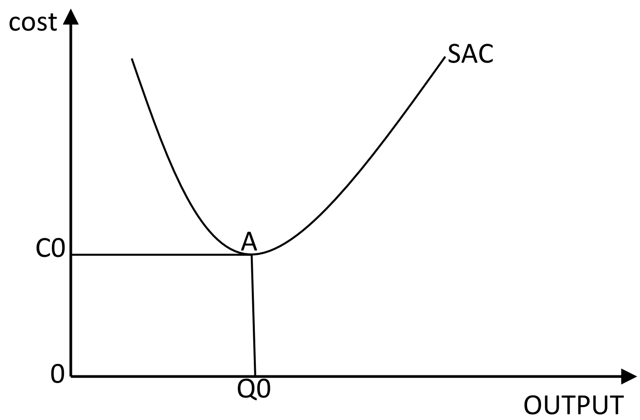
- Average costs (AC) or average total costs (AVC)
- AFC (Average Fixed Cost)
- AVC (Average Variable Cost)
- MC (Marginal Cost)

AVERAGE TOTAL COST/AVERAGE COST (AC/ATC)

This refers to total cost per unit of output,

$$ATC = \frac{TC}{\text{Quantity of out put}}$$

The AC curve is U-shaped in the short run as illustrated below



In the short run, the AC curve is U-shaped because of the law of diminishing returns

The AC curve first falls because of specialization and the increase is due to concentration. Therefore average costs go on reducing. This is because the output of the firm increases at a higher rate compared to the costs because of increasing marginal returns. It then reaches the minimum point i.e. at point A where the firm produces the highest level of output (Q0) at the lowest cost (C0)

Point A is referred to as full capacity

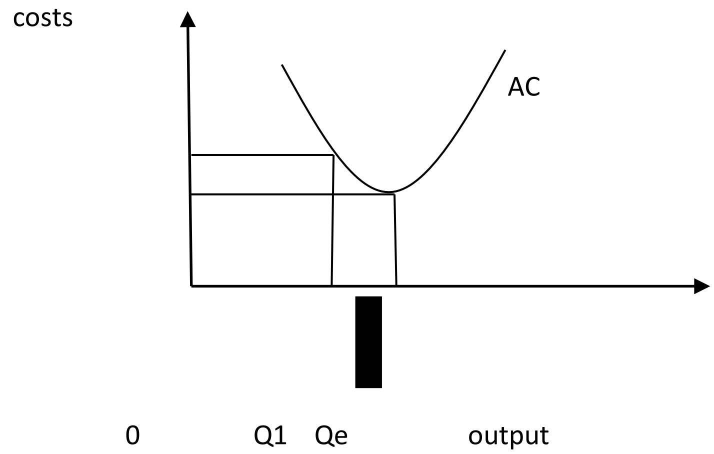
Full capacity refers to a point where a firm is producing the highest level of out put at the lowest cost. It is the point of full utilization of the country's/firm's resources

However, if the firm produces below the installed capacity, it is then producing at **excess capacity**

EXCESS CAPACITY

It is a state of under utilization of a firm's resources. Or a situation where a firm underutilizes its available resources and produces less than the installed capacity. It is a situation where a firm produces at a point less than its installed capacity

AN ILLUSTRATION OF EXCESS CAPACITY



The shaded area represents excess capacity

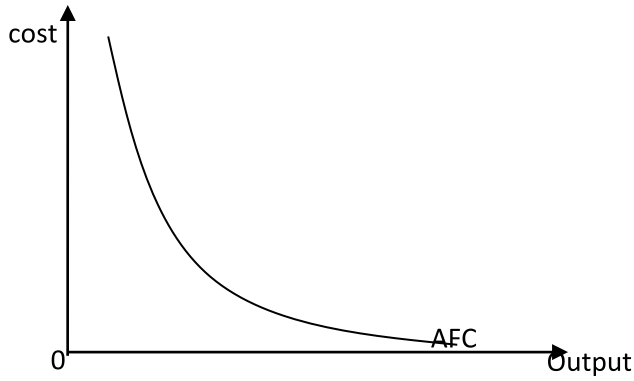
CAUSES OF EXCESS CAPACITY

- Use of rudimentary technology
- Inadequate supply of labour
- Poor quality management
- Small market size
- Inadequate supply of raw materials
- Political instabilities
- Desire to restrict output so as to charge high prices
- Underdeveloped infrastructure

Beyond output (Q0), the law of diminishing returns sets in thus the output of the firm increases at a lower rate compared to the costs which brings about rising average costs. The firm operates at **over capacity**

Over capacity. Is a situation where a firm produces at a point beyond its installed capacity

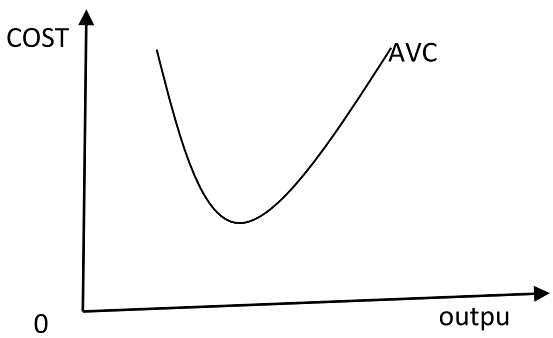
AVERAGE FIXED COST. This refers to the total fixed cost per unit of output produced. It is obtained by dividing the fixed costs by the firm's level of output



Since total fixed costs are constant, average fixed costs decrease as the level of output increases. This is because the total fixed costs which are constant are spread over in all units of output. Hence the AFC is down ward sloping from left to right

AVERAGE VARIABLE COSTS

This refers to the total variable costs per unit of output produced. It is obtained by dividing the average total costs by the firm's level of out put



NB. The AVC curve is U-shaped in that it starts with falling, it reaches the minimum point and begins to rise

MARGINAL COST. This is an extra cost incurred due to production of an extra unit of out put

$$MC = \frac{\Delta T}{\Delta output}$$

ATABLE SHOWING THE RELATIONSHIP BETWEEN AFC, AVC, AC AND MC

Out put	TFC	TVC	AFC	AVC	ATC/AC	MC	TC
0	300	0	Infinity	Infinity	infinity	-	300
1	300	300	300	300	600	300	600
2	300	400	180	200	350	100	700
3	300	450	100	150	250	50	750
4	300	500	75	123	200	80	800
5	300	600	60	120	180	100	900
6	300	720	50	120	170	120	1020
7	300	890	42.9	127.1	170	170	1190
8	300	1100	37.5	137.5	175	210	1400
9	300	1350	33.3	150	183.3	280	1650
10	300	2000	30	200	230	650	2300

EXERCISE

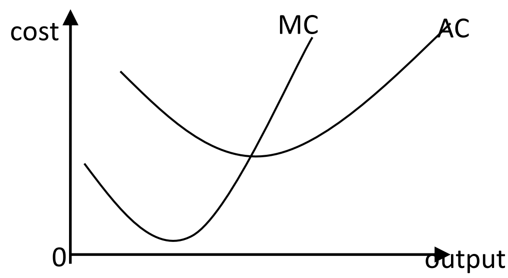
Complete the table below

output	TFC	TVC	TC	AFC	AVC	AC/ATC	MC	
0			**400**					
1			**800**					
2			**850**					
3			**900**					
4			**950**					
5			**1000**					
6			**1100**					
7			**1150**					
8			**1200**					

9			**1300**					
10								

Relationship between AC and mc

- Both are U-shaped.
- Initially fall, reach a minimum and then rise.
- When AC is falling, MC is below .however, MC begins to rise earlier than average cost (AC).
- MC is less than AC because the fall in MC is related to one unit of output while in the case of AC the same decline is spread over all units of output.



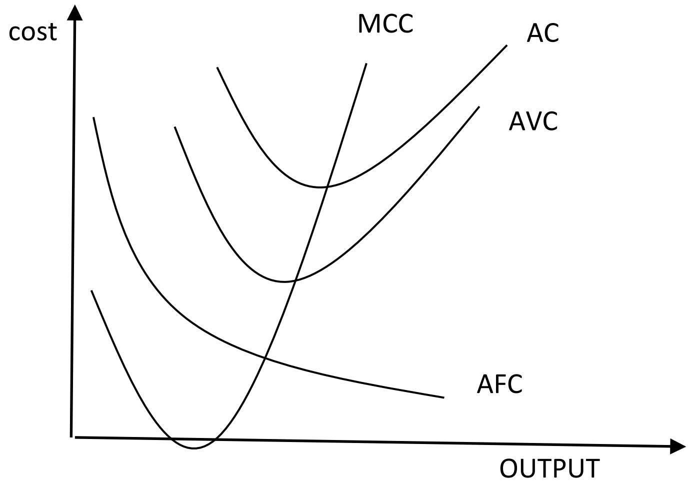
- MC is equal to (AC) when AC is at the minimum.
- The MC curve cuts the AC curve from below at its minimum point.
- When AC is greater than MC i.e. MC is above AC when AC is rising but the rise in MC is the result of the increase in one unit of output while in the case of the AC the same increase is spread over all units of output.
- Both are flat in shape in the long run and in the short run are u-shaped.

RELATIONSHIP BETWEEN MC, AVC, AFC AND AC.

- The AC, MC and AVC are all u-shaped due to the law of variable proportion / diminishing returns.
- The AFC curve declines continuously and is asymptotic to both axes .It means that the AFC approaches both axes but never torches either X-axis or Y-axis.
- The SAVC curve first declines, reaches a minimum and rises thereafter, when the SAVC curve reaches its minimum point A the SMC curve equal the SAVC curve.
- As the level of output increase, AVC curve tends closer to the AC curve due to the continuous falling AFC.

- AC, AVC, AFC and MC are known as per unit cost of a firm and their curves are per unit cost curves of a firm.

- MC cuts AVC at its minimum



QN .Why is it that, AC/ AVC/ mc are u-shaped.

- It is due to the economies and diseconomies of scale in the long run.

- It is due to the law of diminishing marginal returns.

Importance of AC to A firm.

1. It enables a firm to determine the cost of producing @ unit of out put.
2. It helps in calculation of total cost of producing a certain level of output in order to determine profit /losses of a firm.
3. It guides a firm in pricing every unit of output produced .e.g. the price may be made to equal to AC this is called average cost pricing.

Importance of marginal cost (MC) a firm.

1. It helps a firm to know the cost of employing an extra cost of out put
2. It also guides a firm in fixing the price for the extra unit of output produced e.g. the firm can equate price to MC and this is MC pricing.
3. MC helps the firm to make the right factor combinations in order to maximize profits .Profit maximization requires that factor input are hired up to the point at which marginal revenue product of each factor input equals its MC.
4. MC also helps a firm to determine its optimum size i.e. where mc = AC.
5. MC is also the supply curve of a firm in at it shows what number of units of output should be supplied to them at especially if the marginal revenue product of each unit is known.
6. It also helps in determining the profit maximization output of a firm where mc=MR.

7. It helps a firm in making decision i.e. it's profitable to interest when MC is lower than AC.
8. It guides a firm in rewarding factors of production e.g. the wage to be paid to the extra labour (MC) should exceed his /her marginal revenue produce.

SUNK/ RECOVOURABLE COST.

These are costs that are incurred by a firm in production and cannot be recovered in case the firm leaves the industry e.g. the cost of installing machinery

LONG RUN PRODUTION

In the long run the firm can expand in size by varying all factors of production including those which were fixed in the short run i.e. the firm can change the scale of its activities.

The relationship between changes in scale and changes in output are described as **returns to scale.**

RETURNS TO SCALE

As the firm varies the factors of production in the long run, there are three ways of looking in the input –output relationship

1. Increasing returns to scale
2. Constant returns to scale
3. Diminishing returns to scale.

INCREASING RETURNS TO SCALE.

This is a situation where output produced by expanding the scale of production increases more than increase in inputs i.e. which inputs are doubled out put more than that doubles .

Labour units	**Land units(acres)**	**Output(kg)**
4	20	100
8	40	800
16	80	700

NB. Increasing returns are associated with falling average hence the firm is said to be enjoying economies of scale.

CONSTANT RETURNS OF SCALE

This refers to a situation where an increase in out is proportionate to the increase in input as the firm expands its scale of production for example.

Labour	**Land(acres)**	**Output(kg)**

2	20	100
4	40	200
6	600	400

When a firm is experiencing constant returns to scale of average costs remain constant.

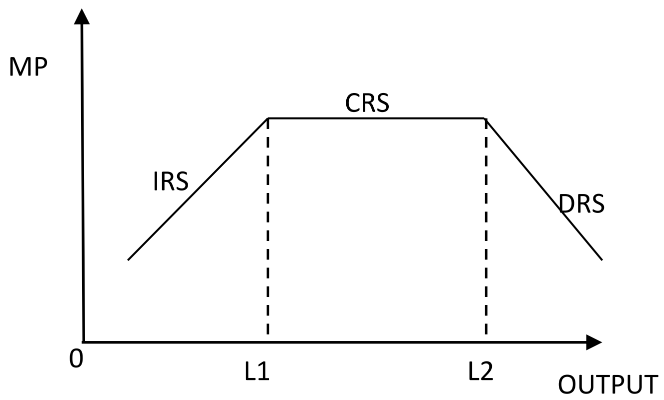
DIMINISHING /DECREASING RETURNS TO SCALE.

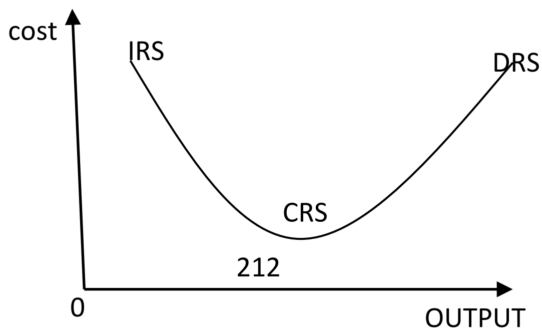
This is when the increase in output is proportionately less than the increase in inputs i.e. when inputs are doubled output less than doubled e.g.

Labour(acres)	**Land(acres)**	**Output(kg)**
4	20	100
8	40	150
16	80	250

NB. Diminishing returns to scale are associated with increasing average costs .Here the firm is said to be enjoying diseconomies of scale.

GRAPHICAL ILLUSTRATION OF IR, GR AND DR



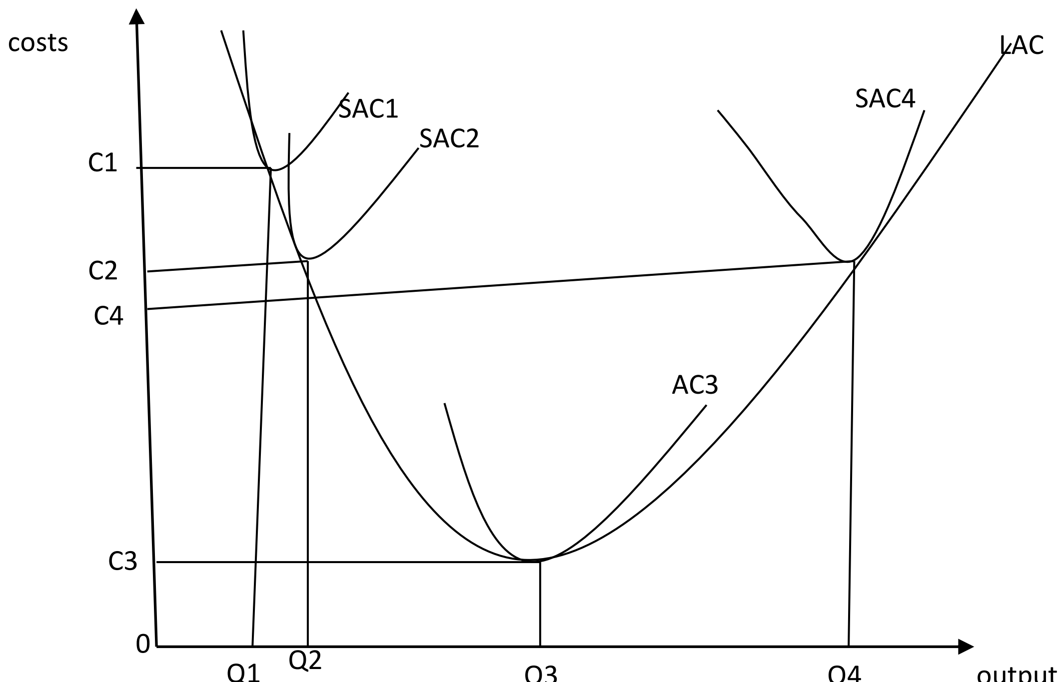


i)Increasing returns (I.R.S) is illustrated by the upward sloping part of the marginal product curve or the downward sloping of AC curve (ii) constant returns to scale(CRS) by the horizontal part of the MP(i) or AC (ii) and decreasing returns to scale(DSR) are shown by the diminishing/decreasing curve of the MP curve (i)

VARIATIONS OF COSTS IN THE LONG RUN

In the long run a firm can expand its sale of operation by acquiring new equipment and building new plants.

Assuming each plant size is replaced by a short run average cost (SAC), the long run average cost curve (LAC) is derived as seen below.



From the illustration above we assume that the firm begins operation in the short run with a small plant re presented by SAC1 producing output/Q1 at an average cost OC1

.An increase in demand for this firm's products increases production to Q2. However with its existing plant output OQ2 would be produced at a cost OC5. Which is higher than that of OQ1

To reduce these costs it pays the firm to increase the size of the firm to a bigger plant represented by SAC2 .Now output Q2 can be produced at a lower average cost OC2

This same thing explains why the firm moves to SAC3 in order to produce OQ(3)

When a series of points corresponding to the minimum possible costs of producing a particular level of output, are joined by a small curve we get a long run average cost curve (LAC).

The LAC curve is also called the **envelop curve** because it encloses many SAC curves. It is also known as the **planning curve** of the most efficient size of the plant to use.

Note: The downward sloping potion of the LAC curve indicates economies of scale while the upward sloping potion of the LAC curve illustrates diseconomies of scale.

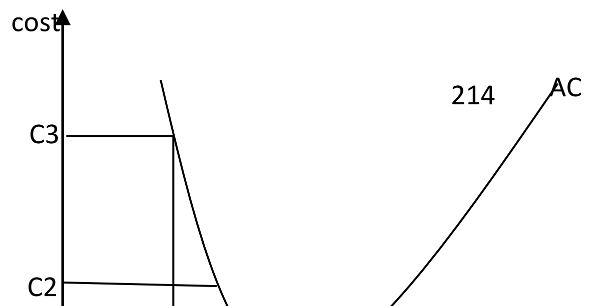
ECONOMIES AND DISECONOMIES OF SCALE

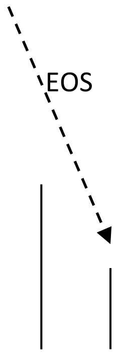
Are advantages of large-scale production that a firm enjoys in form of lower per unit costs as out put increases **OR**

Economies of scale refer to the benefits that accrue to a firm inform of reduced average costs of production as a result of expanding its scale of production.

As output increases the average cost reduces as shown on the diagram below:

AN ILLUSTRATION OF ECONOMIES OF SCALE





An increase in quantity produced from q_1 to q_2 causes a reduction in the average cost from c_1 to c_2

Economies of scale are categorized into two main groups

- Internal economies of scale
- External economies of scale

Internal Economies of Scale

These are advantages accruing to a firm operating on large scale in form of reduced average costs due to its **better internal organization.** They are advantages enjoyed by a firm due to the growth of a single firm independent of what is happening to other firms

Examples of Internal economies of scale include:

Technical economies of scale. Are advantages enjoyed by a single firm operating on a large scale due to use of better machines and techniques of production

Managerial economies. Are advantages of large scale operation enjoyed by a firm in form of specialization of labour.ie the firm is able to operate separate department and also employ specialist managers. E.g. purchasing department, sales department, production department

Marketing economies of scale. Are advantages of large-scale operation enjoyed by a firm in form lower costs on purchase of raw materials in bulk, and ability to expand and maintain market

Financial economies of scale. Are advantages of large scale production enjoyed by a firm due to its ability to raise funds from various sources due to adequate collateral security and ability to borrow money at a reduced interest rate

Research and development economies of scale. Are advantages of large scale production enjoyed by a firm due to its ability to carry out research at low cost

Risk bearing economies of scale. Are advantages of large scale production enjoyed by a firm due to its ability to lower risks of operation like buying raw materials from different sources, selling in different markets, producing a variety of products

Transport economies of scale. Are advantages of large scale production enjoyed by a firm due to owning means of transport, hiring transport at lower costs etc

Welfare or social economies of scale. Are advantages of large scale production enjoyed by a firm in form of being able to provide better welfare facilities like houses, medical care and recreation facilities to motivate workers to produce more

Storage economies of scale. Are advantages of large scale production enjoyed by a firm inform of reduced storage costs per unit of out put produced

EXTERNAL ECONOMIES OF SCALE

External Economies of scale; These are advantages of large scale production enjoyed by the entire industry rather than an individual firm. Or are advantages of large scale operation enjoyed by all firms in the industry resulting in reduced per unit costs of production

They are also referred to as economies of localization or concentration.

External economies of scale include

- **Economies of welfare**. Are benefits enjoyed by an industry in form of better welfare facilities provided to its workers at reduced or lower costs
- **Economies of specialization.** Are advantages of large scale production enjoyed by an industry due to its ability to specialize in different activities at lower cost
- **Economies of concentration.** Are advantages enjoyed by all firms concentrated in an area like pool of required labour, transport facilities etc
- **Economies of information/research.** Re advantages enjoyed by an industry an industry in form of low research costs
- **Technical economies of scale.** Are advantages enjoyed by firms in an industry due to sharing of specialized maintenance facilities e.g. garages, carpentry workshops, insurance, banks etc at a reduced cost

NB. Economies of scale are also classified into pecuniary and Real economies

Real economies of scale: These are advantages accruing to a firm operating on large scale inform of reduced quantity of inputs used in the production process that lead to a fall in average cost **or** Are advantages of large-scale production enjoyed by a firm when it uses less factor inputs to produce a desired level of out put: Examples of real economies of scale includes:

- Labour economies of scale
- Marketing economies of scale
- Managerial economies of scale
- Financial economies of scale

Pecuniary (financial) economies of scale: These are benefits enjoyed by a firm in form of monetary savings as a result of producing on large scale that lead to a reduction in average cost of production.

Or

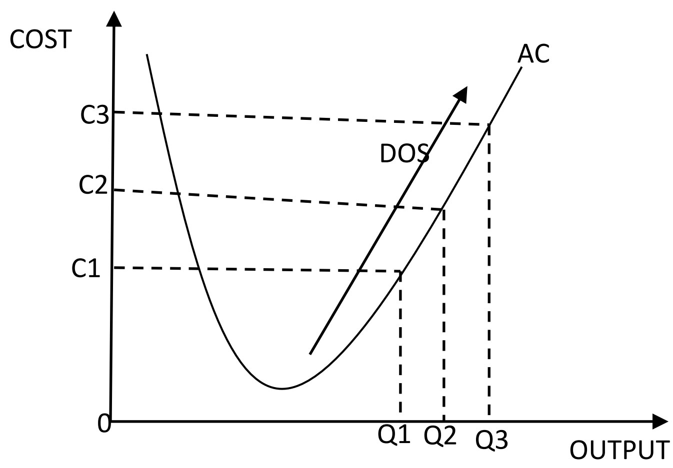
Are advantages enjoyed by a firm operating on large-scale due to reduced monetary costs like discount on bulk purchases for a particular level of output and distribution of products at lower costs per unit i.e. they are to bulk buying and selling

They are advantages enjoyed by a firm of reduced price of input due to large scale production that leads to a reduction in average cost of production.

Diseconomies of Scale

These are disadvantages of large scale production faced by a firm that lead to an increase in average cost of production.

Diseconomies of scale can be illustrated as below



As the level of output increase, the average cost of production reduced up a certain point i.e. optimum point beyond which an increases in output levels lead to increase in average cost of production.

Note: **Optimum point** refers to the level of output beyond which an increase in output leads to an increase in average cost of production.

It is the point where the firm incurs the least cost per unit of output.

Diseconomies of scale can be grouped into internal diseconomies of scale and external diseconomies of scale.

Internal diseconomies of scale: These are the disadvantages faced by a firm due to an increase in its scale of production.

INTERNAL DISECONOMIES OF SCALE INCLUDE,

Managerial diseconomies of scale: These are the problem associated with the management and supervision of the production process as the firm expands its scale of production which requires employing more supervisors leading to increase in average cost
Technical diseconomies of scale: These are the problems associated with increased wear and tear of capital assets which require replacement thereby increasing the production costs.

Marketing diseconomies of scale: These are the problems resulting from the high competition for market which increase the marketing costs like advertising costs, transport costs etc thereby reducing the firm's profits and difficult in getting raw materials.
Financial diseconomies of scale. Are disadvantages of large scale production in form of inadequate capital to facilitate production activities and high cost of borrowing from banks
Storage diseconomies of scale. Are disadvantages of large scale production in form of high storage costs for finished goods and raw materials which increase average cost

External diseconomies of scale: These are the disadvantages faced by the whole industry as firms expand their scale of production. **Or** Are disadvantages that arise due to concentration of firms in an area. They include:

- Pollution of the environment
- Traffic congestion
- High costs of water and power
- High costs of living due to inadequate accommodation
- Increase in cost of land due to high competition
- High transport costs due to high demand for it
- High advertising costs in order to maintain a large market share
- High cost of labour in form of increased wages and salaries due to its high demand

All the above points lead to increased average cost of an industry

THE REVENUE OF A FIRM

Revenue refers to all receipts that a firm obtains from the sell of its products. There three ways of looking at a firm's revenue is total, average and marginal revenue.

(i) **Total Revenue**: This to the total amount of money a firm obtains from the sales of a given volume of its products in a given time. Its is a product of the quality sold and the selling price of the commodity hence total revenue =Price X quantity

I.e. TR=PX Q.

(ii) **Average revenue (AR)**: Refers to revenue per unit of out put sold. It is equal to the co-efficient of total revenue (TR) and the number of units sold and hence $AR=TR/Q=\frac{PX\ Q}{Q}$

NOTE. From above its clear AR is the same as price

(iii) **Marginal revenue** (MR) This is defined as the additional revenue realized from the sell of an additional/extra unit of output .It's the change in TR when quantity sold is increased by one unit i.e its given by

$$MR = \frac{\Delta TR}{\Delta Q}$$

Study the table below and answer the questions that follow

Price of maize (Shs)	Supply of maize (Kg)
50	100
40	250
30	500
20	1100
10	3000

Calculate the average revenue when 1100 units are sold
Calculate the marginal revenue when 3000 kgs of maize are sold

THE CONCEPT OF PROFIT

A profit is usually defined as the reward for an entrepreneur for risk taking

It is looked at as the difference both the revenue the producer gets from the sell of a given volume of products and the total costs incurred in the production of that product hence profit is given as the difference between TR and total cost i.e.

Profit = TR-TC

Since TR=Pxq, a firm can minimize profit in two ways:

- By maximizing revenue this output maximization and increasing the PX of the commodity.
- By minimizing costs

Features of profits /characteristics

Profits differ from other factors payments e.g. wages, rent interest etc in that

- Profit may be negative i.e. firm may make losses where as wages interest and rent are usually positive.
- Profits fluctuation move than the other factor payment
- Profits are a residue payment i.e. what remains of revenue after deducting all other factor rewards.
- Profits are uncertain ,the entrepreneur is sure when and how much they will earn from their employment other factors know how much they will earn from their employment
- Profit is non- contractual payment i.e. earnings are received in the feature if there are enough buyers for the product yet payment to other factors e.g. labour are paid as part of the contract made.

ROLE OF PROFITS.

(ii) Abnormal profits provide reward to entrepreneur for risking.
(iii) Economic profits indicate to an entrepreneur which economic activity which industry to expand and which one to contract and this determine
(iv) Economic profits the resources for expansion of a production unit or firm for increasing investments
(v) Normal profits safe guards firm or producers from competition since it may not induce new firms to enter the industry
(vi) Profits ensures that the most efficient carry out production and hence an indicator of level of efficiency
(vii) Profits guide the government information taxation policies i.e. when profits are high cooperate tax will be high and when profit are low cooperate taxes will be low.
(viii) Profits indicate/measure the level of risks in the higher the level of inputs the higher the profits usually and low level of risk results into low profits usually
(ix) They can be used for unexpected contingencies in features e.g. price fluctuation etc
(x) They can act as incentives for further production.

TYPES OF PROFIT

1) **Normal profit**. This is also known as the supply Price of entrepreneurship. These are rewards that are just sufficient for a firm to remain in a given industry but not sufficient to attract other firms to enter the industry and they occur where average revenue=Average cost. Or.

It refers to the **minimum** reward necessary to induce an entrepreneur to supply his/her service and they are earned when AR=AC.

NOTE: Normal profits are also called zero profits

Abnormal profits/Economic/Supernormal/pure profits .These are profits /rewards to the entrepreneur earned where AR>AC which attracts other firms or products to enter the industry.

Subnormal profits/ losses. These are negative profits expand by firms when AC exceeds average revenue at the equilibrium of output. They discourage firms forcing them to leave the industry.

REQUIREMENTS OR RULES OF PROFITS.

A firm should produce only if AR is greater than. Average variable costs .This is particularly in the short run situation .If the firm finds that, at the current level of output MR exceeds marginal costs then it can increase profits by producing more and if the firm finds that , at the current level of output MC exceeds MRR then it can increase its profits producing less.

Necessary condition : For a firm to produce its profits maximizing out (MR=MC), MR must be equal to MC meaning that at this level, the last unit produced should earn revenue just as it does to cost.

It therefore follows that MC=MR is a necessary evil (condition) not a sufficient condition for a profit maximizing firm because MC=MR can happen even at low levels of output.

Point Q1 is profit maximizing position because below output Q0 mc exceeds MR. While output above/beyond OQ0,MR exceeds MC.

2) **Sufficient conduction.** For an output level to be profit maximizing, it is sufficient that MC is less than MR at a lower output and that MC exceeds MR at slightly higher output.

   In conclusion therefore at the profit maximizing out, the MC curve should intersect the MR curve from below and MC must be rising .This is illustrated at point **A** in the curve below.

EQUILIBRIUM OF A FIRM AND INDUSTRY.

Equilibrium of a firm.

This refers to the profit maximization of a firm where MC is equal to MR and there fore the firm has no tendency to increase or reduce output .This condition of profit maximizing where MC=MR applied to all firms in all market structure

Equilibrium of an industry

This refers to a condition in an industry where all firms in the industry are earning normal profits. At this point there are neither new firms entering the industry nor old firms leaving the industry (because of the normal profits enjoyed which are just enough to keep the firm in the industry but not enough to attract other firms)

MARKET STRUCTURES.

A market refers to an arrangement that brings together a buyer (s) and a seller(s) for the exchange of a well defined commodity hence the essential feature of a market are:

- Existence of a sellers

- Existence of a buyers
- A well defined commodity (good or service)
- Existence of a medium of exchange (money)
- Existence of a price
- Geographical location

A market structure. Is an economic moral which explains the mode of production ,degree of competition and the nature of products produced basically there are of market structures Namely,

- Perfect competition
- Monopolistic (importance competition).
- Oligopoly
- Monopoly market structures

CLASIFICATION OF MARKET STRUCTURE (X-TICS)

Market structures are classified to.

1) Number of firms in the industry. Where there are many firms in the industry the market structure is either perfect competition or monopolistic competition. Where there are few firms its oligopoly and where there is a single firm is monopoly.

2) The nature of product delt in .Where the products are homogeneous, the market structure is either perfect competition or oligopoly where the products are differentiated, the market structure is monopolistic competition or imperfect or oligopoly

3) Freedom of entry and exit. Firms have the liberty to enter the industry and engage in production without any barrier and leave the industry when incurring losses or when they cannot instant the competition such firms are in perfect and monopolistic market structures but firms that have limited /blocked entry into the industry are in oligopoly and monopoly market structures respectively.

4) The level of advertising .If there is a lot of advertising, its either monopolistic or oligopoly market structure where advertisement is informative it is monopoly and where there is no advertisement its perfect competition

5) Level of profits earned by the firms in the long run equilibrium point. when a firm earns zero profits or normal profits the market structure is either perfect competition or monopolistic and where the firm continues earning abnormal profits in the long run its either monopoly or oligopoly

6) The nature of the demanded curve. Where the demanded curve in perfectly elastic it is perfect competition, where the curve is fairly elastic it is monopolistic competition where the demand d curve is inelastic its monopoly and oligopoly firm has a kinked demanded curve.

7) Price determination. where the prices are to a greater extent determined by the buyer s, the market structure is perfect competition in this case the seller is a price taker where prices are determined by a seller its either monopolistic competition or oligopoly or monopoly etc.

PERFECT COMPETION MARKET STRUCTURE.

Perfect competition is defined as a market condition where there are many sellers and buyers dealing in a homogeneous commodity and there is freedom of entry and exit with no government intervention.

Characteristics of silent features /assumptions of perfect competition.

i) **There are many buyer sellers** .This implies that no single seller /buyer can influence the price in the market. Sellers are considered as price takers and not Price makers.

ii) **The commodity dealt in is homogeneous** i.e. each unit of a commodity is the same/ exactly as others .This implies that the buyer has no preference for the product of any particular seller while all firms must charge the same price.

iii) **Freedom of entry and exit into the industry.** Firms are free to enter into the industry and engage in production without any barrier .Similarly, loss making firms that cannot stand the competition are free to quit production

iv) **Buyers and sellers have perfect knowledge** .Buyers and sellers are assumed to have perfect knowledge of all market conditions e.g. buyers should be aware of the exact Price being charged, the right quality of the product and the places where the commodity is being sold .Hence sellers must sell at the same Price ,otherwise ,they stand to lose customers .Similarly sellers should also be aware of activities of other sellers in the market

v) **No transport costs**. The movement of factor inputs to the production place and finished products to the market is done at no cost hence firms must charge a uniform Price for their products

vi) **No government interference**. The government does not interfere in the market through policies e.g. Price legislation taxation subsidization etc.

vii) **There is no collusion** ,sellers or buyers of the commodity don't group together to influence the amount supplied or the Price at which production is to be sold

viii) **Perfect mobility of factors of production.** Factors of production especially labour can easily and freely move from one economic activity to another hence all firms have access to the most efficient factors.

ix) **There are no advertising costs.** Due to product homogeneity and perfect knowledge of market conditions, there is no need for advertising otherwise costs would increase and change the selling Price.

x) **The goal of the firm under perfect market condition is profit maximization** hence each firm try to equate MR to MC.

xi) Buyers aim at maximizing utility.

xii) Prices under perfect competition are the same in all firms because of perfectly elastic demand curve elastic DD curve.

NB

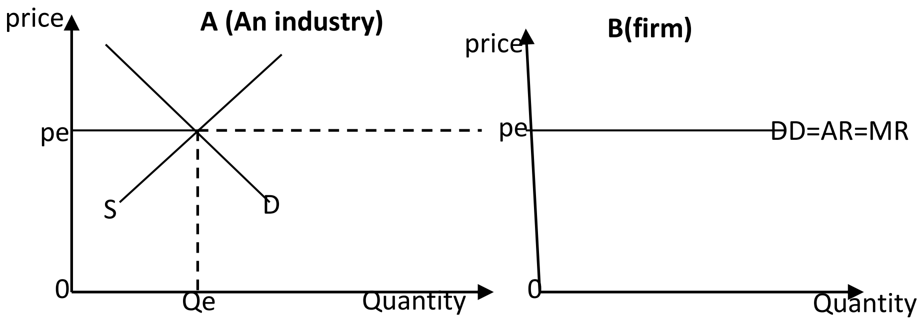
Pure competition is a market condition that encompasses all features of perfect competition except that is no perfect knowledge of market and perfect factor mobility

QN .Distinguish between pure competition and perfect competition market structure.

THE DEMAND CURVE OF A FIRM AND AN IDUSTRY UNDER PERFECT COMPETITION.

The demand curve for the output of the whole industry will be of the normal shape i.e. slopping down wards from left to right hence the market Price for the output of the whole industry is determined by the interplay of the market forces of demand and supply.

However, a single firm will be faced with a perfectly elastic demand curve .This is because all units of the firms output will be sold at the same price since a single firm is a price taker.



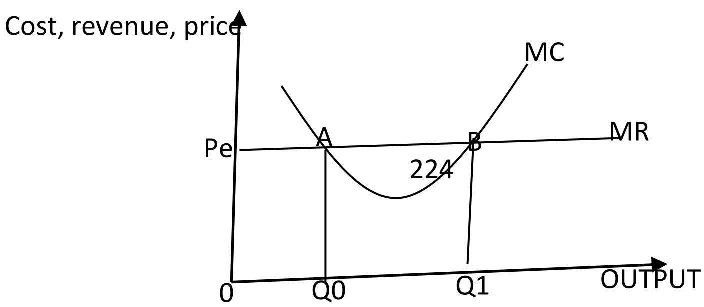
From the figure (A) above, equilibrium price PE is determined by the market forces of demand and supply while in figure **B,** we have the DD curve facing the individual firm which is perfectly elastic and the price (PE) is just taken by the firm

NB

In the concept of revenue, we noted that Price=AR (P=AR) hence, since price is constant it means that each extra unit is sold at a constant price bringing in the same Marginal revenue .This implies that under perfect competition P=AR=MR.

EQUILIBRIUM POSITION OF A FIRM UNDER PERFECT COMPETITION

Given the assumption that a firm under perfect competition aims at profit maximization, it will produce at that Point where MC=MR. since the MR curve is perfectly elastic and the MC is U-shaped. This will appear as follows.



MC=MR is only necessary condition but not sufficient for profit maximization. From the figure above, there are two points where MC=MR i.e. point **A** and **B. The sufficient condition for profit maximization** is that **MC=MR** at the highest level of output which is OQ1. Beyond OQ1, MC would exceed MR and the firm would incur losses.

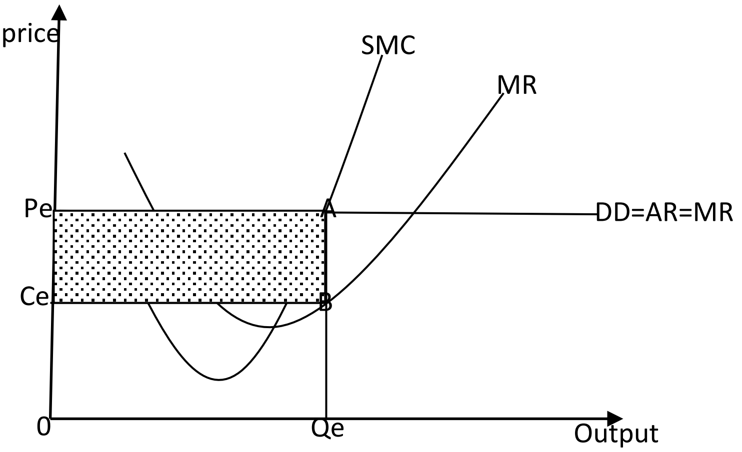
Revision Question

Explain the profit maximizing output of firm. (4mrks)

PROFIT MAXIMISATION UNDER PERFECT COMPETITION IN THE SHORT RUN

In the short run a firm under perfect competition maximizes profit where the equilibrium level of output i.e. at point A.

An illustration of profit maximization under perfect competition in the short run

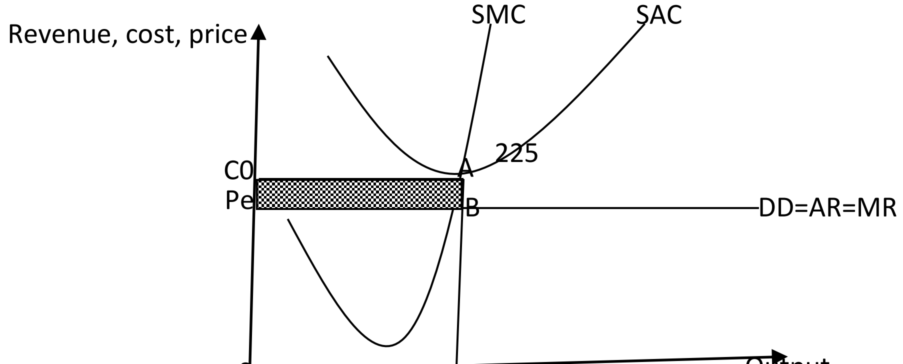


In the short run situation.

- Prices are determined where the output line meets the average AR curve or at point A which is OPE .
- Costs are determined where the output line meets the AC curve at point B which is OCO.
- In the short run the firm earns abnormal profits which are earned where AR is > AC at equilibrium level of output which is got by subtracting total costs (OC BQE) from total revenue (Ope AQe).Hence abnormal profits =Pe ABCo (shaded area)

- NB .In the short run, it's possible for a firm to incur losses. They are incurred where AC exceeds AR at the equilibrium of output of the firm as illustrated

AN ILLUSTRATION OF LOSSES UNDER PERFECT COMPETITION

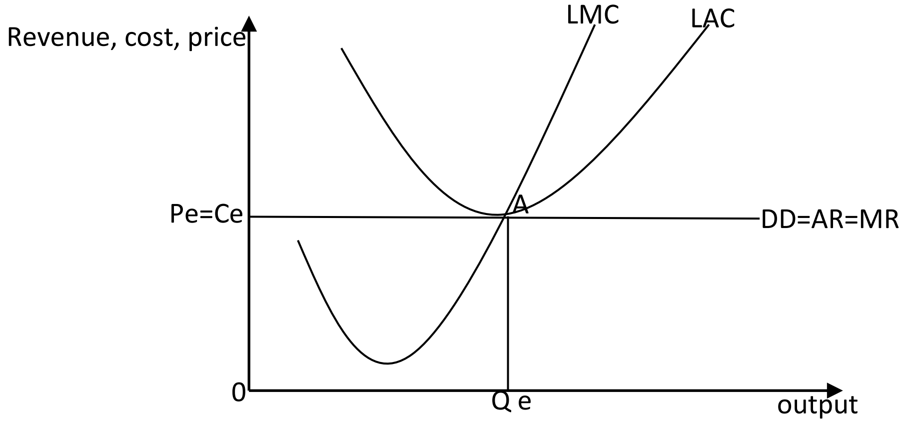


- From the figure above ,equilibrium output oqe is produced at cost oco per unit and sold at a px o per unit and sold at a PX ope per unit hence earning losses equal(PE BO MA) (shaded area)

THE LONG RUN EQUILIBRIUM OF A FIRM UNDER MARKET COMPETITION

- Under perfect competition the abnormal profit earned by firms in the short run do not persist in long run .This is because with freedom of entry into the industry any supernormal profit earned by existing firms tend to attract new firms into the industry.
- With the entry of new firms the industry total supply increases while DD for an individual firms output declines leading to a decrease in equilibrium PX which eventually reduces the abnormal profits.
- In the long ran all firms under perfect competition earn normal profits since abnormal profits will be competed away with the entry of new firms.
- In the long run firms maximize profits where MC=MR at point A

A graph showing profit maximization under perfect competition in a long run



PX is determined where the output meets the demand curve D which is OPe and costs are determined where the output line meets the AC curve at point A(oco).

Normal profit earned where AC is tangential to AR at PX A

Summery

Explain how a perfect competition firm maximize profits in both short and long run

Steps (i) Where profits are maximized i.e. MC=MR at equilibrium level of output
(ii)Talk about price
(iii)Costs
(iv)The type of profits, where are they earned and how.

(v)Illustrate

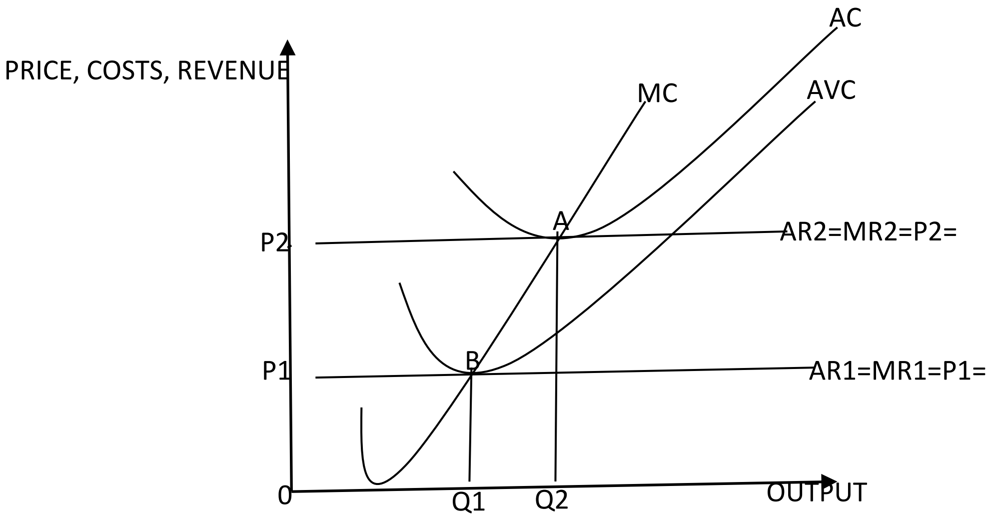
BREAK EVENS AND SHUT DOWN POINT OF A FIRM UNDER PERFECT COMPETITION BREAK EVEN PT.

This refers to the point at which the firm just covers its ACs and earn normal profit i.e. where AC=AR.

SHUT DOWN POINT.

This refers to the point at which the firm only covers its variable costs (AVC) at this point P(AR)=AVC. If the price falls further below the shut down point firm will be unable to operate anymore

ILLUSTRATION OF BREAK-EVEN AND SHUT DOWN POINT OF A FIRM



The level of output 0Q1B represents the shut down point of a firm

The level of output 0Q2A represents the shut down point of a firm

NB never allow a demand curve to touch on the Y-axis because it means that a consumer is willing to pay a given price at zero units of output but it must be as near as possible

- From the diagram A is the break down PT of a firm where P(AR)=AC
- pt is the shut down opt of the firm where p(ar)=AVC.

REASONS WHY A FIRM MAY CONTINUE WITH PRODUCTION AT SHUT DOWN POINT (BELOWAC)

A firm which does not cover its average costs (AFCAVc) is said to be incurring losses and i.e. should ideally close operations. However in the short run a firm may continue operating even If it's incurring losses due to the following reason

I) The firm may be able to cover its variable costs of wages electricity bills etc and may have prospects of covering fixed costs as when in the long run.

2) It may be expecting to get a loan from financial institutions, expand its production and enjoy economies of scale.

3) The firm may be at its infant stage and have hopes of improving in the long run.

4)It may be a government owned firm providing an essential commodity to the public and its closure would have had a diverse effect on the society .

5) The firm may be subsidiary of another profit making firm and using first savings to subsidies [production.

6) The firm may be hopping to change its production techniques and adopt to new prices with prospects of improving its efficiency in feature.

7) The firm may have made supernormal profits before and using pest savings to subsidies production.

8) The entrepreneur may want to maintain his reputation and public image of his business hence making the firm operate below AC (shut down pt)

9) The firm may be laying strategies for monopolizing market through limit pricing which involves losses.

10) The firm may not expect to cover the sunk costs if it leaves production

11) The entrepreneur may expect to increase total revenue by changing marketing strategies and pricing policy.

12) The objectives of the firm may be to provide employment to family members hence operating at a shut down point.

13) The firm may fear to lose skilled manpower hence continuing with production as a way of keeping valuable skilled labour.

14) It may have hope of merging with other prosperous firms hence operate below the AC.

15) Stopping production may create employment to factors of production especially labour.

16) The firm may also expect to receive subsidies from the government which will make it improve and earn profits.

REV QN

1) Under what circumstances may a firm operate below the A at shut down point (conditional question?)

E.g.

In case the firm has hope to change its production techniques.

REASONS A FIRM MAY CLOSE ITS PERATIONS.

1) When the firm persistently incurs loses especially when it’s unable to cover its AVC.

2) If the demand for the firm output has greatly reduced due to changes in tastes and preferences.

3) When the firm has been declared eg due to high indebtness.

4) When the raw materials used by the firm get exhausted and there are no alternative sources.

5) When the firm losses its high skilled labour to another firm and it's not easy to replace it.

6) Expiry of the contract for which the firm was established.

7) Outbreak of war in the locally where the firm was established.

8) The entrepreneur especially sole proprietor may simply decide to close his business

ADVANTAGES OF PERFECT COMPETITION

I. Under perfect competition, there is efficient or optimum use of resources in the long run since firms tend to produce at the minimum point of the AC curve

II. The large number of firms under perfect competition assures high level of output produced thus accelerating the rate of economic growth.

III. There is high quality goods produced by firms because of stiff competition and this improves people's standards of living

IV. There is no wastage of resources in advertising since the commodities are assumed to be homogeneous and consumers are also said to be having perfect knowledge about the market conditions

V. The perfect entry and exit of firms into the industry tend to ensure equitable distribution of income thus reducing income inequality

VI. More employment opportunities are created due to a large number of firms. This increases people's standards of living due to increased incomes of the people.

VII. Under perfect competition, prices tend to be fairly low and stable which benefit the consumers

VIII. It provides an efficient stand/ convenient measuring road for comparison of price determination in other markets

DIS ADVANTAGES OF PERFECT COMPETITION

I. Due to the high level of competition under perfect competition, firms cannot expand because of the normal profits earned in the long run

II. There is limited choice of commodities for consumers since products tend to be homogeneous

III. There are no profits earned by firms in the long run (normal profits) limit investment in research hence no innovations and inventions

IV. There is high risk of unemployment when inefficient firms are driven out of the production process in the long run

V. There is duplication of commodities since there is production of homogeneous goods hence leading to wastage of resources

VI. Since prices are constant. It is not possible to practice price discrimination hence the poor may be discouraged when prices are high

VII. Perfect competition may be misleading since it assumes ideal market conditions that do not exist in real life situation.

REVISION QUESTIONS

MONOPOLISTIC MARKET STRUCTURE

It is a market structure where there are many sellers dealing in differentiated products with many buyers. Firms under monopolistic competition produce almost similar products but are differentiated by the brand names, packaging, trademarks etc

Examples of monopolistic firms/industries include:

Bakery industries e.g. Tip Top, Ntake, Kiddawalime etc, tea leaves industries, Detergents manufacturing industries, Toothpaste industries etc

SALIENT FEATURES/CHARACTERISTICS OF MONOPOLISTIC MARKET STRUCTURE

1. There are many buyers and sellers of products in the market. Under this market structure there are many producers of differentiated products and many buyers
2. There is a high degree of freedom of entry of firms into the industry and exit from the market. Firms are free to enter into the industry to enjoy abnormal profits or to carry out economic activities and they are free to leave the industry in case they are experiencing losses
3. There is product differentiation i.e. firms sell almost similar products but differentiated by the colour, brand name, packaging etc
4. Firms under monopolistic market structure have a fairly elastic demand curve which is down word sloping from left to right

5. Firms under monopolistic market structure operate at excess capacity in both short run and long run
6. There is consumer's brand loyalty under monopolistic market structure. Consumers tend to buy constantly the same products of a particular producer despite the existence of other similar products
7. The major goal of the firm is to maximize profits i.e. profits are maximized where MR=MC
8. Firms under monopolistic market structure can be price makers to a certain extent because of the monopoly power over their brands

PRODUCT DIFFERENTIATION

It is the act of making the product appear distinct from other similar products in the market by monopolistic firms

FEATURES/CHARACTERISTICS OF PRODUCT DIFFERENTIATION

Product differentiation is done in the following ways:

1. **Use of trade marks.** A trade mark is a legal symbol of the product registered by the owner of the business such that there are no other producers allowed to produce products of the same trade mark
2. **Use of attractive and unique packaging materials.** This refers to designing Attractive containers or packaging materials to seal, wrap, cover etc the product so as to prevent it from spoilage/damages/contamination etc during the process of usage/transit
3. **Branding.** This involves giving a product a distinct name to separate/differentiate it from other similar products
4. **Colouring**. This involves choosing a particular colour for the product which is appealing/favorite to consumers. It can be blue, red, yellow etc depending on the age, sex etc
5. **Scent.** This involves making the product smell distinct from other products
6. **Blending and grading.** This involves using good quality ingredients to improve on the quality of products so as to attract more customers
7. **Designing/shaping**. This also makes the product appear distinct from other products
8. **Persuasive advertising.** This involves the use of appealing slogans to make the product distinct from other similar products
9. **Pricing.** Some producers set different prices for similar products to make them unique

ADVANTAGES OF PRODUCT DIFFERENTIATION

- It expands the market of the product hence increasing profits in the business
- It improves on the quality of products
- It creates brand loyalty hence enabling a firm to release stable profits
- It facilitates easy handling of a commodity
- It enables a consumer to identify the product in the market easily

OUT PUT, PRICE, COSTS AND PROFIT DETERMINATION OF A FIRM UNDER MONOPOLISTIC COMPETITION IN SHORT RUN

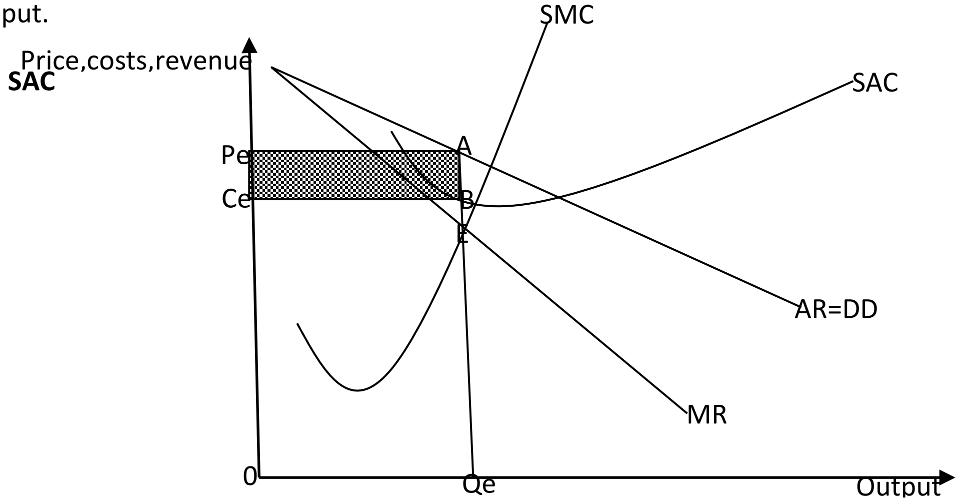
a) Explain how profits are maximized under monopolistic market structure in both short run and long run   14mks

b) Explain the different forms of product differentiation under monopolistic competition 6mks

Solutions:

PROFIT MAXIMIZATION OF A FIRM UNDER MONOPOLISTIC MARKET STRUCTURE IN THE SHORT RUN

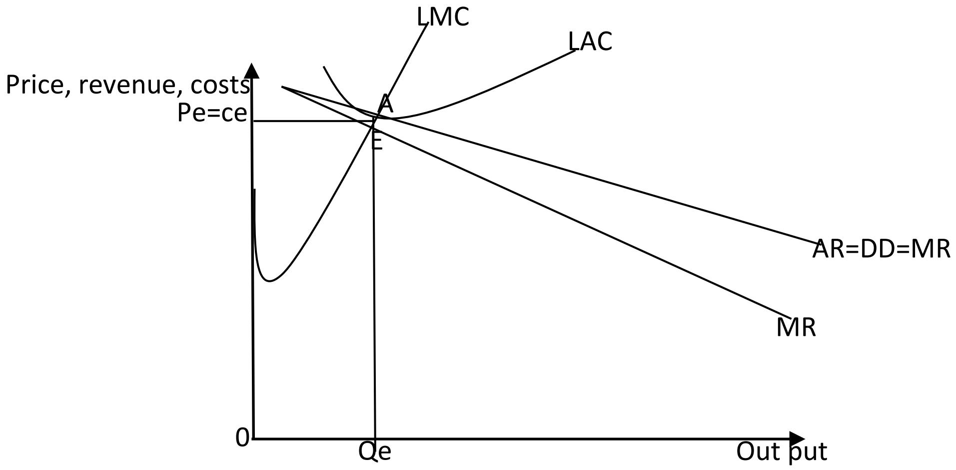
A firm under monopolistic competition maximizes profits where MC=MR at equilibrium level of out put.



Equilibrium output is determined where MC=MR at point E which is 0Qe **1mk**
Price is determined where the output line meets the demand curve at point A which is 0pe **1mk**
Costs are determined where the output line meets the average cost curve at point B which is 0Ce **1mk**
A firm under monopolistic market structure in the short run earn abnormal profits where AR is greater than Ac represented by the shaded area PeABCe **1mk**

PROFIT MAXIMIZATION OF A FIRM UNDER MONOPOLISTIC MARKET STRUCTURE IN THE LONG RUN

In the long run a firm maximizes profits where MR=MC at equilibrium level of out put
However in the long run a firm earns normal profits this is due to abnormal profits earned in short run which attract new firms into the industry, output increases and competition leading to a fall in prices thus earning normal profits



Equilibrium output is determined at point E where MR=MC at equilibrium level of output which is 0Qe
Price is determined where output line meets the demand curve at point A which is 0Pe **1mk**

Costs are determined where the output line meets the average cost curve at point A which is 0C **1mk**
Normal profits are earned in the long run where AR=AC or where average cost curve is tangential to average revenue curve **1mk**

ADVANTAGES/MERITS/POSITIVE EFFECTS OF MONOPOLISTIC MARKET STRUCTURE

1. It promotes even distribution of income. Due to free entry and exist of firms in the industry, many firms participate in the production activities thus bridging the gap between the rich and poor
2. It provides a variety of goods and services which widens the choice of the consumers. This is due to product differentiation and freedom of entry of firms into the industry
3. It promotes consumer's awareness due to persuasive advertising carried out by the firm in the market. This enables consumers to make choices from an informed point of view/it creates brand loyalty
4. The abnormal profits earned in the short run promote research and innovations in the firm hence increasing/improving the quality of products
5. Firms enjoy economies of scale. Many firms under monopolistic competition operate on a large scale and enjoy benefits inform of reduced average cost
6. Monopolistic market structure increases the rate of resource utilization due to many firms in the industry. This promotes economic growth and development in the country
7. Consumers enjoy fairly low prices for the products. Due to stiff competition existing among producers, low prices are charged to attract consumers

DISADVANTAGES/NEGATIVE EFFECTS/CONSEQUENCES/IMPACTS OF MONOPOLISTIC CMPETITION

1. It leads to under utilization of resources since firms produce at excess capacity in both short run and long run period hence contributing to persistent under development
2. It is associated with high operational costs i.e. costs incurred on advertising, packaging, colouring etc. this reduces profits in the firm
3. The normal profits earned in the short run limit research, innovation and expansion of firms. This reduces economies of scale enjoyed by firms
4. It leads to duplication of goods and services produced due to product differentiation. This leads to wastage of resources
5. High degree of product differentiation misleads consumers. Persuasive advertising and other activities intended to make the product distinct distort consumer's choice

SAMPLE QUESTIONS

MONOPOLY MARKET STRUCTURE

MONOPOLY MARKET STRUCTURES

This is a mild situation where there is a single producer or seller of a commodity that has limited or no close substitutes but with many buyers

Monopoly can either be perfect or imperfect

NB Perfect/pure/absolute monopoly is a market situation where there is only one producer or seller of a commodity without any close substitute at all.

Imperfect monopoly refers to a situation where there is a single firm producing a commodity with limited close substitutes e.g. UMEME

FEATURES OF MONOPOLY MARKET STRUCTURES

1. There is only one producer of a commodity in the market for which there are many buyers
2. Monopoly firms aim at maximizing profits ie profits maximized where MC=MR
3. The demand curve of a monopoly firm is inelastic. This is due to absence of limited close substitutes to products of monopoly firms
4. Monopoly firms carry out informative advertisement rather than persuasive advertisement since there is no competitors
5. Monopoly firms operate at excess capacity since they tend to restrict the output in search for high prices
6. There is blocked only for new firms into the industry
7. Products produced by monopoly firms have limited or no close substitutes due to blocked entry or high initial costs incurred in setting up monopoly firms
8. A monopoly firm can influence the price of the commodity to be sold or either the amount of commodity sold but not both

TYPES OR FORMS OF MONOPOLY FIRMS

The following are the major types of monopoly in most economies

- **Absolute monopoly;** This is a form of monopoly where there is only one producer or seller of a commodity with no close substitutes
- **Spartial monopoly**; This is a form of monopoly that arises due to the long distance between producers
- **Imperfect monopoly**; This is a form of monopoly where the produced goods have limited substitutes
- **Statutory monopoly**; This is a form of monopoly that is created by act of parliament which blocks entry of new firms into the industry to provide the same commodity eg UNBS, UMEME
- **Natural monopoly**; This is one which arises from the ownership of specific natural resources OR
- A form of monopoly arising from ownership of strategic natural resources or unique talents by the producer making it almost impossible for other firms to join the industry eg Hima and Tororo cement
- **Collusive monopoly**; This is the type of monopoly which arises from merging of firms to form one big firm which acquires monopoly powers
- **Bilateral monopoly;** Refers to a type of monopoly where there is only one producer of a product sold to a single buyer

- **Quasi monopoly**; This is a type of monopoly created as a result of governments policy of restricting imports that could pose competition to the local producers

NB

Monopsony refers to a market situation where there are many producers but with only one buyer of a particular commodity i.e. marketing boards

Discriminative monopoly is a form of monopoly where there is only one seller or producer of similar products selling them in different markets at different prices.

SOURCES/ORIGIN/BASIS OF MONOPOLY

1. Long distance between producers. Long distance between firms allows them to acquire monopoly producers in their areas of operation as they sell to their respective areas since consumers cannot move long distances
2. Exclusive ownership of strategic raw materials. Areas that have raw materials that are not found in other areas tend to be sole producers of a given product which makes them monopolists
3. Protectionism in international trade. This discourages importation of commodities from other countries which allows domestic producers/firms to acquire monopoly powers in the domestic market
4. Large initial requirement. This discourages firms from joining the industry and the only firm that can acquire capital becomes a monopoly
5. Possession of exclusive knowledge/technology. This makes the only firm with such technology to be a monopolist since it is the only one that can produce a given product
6. Long period of training for some occupations. This allows those individuals who already possess such skills to be monopolists since it takes a long time to join such professions
7. Injunction by the act of the parliament. Some state monopoly firms come into existence by the act of parliament which presents other private firms from engaging in the same business i.e. Uganda Revenue Authority (URA), UNEB etc. this gives such institutions full control of the services they are delivering
8. Existence of patent rights and copy rights. Inventors of new methods of production/new products are normally given a period of time within which no other producers are allowed to produce that product which gives rise to monopoly
9. The narrow/small market size. In situations where the market is too small such that cannot allow more than one firm to produce the commodity give rise to monopoly i.e. spear Motors ltd is the sole importer of Mercedes Benz because of the small market
10. Limit pricing policy. Low cost firms charge very low prices which makes entry and survival of other firms in the same line of production unattractive and unprofitable

Account for the existence of monopoly firms in your country

How can monopoly be regulated in your country

REASONS FOR THE EXISTENCE OF THE STATE MONOPLOY

The following are reasons for the existence of state monopoly

1. To protect the consumers from being over exploited by the producers especially where the elasticity of demand is inelastic

2. To raise enough revenue for the government for financing other development projects since profits can be realized in monopoly

3. To minimize income inequality which individual monopoly tend to create because consumers poorer by spending all their income to one produce only who becomes richer

4. For strategic reasons for example to control the production dangerous products e.g. fire arms

5. To maintain the quality of products because individual monopoly is usually associated with poor quality products because of producing at excess capacity in the long run

6. Some projects require a lot of capital which private individuals can not afford. Because of the importance of these projects, the government takes up responsibility to bring about their existence hence giving a rise to state monopoly

7. To provide essential but unprofitable commodities. The private individuals neglect them hence need for government control for example

8. To reduce regional imbalance in development by establishing state monopoly to some regions as growth poles

9. To regulate economic activities in the economy for example the demand for money and its use through the central bank

10. To control over commanding heights of the economy so as to channel resources to other development projects eg industries

REASONS WHY A MONOPOLY MAY CHARGE LOW PRICES

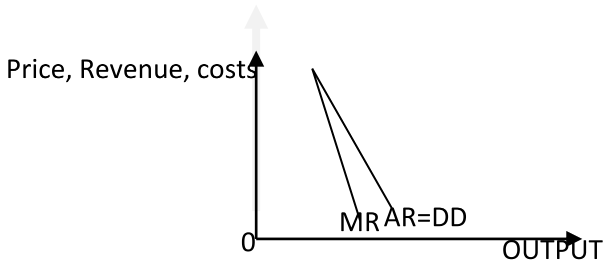
I. Monopolists may fear competition from substitutes since pure monopoly do not exist in reality. There are substitutes of every commodity that are produced in case a monopolist charges a high price, consumers will shift their consumption to substitutes e.g. use of generators instead of HEP
II. The need to restrict new entrants. If monopolists charge high prices, new entrants will enter the production so as to enjoy the high profits. In order to restrict such, a monopolist may charge low prices.
III. The fear of boycott i.e. refusal to consume what a monopoly has produced because of selling it at a high price.
IV. The fear of nationalization i.e. government may decide to take control over the firm that is charging high prices to reduce consumer's exploitation
V. The fear of anti monopoly tendencies practiced by the government e.g. taxing the monopoly to reduce its profits
VI. The fear of government price controls e.g. price ceiling which is relatively lower
VII. The need for cutthroat competition as a result of collusion that puts the prices very low to eliminate inefficient firms in the industry

THE DEMEND CURVE AND MARGINAL REVENUE CURVE OF A MONOPOLIST

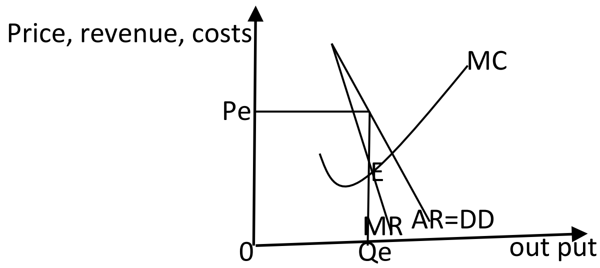
Since the monopolist has the power to determine the price for his output, the demand curve for his product is down ward slopping from the left to the right and it is inelastic.

The curve is inelastic because of the existence of very few close substitutes i.e. a bigger change in price results into a less than proportionate change in the quantity demanded of a commodity.
The marginal revenue curve for a monopolist also takes that same shape as the demand curve. This is because, when more units of a commodity are brought to the market, the price falls and therefore the extra revenue received from an extra unit of output sold (MR) reduces as more units are sold.

THE DEMAND CURVE AND MARGINAL REVENUE CURVE OF A MONOPOLY MARKET STRUCTURE

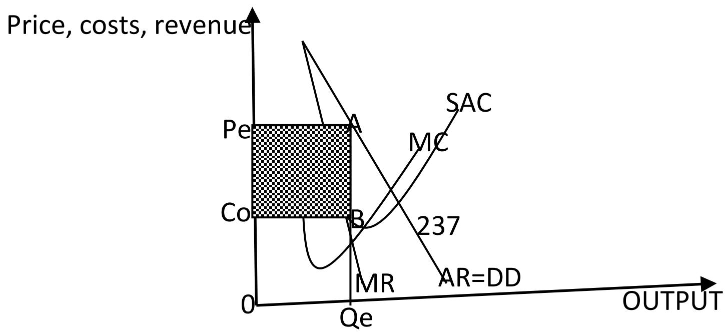


EQUILIBRIUM POSITION OF A MONOPOLIST
Equilibrium position of a monopolist is determined by the intersection of the MC and the MR curve i.e. it is determined where MC=MR



OPe is the equilibrium price, OQe is the equilibrium output of a profit maximizing firm/monopoly. Point E is the equilibrium position of the firm.

DETERMINATION OF OUTPUT, PRICE, COST AND PROFIT MAXIMISATION FOR A FIRM UNDER MONOPOLY IN THE SHORT RUN.



Equilibrium output is determined where MC=MR at point E which OQe.

A monopolist determines the price where the output line meets the demand curve (AR curve) at point A which is point X

A monopolist firm determines costs where the output line meets the AC curve at point y which is OCo.

A monopolist in the short run earns abnormal profits where AR>AC (greater than) which is the shaded area **peABco** which are got by subtracting total costs OCoBQe from the total revenue (OPeAQe)

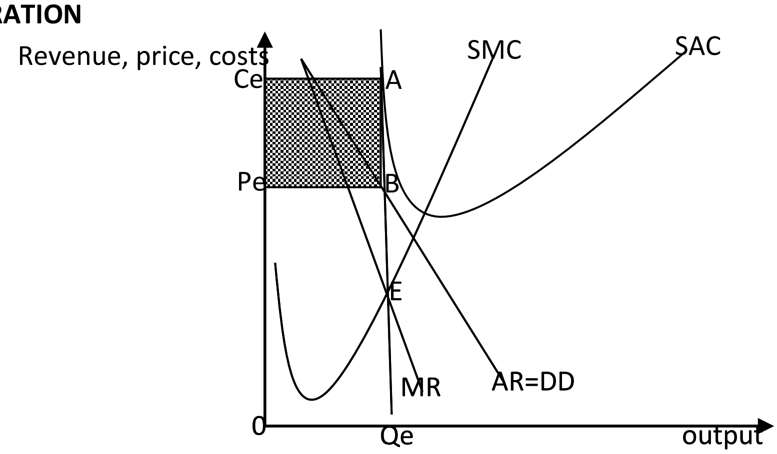
I.e. Abnormal profits = OPeAQe-OCoBQe

=(PeABCo)

A monopoly firm continues to make abnormal profits in the long run because of the blocked entry of new firms. Therefore, the graph for the long run is the same as that of short run period. However, in the long run, a monopolist can re-invest the abnormal profits in the firm and earn bigger profits and expand the scale of production.

A monopolist can also incur losses in the short run where his ACs of production exceed AR at the equilibrium level of production

ILLUSTRATION



A monopolist produces output OQe at a point where MR=MC. He then charges PX OPe where the output line meets the demand curve since AC exceeds AR at the equilibrium level of output, the monopolist incurs losses indicated by the shaded area of CoABPe

IMPLICATIONS /EFFECTS/CONSEQUENCES OF EXISTANCE OF A MONOPOLIST IN AN ECONOMY

The existence of a monopoly in an economy has got both positive and negative implications

Positive impacts

- Under monopoly, economies of scale are enjoyed since firms tend to produce large quantities on large scale. This reduces the average cost.
- There is limited duplication of commodities hence resources are not wasted since there is a single producer in the market
- Monopoly market structures permits the practice of price discrimination which benefits the low income earners.
- Research and innovations are encouraged since a monopolist will be assured of enjoying the benefits alone for example the abnormal profits earned in both short run and long run. Such findings lead to the development of new products and production techniques
- State monopolies provide public utilities e.g. electricity, water, etc at relatively low prices hence improving on the well being of people
- There are generally low operational expenses since there is no competition e.g. persuasive advertising is not necessary
- The patent rights accorded to monopolists lead to development and growth of infant industries because of the limited competition from well established firms
- Since monopolists earn abnormal profits, they are reliable sources of revenue to the government since the government taxes those abnormal profits
- Monopolists enjoy abnormal profits which may be re-invested and improve on the conditions of employees.
- Big monopolies generate employment opportunities and income by operating on large scale thus improving standards of employees

Negative implications

- There is excess capacity in some monopoly firms due to lack of competitors hence retarding the process of economic growth and development.
- Monopolies tend to exploit consumers since they may deliberately limit the level of output and charge high prices
- The existence of monopoly tends to worsen the income and wealth inequalities due to the abnormal profits earned by monopolies and not by other producers
- There is provision of low quality goods or services due to lack of competitors
- It leads to shortage of goods and services. With monopoly, there is a danger of serious shortages being experienced in case firms break down
- Monopolists tend to exert pressure on government to make policies in their favor without considering the impact of those policies to the public
- There is limited variety of products produced hence limited choice for the consumers which lower their standards of living.
- Limited employment opportunities are created due to being a single firm in the industry and operating at excess capacity
- There is limited inventions and innovations in the industry since abnormal profits are guaranteed
- It results into exploitation of workers by underpaying them, not catering for consumers because of the assured market, etc
- Monopoly firms exert pressure on the government. Monopoly firms tend to interfere with the government policies and decisions like sabotaging tax bills, participating in politics etc
- Monopoly firms contribute less to government revenue since many are owned by foreigners and state monopolies are less taxed

Questions

- Give reasons why a monopolist should be eliminated
- How is a monopoly regulated in an economy?
- Under what circumstances a monopolist may be eliminated?

MEASURES TO CONTROL MONOPOLY

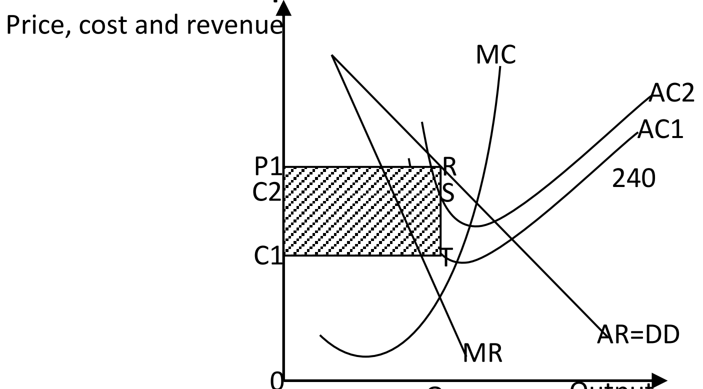
I. By price control by the government. The government may fix the price for the monopolists' products below that being charged by the monopolist hence reducing the monopoly powers
II. By reducing the super normal profits eg a maximum price legislation
III. By removal of foreign trade restrictions to encourage competition with foreign firms which may lead to efficiency of the local firms
IV. BY nationalization. The government can take over ownership and management of monopoly firms and start production in favor of consumers
V. There is removal/reduction of patent rights which protect producers. The government can stop/reduce giving the periods of patents given to investors such that the lifespan of monopoly is limited and this can enable new firms to come up.
VI. Anti-monopoly policies/laws can be undertaken like those prohibiting merging of firms
VII. By establishment of national bureau of standards NBS can be undertaken by the government to ensure that the quality of goods and services produced by a monopolist firm is regulated.
VIII. The government can put in place quotas where it can determine the minimum amount of output that a monopolist can produce per period of time. This can guard against low output levels by monopolists
IX. Setting up of rival firms. The government can set up/influence the establishment of rival firms to compete with private monopolies. This leads to increased output, low prices and promotion of efficiency among monopolists.
X. By boycotting the consumption of products produced by monopolists
XI. Taxation. The government can either impose a lump sum tax or a specific tax so as to reduce monopolists' abnormal profits

Questions

1. Distinguish between lump sum and specific taxes
2. With illustrations, show the effect of ;
   a) Lump sum tax
   b) Specific tax (charged on each unit produced)

   SOLUTIONS

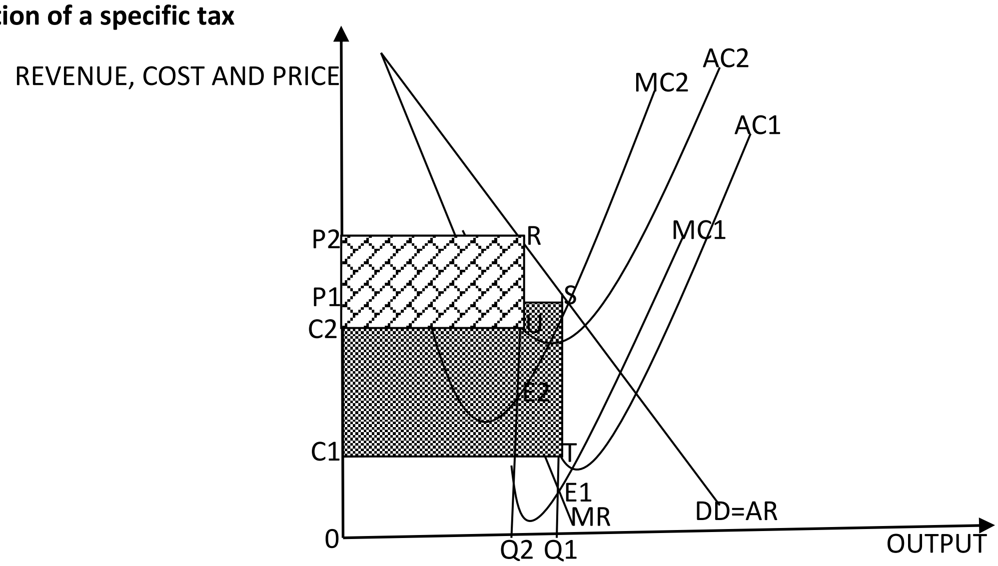
A lump sum tax is the one imposed on the monopolist's products regardless of the level of output produced. To a producer, this is regarded as a fixed cost
While
A specific tax is a tax imposed on each unit of output produced by a monopolist. Its therefore a variable cost to the monopolist.
Illustration of a lump sum



Effects of the tax

- MC increases as AC increases and this is shown by the upward movement from AC1 to AC2
- The MC remains constant hence does not shift
- The price of the product at OP1 per unit sold
- Abnormal profits of the monopolist reduce from C1P1RT to C2p1RS

Illustration of a specific tax



Effects of a specific tax

- The average cost of production increases and this is shown by the upward shift of the AC curve from AC1 to AC2
- MC also increases causing an upward shift of the MC curve from MC1 to MC2
- The price of the product increases from OP1 per unit to OP2 per unit after the tax.
- The abnormal profits of the monopolists reduces from C1P1ST to C2P2RU
- The equilibrium position changes from E1 where MC=MR to E2where MR=MC2

Reasons why a monopolist should be controlled

- To ensure increased level of output
- To reduce income inequality resulting from high profits
- To reduce consumer's exploitation resulting from high prices
- To ensure a variety of products offered to consumers
- To ensure improvement in the quality of a monopolist product
- To promote efficiency in production
- To avoid reliance on the producer that may cause problems during times of break down
- To reduce under and un employment
- To reduce exploitation of workers
- To generate revenue to the government through taxation

- To reduce pressure exerted on government by some monopoly firms

  Question

  Why may a monopoly be eliminated in an economy?
  - A monopoly may be eliminated because it exploits the customers
  - It may be eliminated because it increases unemployment techniques

Under what circumstances a monopoly may be eliminated in an economy?

- When it increases un employment
- In case it exploits consumers, etc

PRICE DESCRIMINATION/ PARALLEL PRICING

- This is where a monopolist /producer charges different prices for similar units of a commodity to different groups of consumers in different markets **or**
- Price discrimination refers to the act of selling a unit of a commodity at different prices to different categories of consumers in different markets without considering the costs of production 1mk

FORMS OF PRICE DESCRIMINATION

I. **Discrimination according to the level of income of the consumer**. This is where a seller/monopolist may decide to sell the same units of a commodity to different people at different prices depending on their levels of income e.g. charging high income earners a higher price for the same product and low price to the poor e.g. medical services
II. **Price discrimination according to time**. There are some goods and services where prices vary with the hours of the day. E.g. video shows are cheaper in the morning than during day, transport charges are expensive in early morning and late evening than day time.
III. **Discrimination according to sex**. Is when a certain good/service is supplied to people at different prices depending on sex e.g. women usually pay less than men in entrance in dance halls and clubs.
IV. **Discrimination according to age**. E.g. the young in foot ball matches are charged more than adults
V. **Discrimination according to location (geographical discrimination**) usually prices in urban areas are higher than those in rural areas. This also involves monopolists charging lower prices in the market with elastic demand and higher prices in the market with inelastic demand.
VI. **Price discrimination according to use**. The same commodity may be charged highly where it's put to several uses and charged lower to a consumer who puts it to few uses.
VII. **Price discrimination according to quality/convenience**. Goods and services that provide high levels of convenience are charged higher prices than those that inconvenience consumers e.g. different classes in bars, stadium e.t.c are of different prices.
VIII. **Price discrimination according to differentiation of the commodity**. This is where a commodity is sold at different prices according to the way it is branded/packed eg packed goods cab be charged highly than un packed ones.
IX. **Discrimination according to relationship between the producer and consumer**. If a consumer is a friend to a seller, he may face low prices compared to other consumers

X. **Discrimination based on fashion or age of the product** i.e. brand new commodities are usually more expensive than the successive products

DEGREE OF PRICE DISCRIMINATION.

- **Perfect discrimination (first degree)** this is when a monopolist takes whatever maximum price a consumer is willing to offer
- **Second degree of price discrimination.** This is when a monopolist charges a uniform price per unit for a specific quantity of a commodity and a higher or lower price per unit for additional units of the commodity. E.g. a monopolist can lower prices for bulk purchases and increase price for buying in small quantity.
- **Third degree of price discrimination/market segmentation.** This happens when the monopolist separates the market like domestic and foreign market by charging different prices for the same units of a commodity in different markets.

CONDITIONS NECESSARY FOR PRICE DISCRIMINATION TO BE SUCESSFUL

- The market should be divided into sub-markets e.g. basing on sex, age, income level etc
- Elasticity of demand at each price level must differ in the different markets so that a monopolist charge high prices in the market with inelastic demand and low prices in the market with elastic demand
- There should be geographical separation of the market so that consumers are not aware of the prices charged by another monopolist.
- The cost of transferring the product from one market to another by the farmer must be high hence selling to a nearby monopolist
- The cost of separating the market by the seller or producer must be low so as to earn profits
- Consumers must be ignorant about the existence of other markets
- There should be no government interference in determining the price and output to be produced. The seller/producer/supplier must be a monopolist
- The commodities sold in different markets should be the same i.e. quality, size, etc
- The exchange should involve personal services which can't be transferred from one person to another e.g. medical services
- It can be successful in case goods are sold by special orders, there the consumers will not be able to know the price at which other consumers are buying the same units of a commodity
- MR in both markets should be the same.

Questions;

1. Explain conditions that may lead to failure of price discrimination
2. Under what circumstances may price discrimination fail?
3. Explain the factors influencing the success of price discrimination in your country/an economy

The following are factors influencing the success of price discrimination:

- Elasticity of demand in different markets. If the elasticity of demand in different markets differs price discrimination will be successful because a monopolist can charge high prices in the market with inelastic demand and low prices in markets with elastic demand but if the elasticity of demand is the same in different markets, the monopolist cannot charge different prices thus price discrimination will not succeed
- The distance existence between markets. If there is a long distance existing between producers it becomes easy for one producer to charge different prices for a unit of a

commodity thus making price discrimination successful but if there shorter distance or no distance between producers price discrimination will fail consumers will be able to go and buy from the cheaper producer

- The cost of transferring the product from one market to another. If the cost of transferring the product by the farmer or producer from one market to another is high price discrimination will be successful because he/she will be forced to sell to the nearby monopolist but if the cost of transferring the product is low, price discrimination will fail because the producer will sell to other buyers who can buy at a high price
- The cost of separating the market by the seller. If the costs of separating the markets are low price discrimination will be successful because it becomes profitable for the seller but if the costs of separating the markets are high price discrimination will fail because a seller will not be able to maximize profits
- The degree of consumers' awareness also influences the success of price discrimination. If there is high degree of consumers awareness about prevailing prices in the market and existence of other producers, price discrimination will be successful because they will not buy the seller's goods at different prices but if consumers are not aware of the prevailing market conditions, price discrimination will fail
- The marginal revenue in both markets. If the marginal revenue in both markets is the same, price discrimination will be successful because the monopolist will be earning profits in all the markets but if the marginal differs in different markets price discrimination will fail because the monopolist will not be able to maximize profits in all the markets
- The degree of government intervention. If there is a high degree of government intervention in determining prices of goods and services, price discrimination will fail because a monopolist will not be able to charge different prices if there is a fixed price by the government, but if there is limited or no government intervention, price discrimination will be successful because a monopolist will be in position to charge different prices in different markets
- The nature of the seller. If the seller is a monopolist, price discrimination will be successful because existence of seller in the market makes it easy to charge different prices for a unit of a commodity. But if the seller is not a monopolist implying that he/she has competitors price discrimination will fail since he will not be able to charge different prices of a unit of a commodity
- The nature of the commodity sold. Incase of personal services like treatment, which cannot be transferred from one person to another price discrimination will be successful. But if it is a normal good which can be transferred to another person, price discrimination will fail because consumers will know the price at which each has purchased it
- Terms and conditions of sale/mode of payment. Where goods are sold on special orders price discrimination will be successful because consumers will not be able to know the price at which others are buying. But if the mode of payment is normal meaning that it is well known by all buyers/consumers price discrimination will fail

ADVANTAGES OF PRICE DISCRIMINATION

1. It enables the poor/ low income groups to get goods and services at affordable prices
2. It increases revenue/turnover of a monopolist as he gets profits from different markets
3. It helps to reduce income inequality since it's a method of income distribution i.e. the rich subsidize the poor in price discrimination according to income
4. It increases government revenue from taxes monopolists pay. This enables the government to extend social services to the people.

5. It enables consumption of certain commodities among certain age groups e.g. sports for youth
6. Enables producers to sell off certain surplus output to other markets(dumping)
7. Eliminates middle men who may tend to increase the prices of commodities because monopolists sell their products to final consumers.
8. It enables monopolists to utilize resources to full capacity hence ensuring increased supply of goods and services.
9. Under operation of price discrimination, consumers in different areas are reached i.e. goods and services are extended to different consumers in all parts of the country

DISADVANTAGES.

The following are short comings of price discrimination in an economy:

- It leads to exploitation of consumers especially where a monopolist fixes a high price for some commodity for a particular group of consumers thus lowering the welfare of people
- It worsens the problem of income inequality since a monopolist earns abnormal profits making him/her richer at the expense of consumers. This in the long run leads to social tensions which culminate into political instabilities
- Commodities being sold at low prices in the market tend to be of poor quality thus leading to poor standards of living of people
- Price discrimination in form of dumping discourages the growth of infant industries in the country. This is because products produced by infant industries are highly priced due to high production costs which make them lack market due to existence of cheaper commodities
- Price discrimination encourages consumers' ignorance since it is a pre-liquisite for its success. This makes many consumers buy defective goods and being exploited
- It is costly to maintain the two markets hence the burden is usually shifted to consumers in form of high prices

OLIGOPOLY MARKET STRUCTURE

This is a market structure where there are few firms or sellers dealing in either homogeneous or differentiated products but with many buyers

Oligopoly can be classified into;

- Perfect oligopoly
- Imperfect oligopoly

Perfect oligopoly is the type of oligopoly where there are few firms/producers of a homogeneous product but with many buyers.

Imperfect oligopoly /differentiated oligopoly is a market structure where there are few firms or sellers dealing in differentiated products but with many buyers

EXAMPLES OF OLIGOPOLY FIRMS IN UGANDA

- Beer industry (Nile breweries, UBL)
- Cement industry(Tororo, Hima are perfect oligopoly
- News papers industry
- Telecommunications e.g. MTN, UTL, Warid, etc

DUOPOLY

This is a market structure where there are only two firms but few buyers of closely related products

SALIENT FEATURES OF OLIGOPOLY MARKET STRUCTURE.

1. There are few firms/sellers in the industry. Oligopoly is characterized by few firms dealing in homogeneous or differentiated products.
2. There are many buyers in the market just like in the perfect competition/monopolistic competition, oligopoly is characterized by existence of many buyers
3. There is interdependence of firms in the industry. There is complete interdependence of firms regarding price and output decision. This is because each seller has significant control or influence upon each other in the industry hence each firm is sensitive in the firms' behaviors.
4. There is limited entry into the industry. This is basically because of high costs of production involved in the industry
5. There is persuasive advertising in the industry. Oligopolistic firms spend so much in advertising especially in perfect oligopoly because the costs of production are just differentiated
6. Firms under oligopoly aim at profit maximization just like in any other market structure
7. There is cut throat competition in the industries under oligopoly firms. There is cut throat competition involving continuous struggle and rivals in the industry by using non price forms eg after sales services , sales promotion, etc
8. There is uncertainty in the industry. An oligopolistic firm is said to face a high degree of uncertainty in the market as far as price and output decision of other firms in the industry are concerned. E.g. a price cut by one firm may lead to various reactions from rival firms.
9. There is no unique pattern of pricing policy in the industry. This is due to rivals arising from interdependence among oligopolistic firms. There are always two conflicting objectives i.e. each firm wants to remain interdependent and act the same time maximize profits. Thus, firms always act and react on the price output movement of another firm hence firms resort to different forms of pricing their products.
10. There is price rigidity in the industry. Price setting tends to remain constant for some time since all firms fear to take the first move to change the price for fear of activities of rival firms.
11. Firms have kinked demand curve. An oligopolistic firm is faced with a kinked demand curve due to uncertainty and high degree of inter dependence and uncertainty.

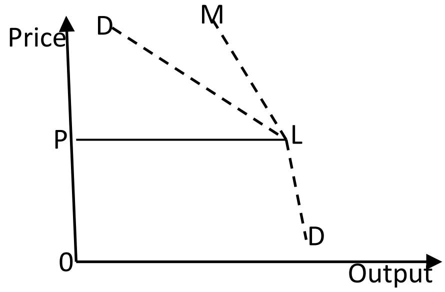
The kinked demand curve under oligopoly

Under oligopoly, each firm is so powerful but its behaviors may provoke reaction from its rivals. If there is no collusion, each firm will be reluctant to change the price for fear that rival firms will react.

Suppose there is an administered price in the industry, it will loose customers because other firms may not react in the same way. Hence the firm is faced with an elastic demand curve above the administered price. And similarly, if the same firm lowers its price below the administered price, rival firms will also reduce price in the same way in order to maintain their market share. Hence the firm is faced with the inelastic demand curve.

If the two demand curves combine, they form a kinked demand curve as illustrated below

Illustration



Pl is the administered price, DD is the demand curve for an oligopolistic firm with a kink at L.

MD is the demand curve for rival firms

A kinked demand curve is a demand curve facing oligopoly firms characterized by a bend and it's elastic above the bend and inelastic below the bend.

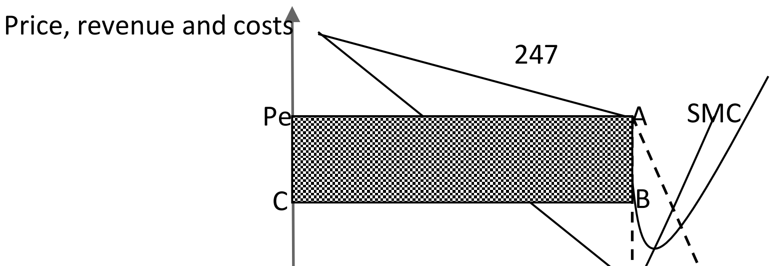
PRICE DETERMINATION UNDER OLIGOPOLY.

Under oligopoly, there is no single method of determining price. Price can be determined in any of the following methods.

- **Independent pricing; This** Is where each firm or seller within an oligopoly industry takes an independent action to fix a price where it shall maximize profits. This action creates rivals in the industry due to counter reactions of other firms .Such rivalry leads to price wars.
  A price war is the competition among rival firms usually dealing in similar goods which involves reducing prices of their respective goods to out compete rivals and attract more customers.
- **Use of collusion/cartel pricing/perfect pricing.** This is where firms in the same industry set a common price in order to reduce competition and increase profits.
  NB: A cartel is an organization of independent firms within the same industry formed to reduce competition by regulating output to influence price of their products.
  A cartel in which price- output policies for all members is taken by a cartel board is known as a **perfect cartel**.
  A cartel which is found in differentiated oligopoly where all firms in the industry enter into collusion and charge a uniform price is known as a **market sharing cartel**

  HOW OLIGOPOLISTICFIRMS MAXIMISE PROFITS, DETERMINE OUTPUT AND PRICE IN BOTH THE SHORT AND LONGRUN PERIODS.
  An oligopolistic firm maximizes profits where MC=MR.

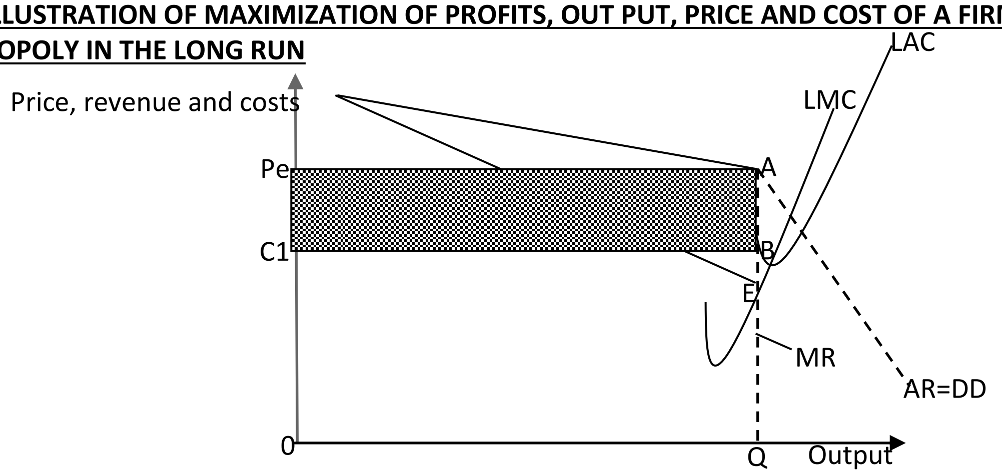
<u>AN ILLUSTRATION OF MAXIMIZATION OF PROFITS, OUT PUT, PRICE AND COST OF A FIRM UNDER OLIGOPOLY IN THE SHORT RUN</u>



- From the diagram above the MR curve has two portions one for the elastic portion of the demand curve and a another one for the inelastic portion of the demand curve
- The dotted line of output indicates the high degree of uncertainty under oligopoly
- Oligopoly firm maximizes profits at a point where MC=MR at equilibrium level of out put
- Output is determined where MR= MC at point E which is OQ **1mk**
- Price is determined where the output line meets the demand curve or AR curve at point A which is OPe **1mk**
- Costs are determined where output line meets the average cost curve at point B which is OC1 **1mk**
- A firm under oligopoly in the short run earns abnormal profits where AR>AC represented by the shaded area **PeABC1**. It is got by subtracting Total costs (0C1BQ) from Total revenue (0PeAQ). Hence, profits= 0peAQ-0C1BQ = PeABC1 1mk

7x1=7mks

<u>AN ILLUSTRATION OF MAXIMIZATION OF PROFITS, OUT PUT, PRICE AND COST OF A FIRM UNDER OLIGOPOLY IN THE LONG RUN</u>



- In the long run profits are maximized where MC=MR at equilibrium level of out put**1mk**
- Out put is determined where MC=MR at point **E**which is 0Q **1mk**
- Price is determined where the out put line meets the demand curve at point A which is 0Pe 1mk
- Costs are determined where the out put line meets the LAC at point B which is 0C1 1**mk**
- A firm in the long run continues to earn abnormal profits due to restricted entry and exit of firms under oligopoly. This is represented by the shaded area **PeABC1** **2mks**

ADVANTAGES OF AN OLIGOPOLISTIC MARKET STRUCTURE

b)The following are merits of oligopoly firms in my country:

- Consumers enjoy fair and stable prices due to existence of price rigidity thus improving on their welfare
- Consumers under oligopoly enjoy better quality products resulting from the stiff competition existence among producers.
- Oligopoly firms produce a variety of goods and services due to product differentiation thus widening their choice
- Consumers enjoy gifts and prizes from the firms resulting from non price competition forms like giving after sales services, in form of discounts, samples etc
- Oligopoly firms promote consumers' awareness through both informative and persuasive advertising hence enabling consumers to make appropriate decisions from informed point of view
- Oligopoly promotes innovations and inventions due to the abnormal profits earned both in the short run and long run.
- It provides revenue to the government through taxes paid by oligopoly firms and people employed there. This enables the government to extent social services to people for example drugs in hospitals
- It creates employment opportunities due to large scale operation of firms under oligopoly thus improving on the earnings of people
- Firms under oligopoly enjoy economies of scale like marketing, managerial, transport economies of scale6x1=6mks

DISADVANTAGES

1. High operational costs are incurred by the firm which reduces their profitability eg advertising costs and after sales services
2. Low level of output is produced due to restricted entry of the firms in the industry thus limiting consumers' choice
3. There is wastage of resources especially in extensive sales promotion activities
4. Excess capacity. Firms produce at excess capacity in both short and long runs leading to low employment opportunities Created.
5. High degree of uncertainty is experienced by the firms thus making it difficult to plan for their activities.
6. It worsens income inequality since firms enjoy abnormal profits at the expense of other firms outside the industry
7. Oligopoly market structures may result into un employment if the inefficient firms are pushed out of the industry
8. Duplication of products especially in imperfect oligopoly where there is a homogeneous product dealt in which reduces the standards of living.

REASONS FOR PRICE RIGIDITY UNDER OLIGOPOLY

Rigidity is a tendency (especially under oligopoly) of prices in the market to remain stable over a given period of time despite changes in the cost of production.

Under oligopoly, prices have a tendency of being rigid for a long period of time and this is explained by the following reasons

1. Firms may not change their prices if such prices have been determined by all firms i.e. through collusion to avoid price war.
2. Firms may be contented with the current price and profit levels hence they see no need th change prices
3. If the administered price is set by the leading or low cost firms, its hard for small firms to tamper with the prices
4. Prices may remain rigid because the existing firms may want to limit the country of new firms into the market i.e. limit pricing
5. Firms usually adopt non price competition or other methods of increasing sales and profits eg by branding, after sales services, etc so they see no need to change prices.
6. Price increase may chase away customers hence leaving prices relatively stable.
7. Lowering price may not enable the firm to cover production costs hence no need for lowering prices
8. There is a lot of uncertainty in the market arising from the behaviors of other firms therefore firms try to maintain the current prices.

Question

Account for price rigidity under oligopoly

NON PRICE COMPETITION

This is a competition strategy in oligopoly market structures where a firm uses other means than reducing price in an attempt to attract more customers to buy its products and not of rival firms.

c)The following are non-price competition methods used by firms under oligopoly in Uganda:

- Use of persuasive advertising. Many firms in Uganda persuasively advertise their products on radios, televisions in order to attract more customers to buy these products
- Offering of free sample to customers is also a strategy employed by many firms in Uganda under oligopoly so that customers can get the taste of new products being produced e.g. Mountain Dew when it was still a new product on the market
- Firms also give after sales services to customers for example cleaning of car screens at fuel stations, servicing and repairs in order to attract them to buy more fuel
- Many firms are participating in sponsoring community development programs like games and sports for example coca-cola post primary football tournament Bell cup Uganda to develop talents of their clients as clients are buying more goods from these companies
- Opening branches or distribution points in different places and improving the quality of shopping outlets so as to bring goods and services nearer to the customers. For example banking institutions like Equity have several branches in different urban centres, telecommunication companies like Warid and MTN etc
- They use appealing slogans, trademarks and brand names that distinguish their products from those of rival firms for example appealing slogans like we care by warid, everywhere you go by MTN, where quality matters by WBS etc
- Use of attractive packaging materials in order to win customer’s loyalty. Most firms use unique wrappers on their products to prevent them from pouring and contamination and also to attract customers. For example this is common with big super markets like Uchumi, capital shoppers etc
- Most enterprises are using one stop shopping centers for example fuel stations have super markets which saves customer’s time

- Renovating customers' premises through painting them company's colours. This also attracts many people to buy products from such companies in order to get such privileges for example telecommunication companies like MTN
- Participating in trade fairs and exhibitions where customers are given extra attention especially as far as the use of and benefits of the products is concerned. For example the annual trade faire held at LUgogo UMA show ground
- Organizing promotional events where consumers purchase commodities at lower prices for example Warid lines are sold at shs.500/= on promotion
- Firms also organize raffle draws and games in order to increase sales for example Beera mulodi by centenary bank
- Some firms provide credit facilities to their customers to attract them buy more goods and services

NATIONAL INCOME

National income can be defined as the total monetary values of all goods and services arising from the productive economic activities carried out by the nationals and foreigners in the country in a given period of time.

National income and national income concepts are usually defined in terms of goods and services because the income that people get arise from the goods and services that they produce. This national income is the same as national products.

National expenditure refers to the total expenditure in monetary terms on goods and services in an economy by the nationals of a country in a given period of time.

National income, national products and national expenditure are equivalent or are the same because they all represent the productive economic activities of a country in a given period of time.

CONCEPTS OF NATIONAL INCOME

1. **Gross Domestic Product (GDP).**This is the monetary value of all goods and services produced within a country (by both nationals and foreigners) in a given period of time (including the value of depreciation).

2. **Net Domestic Product(NDP).** This refers to the monetary value of all the final goods and services produced within the territorial boundaries of a country (by both nationals and foreigners) in a given period of time excluding the value of depreciation.

3. **NB .Depreciation** is the wear and fear of capital equipment during the production process. It's also referred as capital consumption.NDP=GDP-Depreciation.

4. **Gross National Product (GNP)**.This refers to the total monetary value of all the final goods and services produced by the nationals of a country (both within and abroad) in a given

period of time (including the value of depreciation).GNP=GDP+ Net income from abroad. Where net income is the differences between the incomes got from nationals abroad and incomes got by the foreigners from the country.

5. **Net National Product (NNP).**This refers to the monetary of all final goods and services produced by 2citizens of a country (both at home and abroad during a given period of time excluding depreciation.NNP=GNP-Depreciation. Other concepts related to national income include:
6. **Income per capital**. This refers to the average income per person in a country in a given period of time. Its obtained by dividing the country's national income by population
7. **Income per capital** = national income/population or GNP per capita= GNP/ population
8. **Disposable income** (take home pay). This refers to the income available to the individuals for spending/ saving after the personal income taxes and other compulsory contributions have been deducted.
9. **Personal income**. This includes the income received from the productive economic activities as well as the income received without having carried out any productive activity e.g. those in form of transfer payments from the government at business.

NB.

Transfer payments are payments received without corresponding goods and services rendered that is to say they are payments for no work done. They are also known as non-quid-proquo payment e.g. in form of old age person. They are called non-quid-proquo payment because there is no direct good and services expected from the one who has received it**. Forms of transfer payment include**: student's allowances, pocket money, old age persons, gifts, unemployment benefits, social security benefits etc.

DETERMINANTS OF THE LEVEL/ SIZE OF A COUNTRY'S NATIONAL INCOME

1. **The techniques of production/ the level of technology used in production**. Poor technology leads to low productivity of labour which leads to the low volume of goods and services produced at therefore low levels of national income while modern technology leads to high productivity of labour, hence high output of goods and services are hence high levels of national income.

2. **The size of a market**. A large market encourages investments in the country which leads to high output production and output of goods and services therefore high levels of national income while a small market discourages investments which leads to low level of output and low levels of national income.

3. **The political climate**, Political instabilities in a country discourages investments which leads to low production and output hence low levels of national income while political stability encourages investments which leads to high production and output hence high levels of national income.

4. **The level of skills/ labour skills.** A high level of skills of labour in a country results into high productivity of labour and high output of goods and services and therefore high levels of national income but low levels of skills leads to low productivity of labour this leading to low output and low levels of national income.

5. **The level of exploration of the country's natural resources**. A high level of a country's resources leads to high production which leads to high output of goods and services and hence high levels of national income while a low level of exploration of a country's resources leads to low production and low output of goods and services and therefore low levels of national income.

6. **The size of capital stock**. A high capital stock leads to a high level of investments hence leading to high production, output and high levels of national income but a small size of capital stock leads to low level of investment thus leading to low production and output hence low levels of national income.

7. **The level of development of a country's infrastructure.** Infrastructure discourages investments in a country which leads to low output and low levels of national income while well developed infrastructure encourages investments which leads to high output and high levels of national income.

8. **The investment climate/ availability of investment incentives**. A conducive investment climate characterized by low taxes, tax holidays encourages investments which leads to high output and high levels of national income but a poor investment climate eg high taxes discourages investments which leads to low output and low levels of national income.

9. **The level of accountability**. The degree of corruption. Low levels of accountability are characterized of a high degree of corruption discourages investments which leads to low levels of output and low levels of national income but high leads of accountability leads encourages investments which leads to high output and high levels of national income.

10. **The population growth rate.** A high [population growth rate leads to a high expenditure on consumption which leads to low saving, low investments, low output and low levels of national income while a low population growth rate results into a high level of saving, high level of investments, high output and high levels of national income.

11. **The level of entrepreneurship skills**. A high level of entre skills leads to high level of investments, high output and high levels of national income but low entrepreneurship skills leads to low investment rates, low output and low levels of national income.

12. **The level of monetization**. A low level of monetization e.g. where there is a large subsistent sector results into low investments, low output and low levels of national income while a

high level of monetization leads to high level of investments, high output and high levels of national income.

13. **Attitudes towards work**. Positive attitude towards work leads to high production and output hence leading to high national income levels while a negative attitude towards work leads to low production and output hence low national income levels.

14. **The level of savings**. A high level of saving leads to a high level of investment which leads to high output and high levels of national income while a low level of saving leads to a low level of investment which leads to low output and high levels of national income.

15. **The rate of inflation**. High rates of inflation discourages investors because they lead to an increase in production costs thus leading to low output and low levels of national income while low rates of inflation encourages investments which results into high output and thus high levels of national income.

FACTORS RESPONSIBLE FOR LOW LEVELS OF NATIONAL INCOME/ GROSS DOMESTIC PRODUCTS.

1. High population growth rates. This leads to high expenditure on consumption which leads to low savings, low investments, low output and low levels of national income.
2. Low levels of monetization of the economy. e.g where there is a large subsistence sector results into low investments, low output and low levels of national income.
3. Poor technology. This leads to low productivity of labour which leads to volume of goods and services produced and therefore low levels of national income.
4. Political instability. This discourages investments which lead to low output and low levels of national income.
5. Small market.
6. Low level of labour skills.
7. Poor investment climate/ absence of investment incentives.
8. Limited capital.
9. Low levels of exploration of a country’s resources.
10. Poor attitude towards work.
11. Low entrepreneurial ability/ skills.
12. Small size of capital stock.
13. Low levels of development of infrastructure.
14. Low levels of accountability.
15. Low levels of saving.

QUESTIONS.

1a) Distinguish between GDP and NNP (4mrks).

b) Explain the factors that influence the level of national income in your country. (16mrks).

2 Examine the factors that have influenced the level of national income (EDP in your country.

3a) Account for the low levels of national income /GDP in your country (10mrks).

b) Suggest measures of increasing the level of national income in your country (10mrks).

4 Account for the differences in the level of income of USA and that of Uganda.

STEPS THAT SHOULD BE TAKEN TO INCREASE THE LEVEL OF NATIONAL INCOME.

1. **Improve technology**. The government should improve technology i.e. new methods of production like automation and computerization should be undertaken. This leads to an increase in output of goods and services which leads to an increase in the size of national income.
2. **Improve on the infrastructure.** The government should infrastructure eg better roads, communication and warehousing facilities can be put in place. The developed infrastructure can promote investments which leads into production of more goods and services which leads to an increase in the size of national income.
3. **Improve labour skills.** The government should improve labour skills through training to give labour the necessary practical skills to enable them to produce more goods and services which leads to an increase in national income.
4. **Offer investments incentives.** The government should offer investments incentives to potential investors e.g. tax holidays which attract more investors who produce more goods and services leading to an increase in the size of national income.
5. **Ensure political stability/ Improve political climate**. The government should ensure political stability such that peace prevails in most parts of the country. A stable political environment can encourage investors to set up economic projects to produce more goods and services this leading to an increase on the size of national income.
6. **Improve entrepreneur skills.** The government should improve entrepreneurial skills through training people to acquire skills of organizing factors of production. This leads to an increase on production and output hence leading to an increase in national income.
7. **Expand the market.** The government should expand market through joining economic integrations. An expanded market can promote investment hence leading to production of more goods and services which leads to an increase in the size of national income.
8. **Further liberalization of the economy/ trade.** The government should liberalize the economy by removing unnecessary controls on trade and economic activities. This will promote investment which will lead to an increase in production and output hence leading to an increase in the national income.
9. **Further privatization.** The government should privatize public enterprises to become more in efficient and they can produce more goods and services which leads to an increase in the size of national income.
10. **Modernization of agriculture**. The government should encourage modernization of agriculture sector because a modernized agricultural sector increases productivity in the agriculture sector which leads to an increase in output and national income.
11. **Further Diversification of Uganda's economy**. The government should diversify the economy where diversified economic activities like farming, mining, manufacturing, construction, banking, tourism, insurance e.t.c can be undertaken. This can improve on the volume of goods and services produced in a country hence there is consequent increase in the size of national income.
12. **Encourage savings to accumulate more funds for further investments**. The government should encourage and promote voluntary and compulsory saving schemes so that people

can accumulate saving for investments. As investment levels rise, more goods and services are produced and this leads to an increase in the size of national income.

13. **Extension of credit to individuals who want to invest**. The government should encourage financial institutions to offer credit to individuals. This will increase investment and production of goods and services this leading to an increase in an output thus increase in national income.
14. **Control population growth rates**. The government should control high population growth rates by encouraging use of family planning methods. This can reduce the dependency burden which leads to an
15. **Increase in saving and investment** hence leading an increase in output and thus increase in national income.

MEASUREMENT OF NATIONAL INCOME

National income is measured or computed by use of the three approaches;

1. The income approach.
2. The expenditure approach.
3. The output approach.

The income approach.

This involves a summation of all incomes received by the people in a country from productive economic activities in a given period of time.

It should be noted that only incomes received from productive economic activities are considered when computing national income. Non-quid-quo payments or transfer payments/incomes (incomes received without have produced any goods and services should not be considered when computing national income.

Computation of national income using the income approach involves adding the wages received labour, rent received by owners of land and property, interest received by owners of capital and profits received by owners of business entrepreneurs.

Thus using the income approach;

National income=wages +rent +profits +interest.

National income arrived at using the income approach is usually referred to as national income at factor costs.

National income at factor costs:

This is the national income obtained by adding the payments made to the factors of production for their contribution in production of goods and services in a given period of time.

The expenditure approach.

This involves a summation of all the expenditures of final goods and services in an economy and in a given period of time.

It involves a summation of consumption expenditure, investment expenditure, government expenditure and net exports (exports-imports).

Thus using the expenditure approach;

National income =consumption expenditure+ interest+(x-m).

The national income obtained by using the expenditure approach is usually referred to as the national income at market price.

National income at market price;

Thus is the national income obtained by adding up the payments made for goods and services in the market in a given period of time.

The output approach/ product method/ value added method.

Using the output method we add or sum up the monetary value of output of all final goods and services produced by the firms in a country in a given period of time.

Alternatively instead of considering the final output, the value added by the firms can be considered which is the value added method.

Using the value added method we add or sum up the contributions made to the final output by the various firms at all stages of production.

The value added method of a firm is got by subtracting the value of inputs used by the firm in production from the values of it's outputs.

Value added=value of outputs –value of inputs.

The example below illustrates the use of the value added method in computation of national income.

Firms	**Value of output**	**Value of inputs**	**Value added**
Wheat farm	10 million shs.		10 million shs.
Millers	15 million shs.	10 million shs.	5 million shs.
Bakery	25 million shs.	15 million shs.	10 million shs.
Retailers	30 million shs.	25 million shs.	5 million shs.

The total values added by the firm above is 10+5+10+5 =30 million shillings which is the same as the value of the final output by there firms.

Questions.

1. a) How is national income computed or measured in your country?(6mrks).

b) Suggest measures that should be taken to increase national income In your country.

2. a) Explain the measures being used to increase national income in your country.

b) Explain the measures that have been used to increase national income in your country.

IMPORTANCE OF NATIONAL INCOME STATISTICS.

1. National income statistics are used in planning. The government and the policy makers use information about a country's national income e.g. GDP, GNP, investments, consumption in formulation of policies for national development.
2. NB. Using the information from the expenditure approach. Government can find out how much of a country's income goes to consumption and how much goes to investments of a bigger percentage goes to consumption, government can put in place policies to encourage saving and investments.
3. National income statistics are used to calculate the country's income pre capita. This is calculated by dividing a country's national income by the population.
4. National income statistics are used to measure the standard of living. This is found out by looking at a country's income per capita. Generally a high income per capita implies a high standard of living and low income per capita implies a low standard of living.
5. Alternatively the standard of living can be indicated by the size/ level of a country's national income in that a high national income figure of a country indicates a high standard of living and vise versa.
6. It can be used to find out the rate of economic growth / economic progress in a country over a period of time. If a country's national income increases from one period to another then there is economic growth.
7. It is used to indicate the distribution of income in the country. From the income approach , national income=wages+ rent+ interest+ profits. This indicates that proportion of a country's national income which goes to labour and wages, capital and interest, land and rent, and to the entrepreneur and profits.
8. National income statistics indicate the productive sector of a country's economy and their relative performances e.g. from the output approach, we can find out the value of output from the agriculture sector, industrial sector, the service sector, tourism sector e.t.c.
9. National income statistics are used for comparison purposes between countries especially when it comes to the standard of living, economic performances e.t.c. Generally the standard of living is higher in a country with higher income per capita.

10. National income statistics indicate the expenditure pattern in a country. From the expenditure approach, national income= consumption expenditure interest+ interest+(X-M). We can establish how much of a country's income goes to consumption expenditure, interest expenditure, e.t.c.
11. It can indicate the level of dependency of a country's economy on other countries' economies. This is indicated by the level of exports and imports, e.g. a high level of import implies a high level of dependence on those countries where the imports came from.
12. National income statistics are used by countries when soliciting for foreign aid. Donor countries need to look at the country's national income statistics and figures before extending aid to that country i.e. they used to know the performances of the economy one time.
13. National income statistics are used for academic and research purposes. E.g students of economics and researchers need information about the trends of a country's GDP, savings, investments, incomes e.t.c. for study and research purposes.

Question;

a) Explain the importance of national income statistics in your country.

b) Why do countries compute national income statistics?

REASONS FOR COMPUTING NATIONAL INCOME STATISTICS

To help in planning. This is through the government and policy makers' use of information about a country's national income i.e. GDP,GNP investments, consumption in formulation of policies for national development.

To help in calculating a country's income per capita .This is through calculating a country's national income by the population.

To help in measuring the standards of living .This is through looking at a country's income per capita. A high income per capita implies a high standard of living and a low income per capita implies a low standard of living.

PROBLEMS ENCOUNTERED IN CALCULATION OF NATIONAL INCOME.

The problems encountered in the computation of national income are divided into two;

(a) Conceptual problems.

These are problems of interpretation of national income.

They are related to the way national income and national income concepts are defined and interpreted by the people compiling national income. Such problems include;

i. The difficulty of determining the boundary of production is what to include and what to exclude.
ii. The problem of unpaid for services e.g those of a house wife.
iii. The failure to distinguish between the final and intermediate products.

(b) The statistical problems.

These are problems related to data collection. They include;

i. Inadequate data information.
ii. The problem of double counting.
iii. However, many of the problems are both conceptual and statistical act the same.

Generally, the problems include;

1. **Inadequate statistical data**. There isn't enough information regarding people's incomes, expenditures and output. This is largely due to lack of proper keeping of records.
2. It is difficult to **determine the boundary of production**. Boundary of production refers to those activities that are considered to be productive and which must be considered when computing national income. Those activities which are taken to be unproductive are outside the boundary of production and thus are not considered when complying national income. The boundary of production may vary from country to country.
3. The problem **of double counting**. This is where by the value of an item/ activity is counted more than once when computing national income. Double counting usually arises out of the failure of distinguishing between the final and intermediate products. Double counting results into a figure of national income which is bigger than the actual and these results into wrong policy formulation.
4. The difficult of **valuing subsistence output** in monetary terms. Subsistence output does not go through the market and therefore has no market price thus the value of subsistence output can only be estimated which brings about inaccuracies in the national income estimation.
5. **Depreciation is difficult to calculate** i.e. the wars and fears of machinery, buildings are difficult to express in monetary terms.
6. The **problem of illegal activities.** These include gambling, prostitution, black marketing e.t.c The incomes from such activities may wrongly be considered when computing national income. Such activities have to be identified and excluded when computing national income.
7. The **problem of transfer payments/incomes**. These do not reflect any economic activity and therefore should not be considered when computing national income.
8. **The problem of inventories and the work in progress**. Some goods are produced in a particular year and are not yet sold at the end of that year period and also some productive activities extend over several years. This brings a problem when computing national income or total output in a particular year.
9. **The problem of unpaid for services.** eg those of a house work, house wives carry out a number of productive economic activities within a home but don't receive payments for

such activities /services therefore valuing their services in monetary terms is a very big problem.

10. **It is difficult to estimate the country's income from abroad.** This is due to lack of records for such incomes as so many people do not declare such incomes.
11. **It is difficult to determine the value of services offered by the government** e.g. defence; these are not paid for by the individuals and thus have no market price.
12. **Shortage of trained personnel**, to collect and compute national income data eg economists stations.
13. **The problem of price changes especially due to inflation**. As the prices increase in an economy, the country's national income will appear to increase even though the actual output of goods and services has not thus the normal national income figure has to be deflected to remove the affects of inflation in order to get the real national income figure.

ADJUSTMENT FROM NATIONAL INCOME FAD MARKET PRICES TO NATIONAL INCOME AT FACTOR PRICES.

In order to convert national income at market prices to national income at factor costs, we subtract indirect taxes and add subsidies ie;

NYfc=NYmp-indirect taxes +subsidies

Indirect taxes are subtracted because they are paid on part of the price of the commodity in the market but they are not received as incomes by the factors of production instead they go to the government.

Subsidies are added to the market prices at factor p national income at market prices to obtain national income at factor costs because where producers are subsidized the factors of production receive more than what is spent on purchasing goods and services in the market.

1. E.g. convert national income at factor costs to national income at market prices'
NYfc to NYmp

NYmp = NYfc + indirect taxes – subsidies.

2. Adjust GDPmp to GDPfc
GDPfc = GDPmp – indirect taxes + subsidies.

3. Given GDPmp what adjustments should be done to obtain GNPfc
GNPfc = GDPmp – indirect taxes+ subsidies + net income from abroad

4. Given GDPfc = GDPmp –indirect taxes + subsidies
=500 – 155 + 200

=545bshs

(i) Adjust NNPmp to GNPfc
GNPfc = NNPmp – indirect taxes + subsidies – net income from abroad

(ii) Given GDP. How do you arrive at NNP
NNPmp = GDPfc + indirect taxes – subsidies – net income from abroad.

Equivalency of the three approaches to estimation of national income.

The three approaches to estimation of national income i.e. the income approach, output approach, expenditure approach give us the same results or the same figure of national income. Thus the three approaches are equivalent i.e. the output approach = the income approach = the expenditure approach (O = Y = E)

Example;

If John produces a bicycle and sells it to peter at 100,000sgs;

Value of john's output = 100,000shs

Income of john = 100,000shs.

Expenditure = 100,000shs.

- The equivalency of the three approaches is explained and illustrated by the circular flow of income and expenditure.
- The circular flow of income and expenditure.
- The circular flow of income and expenditure illustrates the flow of income and expenditures between the households and the business sector.
- The business sector consists of firms which produce goods and services and supplies them to the households sector. The households sector consists of individuals who are owners of the factors of production and at the same time consumer goods and services produced by the business sector.

Assumptions of the circular flow of income and expenditure.

i. There are only two sectors in the economy i.e. the business sector and the household sector.
ii. There is no government sector i.e. no taxation and no subsidization by the government.
iii. There is no foreign sector i.e. no exports and no imports. This implies that the economy is closed.
iv. The household sector does not save. All its incomes are spent on the goods and services produced by the business sector.

v. All production takes place in the business sector and all consumption takes place in the household sector.

Illustration

From the circular flow of income and expenditure above.

Factor income payments are equal to the government expenditure on goods and services in the market.

Inotherwords the income received by the households as factor income payments are spent on purchasing goods and services in the market hence Y=E.

The receipts from the sale of goods and services by the firm are equal to the household's expenditure on those goods and services in the market. In otherwords the amount of money spent on goods and services represents the value of output produced by the firm hence O=E.

The receipts got from the sale of goods and services are equal to the payments made to the factors of production. In otherwords the total amount of money got by firms from selling their output in spent on paying the factors of production for their services hence O=Y.

Since O = Y, Y=E and O = E it follows that O= Y = E thus the three approaches are equivalent.

There are two types of flows in the circular flow of income and expenditure.

a) **The real flow** which involves the flow of factors of production as well as the flow of goods and services i.e. (arrow 2 and 1)
b) **The monetary flow** which involves the flow of expenditures on the goods and services as well as the factor income payments. (arrow 3 and 4).

THE STANDARD OF LIVING

This refers to a measure of human level of human, social and economic welfare of an individual or society as determined by the level of goods and services consumed.

OR

It refers to the conditions of life in which people live.

If people live in poor conditions of life e.g. poor housing and sanitation, poor feeding, lack of freedom etc then their standard of living can be said to be poor or low.

The greater the amount of goods and services one is able to enjoy the higher the standard of living and vice versa.

The international or basic measure for standard of living is **income per capita**. Generally, a high income per capita implies a high standard of living and a low income per capital implies a low standard of living. However, this generalization is subject to a number of limitations as there are a number of other factors both social and economic which greatly affect people's standard of living i.e. income per capita ignores all there factors that greatly affect people's standard of living.

Determinants of standard of living

1. **The price level of goods and services**. A high price level of goods and services leads to a low standard of living because with a high price level, goods and services are expensive and unaffordable for most of the people while a low price level leads to a high standard of living because people are able to buy more goods and services as they are affordable.

2. **The level of incomes in a country.** High income levels lead to a high standard of living because with high income levels, people have enough money and can afford to enjoy various goods and services while low income levels lead to low standards of living because individuals are unable to purchase the goods.

3. **The distribution of income in a country**. Uneven distribution of income or income inequality leads to a low standard of living because with uneven distribution of incomes, the incomes are concentrated within a few individuals while majority of the people are very poor and cannot afford to purchase goods and services while even distribution of income leads to high standards of living as majority of people have incomes that are able to purchase goods and services.

4. **The level of education and skills**. A high level of education and skills implies that most of the people have access to jobs and incomes therefore can afford to purchase and enjoy enough goods and services but low levels of education and skills lead to low standards of living because the people are unable to get profitable employment opportunities.

5. **The quality of goods and services produced in a country**. Poor quality goods and services in a country lead to a low standard of living because such goods endanger people's health resulting into high expenditure on treatment while high quality goods in a country lead to a high standard of living.

6. **The nature of goods produced in a country.** Production of more capital goods at the expense of consumer goods leads to a low standard of living because capital goods do not directly contribute to people's welfare while production of more of consumer goods in a country leads to a high standard of living.

7. **The political climate prevailing in a country.** Political instability in a country leads to a low standard of living because with political instability people cannot settle down and their lives and property are always in danger while political stability in a country leads to a high standard of living.

8. **The rate of unemployment prevailing in a country.** A high rate of unemployment leads to a low standard of living because with a high rate of unemployment many people have no jobs, no incomes, and therefore cannot afford to purchase and enjoy enough goods and services but a low rate of unemployment implies a high standard of living because people have jobs and are able to earn income to buy the basic necessities of life.

9. **The number of hours worked for compared to the leisure enjoyed**. if people are over worked in a country, their standard of living is likely to be low because they have no time for relaxing or resting but where people enjoy enough leisure time the standard of living is likely to be high.

10. **The level of social costs in a country. E.g. pollution**. High levels of pollution in a country leads to a low standard of living because pollution endangers people's health leading to high expenditure on treatment instead of consumption but low levels of pollution lead to a high standard of living.

11. **The level of taxation in a country.** A high level of taxation on a country leads to a low standard of living because high taxes reduce the disposable income of the consumer leaving them with less money for purchasing goods and services while low levels of taxation lead to high standard of living.

12. **The degree of freedom in a country**. Lack of freedom in a country leads to a low standard of living while presence of freedom leads to a high standard of living.

13. **The availability of social series**. E.g. medical care. Availability of enough social services leads to a high standard of living while inadequate social services lead to a low standard of living.

14. **The nature of government expenditure**. If the government spends a lot of activities that do not contribute to people's welfare e.g. foreign missions the standard of living is likely to be low but it spends a lot of activities that contribute to peoples welfare and standard of living is likely to be high.

FACTORS THAT LEAD TO A LOW STANDARD OF LIVING

1. A high price level of goods and services. This leads to low standards of living because with a high price level of goods and services are expensive and unaffordable for most of the people.
2. Level of education
3. Political climate
4. Nature of goods produced
5. Quality of goods produced
6. Low income levels

LIMITATIONS FOR USING INCOME PER CAPITA FOR MEASURING THE STANDARD OF LIVING IN A COUNTRY.

Generally, a high income per capital implies a high standard of living and a low income per capital implies a low standard of living. However, this is not always true as there are likely to be instances when the standard of living is low despite the high income per capita. This is because income per capital ignores a number of important factors that affect people's standards of living.

1. **Income per capital ignores the general price level of goods and series in a country**. A high price level in an economy implies that goods and services in an economy are very expensive and unaffordable for majority of the people which leads to low standards of living despite income per capital being high.
2. **Income per capita ignores the distribution of income in a country.** Uneven distribution of incomes in a country implies that majority of the people have low incomes which makes it difficult for them to acquire goods hence leading to low standard of living despite a high income per capita.
3. **Income per capita ignores the nature of goods and series produced in a country**. Production of capital goods at the expense of consumer goods leads to a low standard of living despite income per capital being high.

4. **Income per capital ignores the quality of goods and services produced in a country**. Production of poor quality goods and services in the country leads to a low standard of living despite income per capital being high. This is because poor quality goods endanger peoples' health resulting into high expenditure on treatment.

5. **Income per capital ignores the number of hours worked compared to the leisure enjoyed**. Where people are over worked in a country the standards of living is likely to be low despite income per capita being high.

6. **Income per capital ignores the political climate prevailing in a country.** A poor political climate characterized by wars results into a low standard of living despite a high income per capita.

7. **Income per capita ignores the level of taxation in the country**. High levels of taxation in a country reduce the disposable incomes of consumers leaving them with less and less money for purchasing goods and services. This leads to a low standard of living despite a high income per capita.

8. **Income per capita ignores the rate of unemployment in a country.** A high rate of unemployment tin a country leads to a low standard of living despite income per capita being high. This is because with a high rate of unemployment, many people have no jobs, no incomes and therefore cannot afford to purchase and enjoy enough goods and services.

9. **Income per capital ignores the social costs** e.g. pollution. A high level of pollution in a country leads to a low standard of living despite a high income per capita. This is because pollution endangers people's health.

10. **It ignores the nature and pattern of government expenditure in a country**. Where government spends a lot of money on activities that do not directly contribute to people's welfare, the standard of living is likely to be low despite the high income per capita.

11. **It ignores the requirements for comfortable living in a country**. Where comfortable living in a country requires huge expenditure e.g. warm clothing, warming houses etc in wonder the standard of living is likely to be low despite a high income per capital.

LIMITATIONS OF USING INCOME PER CAPITA TO COMPARE STANDARD OF LIVING BETWEEN TWO COUNTRIES

1. Income per capita ignores **differences** in the price level on the different countries. Although income per capita is high is a given country, but the price level of goods and services in that country is high, there results a low standard of living despite a high income per capita while in

another country where the price level of goods and services is low, the standard of living is higher despite a low income per capita.

2. Income per capita ignores the **differences** in the distribution of incomes in the different countries. In a country where there is un even distribution of income the standard of living tends to be low despite a high income per capita while in a country with an even distribution of income the standard of living tends to be high despite a low income per capita.

3. It ignores **differences** in the quality of goods and services produced in different countries.

4. It ignores differences in the nature of goods and services produced in different countries.

5. It ignores the **differences** in the number of hours worked for compared to the leisure enjoyed in different countries.

6. It ignores **differences** in the political climate prevailing in different countries

7. It ignores **differences** in the level of taxation in different countries

8. It ignores **differences** on the rate of unemployment in the different countries.

9. It ignores the **differences** in the social costs e.g. pollution in the different countries.

10. It ignores the **differences** on the pattern and nature of the government expenditure in different countries.

Limitations of using income per capita for comparing/measuring the standard of living overtime.

1. **Income per capita ignores changes on the levels of prices overtime**. An increase in the price level in a country overtime implies a lower standard of living despite increasing income per capita. This is because an increase in price level implies that goods and services are more expensive and an affordable for the majority of people in a country hence leading to a low decline in the S.O.F.

2. Income per capita ignores **changes** in the distribution of income of a country overtime.

3. Income per capita ignores changes in the quality of goods and services produces in the country overtime.

4. It ignores **changes** in the level of taxation in the country overtime.

5. It ignores **changes** in the political climate prevailing in the country overtime.

6. It **changes** the nature of goods and services produced in a country over time.

7. It **ignores changes** in social costs e.g. pollution in country overtime.

8. It ignores **changes** in the nature and pattern of government expenditure in country overtime.

Questions

1. What are the limitations of using income per capita for measuring standard of living in a country?

2. Explain the weaknesses of using national income statistics as a measure of standard of living in the country

3. Why may income per capita not be a good measure for comparing people’s welfare in different countries?

4. Why may income per capital not be a good measure for comparing people’s welfare overtime?

5. Explain the limitations of using income per capita to compare people's welfare in the country overtime.

THE COST OF LIVING

This refers to the amount of money required for purchasing goods and services to maintain a given level of standard of living in a country in a given period of time.

The amount of money needed for purchasing goods and services depends on the general price level of standard of living in a country. If the price level of goods or services is high meaning that goods and services are very expensive than a lot of money us required to purchase the goods and services. This implies that the cost of living is high. Thus the cost of living directly varies with the price level in the country in that if the price level is high, then the cost of living is high that if the price level is low, then the cost of living is also low.

Measurement of changes in the cost of living

Since the cost of living directly depends on the general price level, then changes in the cost of living can be measured by finding out changes in the price level.

Price level refers to the average level of prices of goods and service in an economy at a given period of time. If it's found out that the price level has increased by 10% then the cost of living has also increase by 10%

A price index

This refers to a number of figures that measures relative changes in the average price levels of goods and services in a country from one period to another.

It can also be defined as a ratio of the current year price of a commodity to the base year price of a commodity.

Price index = $\frac{Current\ year\ price}{Base\ yearr\ price}\ x\,100$

This is the price index for one commodity which is particularly referred to as the price relative.

e.g.

Given that the price of maize in 1980 was shs. 200 per kg and in 1990 the price of maize was shs.300 per kg. Taking 1980 as the base year. Calculate the price index for maize.

Price index = current year x 100

Base year

= $\frac{300}{200} x\,100$ = 150

NOTE:

i) The base year refers to a year from which the changes in prices are being measured and a current year refers to a year for which the changes in prices are being measured.
ii) Price indices have no units and are not written as percentage.
iii) The price index for the base year is taken to be at a leve of 100 always and then the calculated price index is for the current year.
iv) A computed or calculated price index of 150 implies that the price level of goods and services increased form the level of 100 in the base year to a level of 150 in the current year i.e. on average the price increased (150 -100) = 150%.

Examples of price indices;

i) The price relative
This is the ratio of the current year price to the base year price of one single commodity.
It is a price index for one single commodity

ii) The simple index or average price relative, average simple index.
This refers to the average of the price relatives of selected commodities.

Simple index = $\frac{sum\,of\;\;price\,relatives}{No.of\;\;com\mathrm{mod}ities}$

iii) The consumer price index
This is a price index that measures relative changes in price of consumer goods from one time period to another.

iv) Retail price index
This is a measure of relative changes in the retail price of commodities from oen time period to another.

v) Wholesale price index
This is a measure of relative changes in the wholesale prices of commodities of one time period to another.

vi) The cost of living index
This refers to a measure of relative changes in the cost of living or relative changes in the average prices of goods and services on an economy from one time period to another.

vii) The weighted price index

This is a price index that takes into consideration the weight or importance attached to commodities by the consumers.

viii) Unweighted price index.
This is a price index computed without considering weight or importance attached to the commodities by the consumers. This is the same as the simple index or simple price index.

COMPUTATION OF PRICE INDICES.

The following steps or procedures can be followed when compiling price indices e.g. the simple index.

1. **Selection of the base year**. This must be a year when the prices of commodities were relatively stable.
2. **Selection of the market baskets**. This refers to a set of commodities consumed in a country that are chosen to represent all the commodities consumed. The market or representative basket should not be based to a given income group or region.
3. **Collection of information or data** i.e. information about the prices of the selected commodities both in the base year and the current year as well as the quantities of those commodities consumed.
4. **Calculation of the price relative or simple price index** for each one of the selected commodities. This is calculated by the use of the expression;

   Price relative = $\frac{current\ year\ price}{base\ year\ price}\ x\ 100$

5. **Calculation of the simple price index** (average price relative, unweighted price index or simple index. This is calculated by summation of the price relatives by the number of commodities.

   Simple price index = $\frac{Sum\ of\ \ price\ relatives}{number\ of\ \ com\mathrm{mod}ities}$

6. **Weighting of the commodities / attaching weights to the selected commodities.** Weights are numbers which indicate the relative importance attached to each one of the commodities by the consumer. A commodity which is more important to the consumer is assigned a bigger weight than a commodity which is less important.
7. **Calculation of the weighted price index for each commodity**. This is calculated by multiplying the price relative for each commodity by the weight attached to the commodity.
   WPI = price relative x weight
   WPI = Simple price index x weight

   This should be done for the commodities in the market baskets

8. **Calculation of the average weighted price index/ weighted index**. This is calculated by dividing the summation of weighted price indexes for the commodities by the summation of the weight

AWPI = $\frac{\varepsilon \text{ Price index} x \text{ weight}}{\varepsilon \text{ weights}}$

OR

$$= \frac{\varepsilon WPI}{\varepsilon w}$$

The table below shows the price of some selected commodities in 1998 and 1995.

Commodity	Average price 1998	Simple index 1998	Average price 1995	Weight
Sugar	800	100	1000	3
Salt	450	100	600	5
Maize	220	100	400	6
Meat	100	100	1200	2
Fuel	550	100	950	4

i) Calculate the price relatives for the commodities.
ii) Compute the simple index for 1995
iii) Calculate the weighted price index for each one of the commodities.
iv) Compute the weighted index for the commodities.

i) Sugar

Price relative = $\frac{\text{current year price}}{\text{base year price}}$

$= \frac{1000}{800} x\ 100$

= 125

ii) Salt

Price relative = $\frac{\text{current year price}}{\text{base year price}}$

$= \frac{600}{450} x\ 100$

= 133.3

iii) Maize

Price relative = $\frac{current\ year\ price}{base\ year\ price}$

$= \frac{400}{220} x\ 100$

= 181.8

iv) Meat

Price relative = $\frac{current\ year\ price}{base\ year\ price}$

$= \frac{1200}{100} x\ 100$

= 171.4

v) Fuel

Price relative = $\frac{current\ year\ price}{base\ year\ price}$

$= \frac{950}{550} x\ 100$

= 172.7

(ii) simple index for 1995 = $\frac{sum\ of\ price\ relatives}{number\ of\ commodities}$

$$= \frac{125 + 133.3 + 181.8 + 171.4 + 172.7}{5}$$

NB:

(i) That year when the price indices for all the commodities in the table are indicated as 100 must be the base year.

(ii) The year for which the price indices are to be calculating in the question must be the current year.

Interpretation of price indices.

(i) If the computed price index is greater than 100 then general price level for goods and services in the economy increased by a percentage which can be calculated. However, this does not imply that the prices for all commodities considered increased. The prices for some of the commodities may have reduced or remained constant.

(ii) If the computed price index is equal to 100, this implies that on average the prices remain the same i.e. the price level did not change from the base year to the current year.

(iii) If the computed price index is less than 100, then the price level in the economy reduced from the base year to the current year.

PROBLEMS ENCOUNTERED IN COMPUTING OF PRICE INDICES.

1. **Selection of the base year is difficult**. This is because it's very hard to find a year where prices are stable.
2. **Selection of the market / representative basket is difficult.** This is because there are many commodities consumed in the country and selecting a few of them without being biased is not easy i.e. a market basket which represents the purchases of all the people in the country is difficult to obtain.
3. **Changes in tastes and preferences**. This result into a change in composition of the commodities actually consumed by the people in the country compared to the commodities considered in the market baskets when computing the price index.
4. **Inadequate statistical data.** There is not enough information about the prices of the commodities selected both in the bare year and current year. This is due to lack of proper keeping of records.
5. **Inadequate skilled personnel with adequate appropriate skills for computing** the price indices e.g. economists. The use of people without appropriate skills in computing price indices sometimes results into unreliable figures of the price indices.
6. **Appearance and disappearance of some commodities from the market**. Sometimes, commodities disappear from the market e.g. due to changes in seasons or in times of off season. These results into a change in the composition of commodities consumed by the people compared to those considered in the market basket when computing the price index.
7. **Lack of standard measures.** In some cases, commodities are measured in kilogrammes and in other cases or areas the same commodities are measured in heaps, tins and each one of these has its own price which is different from the other units or measure.
8. **Variation in prices of the different regions or areas of a country**. The same commodity may be sold or bought at different prices depending on the area of a country where you are buying it from. Thus if prices of a commodity in one area are considered, the price index computed may not be valid for the rest of the commodities in the country.
9. **Weighting of commodities is difficult**. This is because different consumers attach different levels of importance to the different commodities in the market basket. In that a commodity which is not important to one person may be of least importance to another thus it's difficult to obtain realistic weights.
10. **Changes in the prices of the commodities during the year especially due to inflation**. As prices increase during the same year, the actual price level of a commodity in the economy turns out to be higher than what the computed price index indicates.
11. **Improvement in the quality of products**. This results into higher prices for the commodities which may be mistaken for inflation.

12. **Limited facilities for computing the price indices** e.g. computers for analyzing the data, transport facilities for the movement of people compiling price indices.

(a) Describe the steps followed when computing price indices in your country.
(b) Explain the problems encountered when computing price indices in your country.

USES OF PRICE INDICES.

1. Price indices are used in **determination of wages**. In some cases, wages are adjusted upwards depending on the price level or cost of living. If the computed price index indicates that the cost of living has gone up, then wages have to be adjusted upwards.
2. Price indices are used to **measure the rate of inflation or deflation**. The rate of inflation is indicated by the percentage increase in the price level from the base year to the current year e.g. if the computed price index is 110, then the rate of inflation is 110 – 100 = 10%.
3. Price indices are used to determine the **cost of living in a country**. If the computed price index is greater than 100 then it implies that the cost of living has gone up and if it is less than 100 then the cost of living has gone down.
4. They are used in determining the **taxation rates or levels on an economy**. If the computed price index indicates that the prices of consumer goods have gone up then taxes on consumer goods have to be reduced to enable the people afford the goods and services.
5. They are used to determine the **value of money in an economy**. A computed price index which is more than 100 indicates that the price level has gone up and therefore the value of money has gone down e.g. if the computed price index is 110 then the value of money has reduced by 10%.
6. Price indices are used to deflect or adjust nominal GDP to real GDP. This can be done by the formula;

   Real GDP = $\frac{nor\min al\, GDP}{price\ index}\ x\ 100$

   Such a price index is referred to as the GDP deflator.
   It adjusts or converts nominal GDP to real GDP by removing the effect of deflation from nominal GDP.

   NB: Real GDP is the GDP expressed at base year prices
   Nominal GDP is the GDO expressed or values at current year prices.

REASONS WHY PRICE INDICES MAY BE UNRELIABLE OR INVALID.

Sometime the computed price index may be unreliable or invalid in that e.g. it may indicate that the price level or cost of living has increased by a given percentage where as in actual sense or cost of living or price level has not changed. This implies that the actual price index is a wrong or inaccurate indicator of the price level or cost of living. This is due to the factors that result into an inaccurate figure of the price index.

1. **Sampling a few areas of the country to represent the whole country**. This implies that the price index computed may be appropriate for those areas that were sampled but invalid for the rest of the area of a country.
2. Changes in tastes and preferences. Whenever tastes and preferences change, people start consuming different commodities compared to those that were considered when computing the price index. In this case, the price index computed is not representative of the price level in the economy.
3. Use of unreliable base year i.e. a base year where the prices are not stable.
4. Use of estimated prices in computation.
5. Changes in prices of the commodities selected due to changes in seasons.
6. Use of a biased market basket e.g. one which consists of commodities selected due to changes in seasons
7. Use of a biased market basket e.g. one which consists of commodities consumed by one income group like the low income earners.
8. Use of un reliable data.
9. Appearance or disappearance of commodities from the market.
10. Variation in prices across the country
11. Use of unqualified personnel in the computation of price indices.

Question

a) Why may price indices be unreliable indicators of the cost of living in an economy?

THE MULTIPLIER

An increase in expenditure in an economy e.g. an increase in consumption expenditure, investment expenditure, government expenditure etc. results into a final increase or change in a country's national income but the final change in the country's national income that results is usually bigger than the initial change that led to it.

Example

An increase in consumption expenditure amounting to 10 billion dollars may result into a final change in income amounting to 20 billion dollars. This is because of the multiplier process. The multiplier in this case is; $\frac{20\ billion\ dollars}{10\ billion\ dollars}$ = 2 times.

The final change income that results happens to be bigger than the initial change in expenditure because nay increase in expenditure results into an increase in incomes for some groups of people or individuals who also increase their expenditure leading to increase in incomes for other groups of individuals who also increase their expenditure and so on and so forth such that at the end of the day, the final increase in income is ....which bigger than the initial increase in expenditure.

Multiplier = $\frac{Change\ in\ income}{Change\ in\ \exp enditure}$

The multiplier can be defined as the number of times the initial change in expenditure in an economy multiplier itself to give the final change in income.

The final change in income that results and the magnitude of the multiplier depends on the proportion of the extra income that is spent on consumption and that which is saved.

Marginal propensity to consume.

This refers to the fraction of the extra income which is spent on consumption

Or

This is the proportion of the additional income that is spent on consumption

mpc = $\frac{change\ in\ savings}{Change\ in\ income}$

= $\frac{\Delta C}{\Delta Y}$

<u>Marginal propensity to save</u>

This refers to the fraction of the extra income which is saved.

Or

It is the proportion of the additional income which is saved.

mpc = $\frac{Change\ in\ consumption}{Change\ in\ income}$

= $\frac{\Delta S}{\Delta Y}$

Relationship between mpc and mps

Since income = c+s then a change in income results into a change in consumption or a change in saving.

Income = C + S

$\Delta Y = \Delta C + \Delta S$

$= \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$

1 = mpc + mps

This mpc + mps is always equal to 1.

Relationship between mpc, mps and the multiplier

The bigger the mps, the smaller the multiplier and the smaller the mps, the bigger the multiplier.

This relationship can be represented by the formula;

m = $\frac{1}{mps}$

The bigger the mps the bigger the multiplier and the smaller the mpc the smaller the multiplier.

Thus relationship is represented by the formula;

m = $\frac{1}{1 - mpc}$

Example

If mpc in an economy is 0.75, calculate the mps.

Mpc + mps = 1

0.75 + mps = 1

0.75 - 0.75 + mps = 1 - 0.75

<u>mps = 0.25</u>

1. Calculate the mpc in an economy if the mps is 20%

mps = $\frac{20}{100}$

mps = 0.2

mpc + mps = 1

mpc + 0.2 = 1

mpc + 0.2 - 0.2 = 1 - 0.2

<u>mpc = 0.8</u>

2. Calculate the magnitude of the multiplier in an economy if the mpc is 25%.

m = $\frac{1}{1 - mpc}$

= $\frac{1}{1 - 25\%}$

= $\frac{1}{1 - 0.25\%}$

= $\frac{1}{0.75}$

= $\frac{1}{0.75}$

= 1.3

3. Given that mpc in an economy is 0.7, and there is a change in investment expenditure of shs 50 million. Calculate;

(i) Multiplier

(ii) Final change in income of the economy

= m = $\frac{1}{1 - mpc}$

= $\frac{1}{1 - 0.7}$

= $\frac{1}{0.3}$

= 3.3

Average propensity to consume and average propensity to save.

Average propensity to consume refers to the fractions of income spent on consumption or it is the level of consumption to income in an economy.

APC = $\frac{Consumption}{income}$

= $\frac{C}{Y}$

Average propensity to save refers to the fraction of a country's income which is saved or the ratio of savings to income.

= APS = $\frac{savings}{Income}$

= $\frac{S}{Y}$

TYPES OF MULTIPLIER

1. **The investment multiplier**
   This is the number of times an initial change in investment expenditure multiplies itself to give a final change in income.

   Investment multipliers = $\frac{change\ in\ investment\ income}{change\ in\ investment\ expenditure}$

2. **Consumption multiplier**
   This refers to the number of times the initial change in consumption expenditure multiplies itself to give the final change in income.

   Consumption multiplier = $\frac{Change\ in\ income}{Change\ in\ consumption\ expenditure}$

3. **Government multiplier**
   This refers to the number of times by which an initial change in government expenditure multiplies itself to generate a final change in initial income.

   Government = $\frac{Change\ in\ income}{Chamge\ in\ governemnt\ expenditure}$

4. **The export multiplier**
   This is the number of times the initial change in export earnings multiplies itself to give the final change in income.

   Export multiplier = $\frac{change\ in\ income}{Change\ in\ export\ earnings}$

5. **The income multiplier**
   This is the number of times the initial change in total expenditure in an economy multiplies itself to give the final change in income.

   Income multiplier = $\frac{Change\ in\ income}{Change\ in\ total\ expenditure}$

   NB: Since national income = C + I + G + X - M
   Total expenditure = C + I + G + X - M

$\Delta TE = \Delta C + \Delta I$

6. Employment multiplier

This is the number of times the initial change in employment in an economy multiplies itself to give final change in income.

7. Tax multiplier

This is the number of times the initial change in tax revenue multiples itself to give the final change in income.

NB: Marginal propensity to import, save in the fractions of extra income which is spent on imports.

mpi = $\frac{Change\, ion\, \exp enditure\, on\, imports}{change\, in\, income}$

marginal propensity to consume is the fraction of extra income got from exports.

Working of the multiplier prices

Operation of a multiplier process begins with an increase in expenditure eg. ΔI = 1000 billion dollars.

This increase in investment expenditure results into an increase in income for some people thus in the first stage.

$\Delta Y = 1000$billion dollars.

Out of this increase in income, a given fraction is spent on consumption and the remaining fraction is saved according to mps or mpc in the economy.

If the mpc in the economy is 805% then; Δ

Δ C = 80% x 1000 billion dollars

= 800 billion dollars

Δ S = 20% x 1000 billion dollars

= 200 billion dollars

The increase in consumption of 800 billion dollars turns into an increase in income for another group of individual in periods or stage two thus;

This Δ Y2 = 800 billion dollars

Out of this 80% is spent on consumption and 20% is saved.

The process continues until when there are no further increases in income. The process is illustrated in the table below;

Stage	∆ Y (bn $)	∆ C (bn $)	∆ S (bn $)
1	1000	800	200
2	800	640	160
3	640	512	128
4	512	409	102.4
1	1	1	1
1	1	1	1
1	1	1	1
1	1	1	1

The final change in income is obtained by adding the changes in income in period 1, period 2, period 3 and period 4 until the end which is practically impossible. Thus we use the formular multiplier = $\frac{\Delta Y}{\Delta I}$

$\Delta Y = M \times \Delta I$

But m = $\frac{1}{1 - mpc}$

$= \frac{1}{1-80\%}$ $\quad = \frac{1}{1-0.8}$ $\quad = \underline{5}$

$S = \frac{\Delta Y}{\Delta I}$ $\quad S = \frac{\Delta Y}{1000}$ $\quad \Delta Y = 5000$ billion dollars

How does the multiplier process apply in an economy?

NB: For the multiplier process to operate effectively, the mpc is assumed to be constant.

1. There is an initial change in income earnings during period.
2. A percentage of the initial change in income is spent on consumption.
3. A percentage of the initial earnings is saved during time period.

4. Consumption expenditure during time period 1 becomes the new income in time period 2.
5. A percentage of the new income earned in time period 2 is spent on consumption.
6. A percentage of the new income earned on time period 2 is saved.
7. The process goes on and on.

DETERMINANTS OF THE SIZE OF THE INVESTMENT MULTIPLIER

Since m = $\frac{\Delta Y}{\Delta I}$, factors that encourage increases in production of goods and services and this lead to tremendous increases in national income encourage operation of the multiplier process and eventually leads to a big size of the investment multiplier but those factors that limit or discourage production of goods and services limit the operation of the investment multiplier and thus leads to a small size of the investment multiplier.

1. **The market size**. A large market encourages investment which leads to increased output of goods and services and large increases in national income leading to a big size of the investment multiplier while a small market discourages further investments which limits increases in the country's final income and hence a small size of the investment multiplier.
2. **The political climate**. Political stability encourages investments which results into increases in output and national income hence a big size of the investment multiplier while political instability discourages investors which limits increases in output and national income hence a small size of the investment multiplier.
3. **The level of accountability in the income level of corruption and embezzlement**. Low levels of accountability i.e. high rates of corruption and embezzlement discourage investments which limits increases in output and national income hence a small size of the investment multiplier while high levels of accountability encourage investments which results into increases in output and national income hence a big size of the investment multiplier.
4. **Availability of investment incentives**. Offering of investment incentives e.g. tax holiday to investors encourage investments hence leading to increases in output and national income thus a big size of the investment multiplier while absence of business incentives discourage investments which limits increase in output and national income hence a small or limiting investment multiplier.
5. **Level of development of a country's infrastructure**. Well-developed infrastructure e.g. good transport network encourage investments which leads to increases in output and national income hence the big size of the investment multiplier while poor infrastructure i.e. poor transport and communication networks discourage investment which limits increases in output and national income.
6. **Level of entrepreneurship skills**. High level of entrepreneurial skills implies better organization of the factors of production which leads to high investments thus increase in output and hence a big size of the farm. Low levels of entrepreneurial skills discourage investment, hence limiting increases in output and national income hence small investment multiplier.

7. **The existence of capital stock**. A large amount of capital stock encourages investment which increases output and national income but a small size of capital stock discourages investment which limits increases in output and national income hence a small size of the investment.
8. **The population growth rate**. A high population growth rate leads to high expenditure to certain the population thus leading to low saving which limits increasing output and national income hence small size of investment multiplier while low population growth rate encourages investment which leads to increases in output and national income hence a small size of the investment multiplier.
9. **Income levels in the economy**. High incomes leads to a high level of saving and investment thus a big size of the investment multiplier while low income level limits increases in output which limits increases in savings hence a small size of investment multiplier.
10. **The rate of inflation in the economy**. High rates of inflation make it difficult for the investors to predict e.g. the prices of the commodities which discourage the investors. Thus limiting increases in output and investment hence a small size of the investment multiplier while low rates of inflation encourages investment which results into increases in output and national income hence big size of investment multiplier.
11. **The level of capital inflows and outflows**. High levels of capital inflows e.g. by a foreign investors results into more investments in the country which leads to increases in output and national income hence a big size of investment multiplier while low levels of capital outflows through profits repatriation discourage further investment which limits increases in output and national income hence small size of investment multiplier.

Questions

a. Examine the factors influencing the operation or magnitude or size of the investment multiplier in LDCs.
b. Explain the factors limiting the operation of the investment multiplier in a country.

FACTORS LIMTIING THE OPERATION OF THE INVESTMENT MULTIPLIER OR LIMITATIONS TO THE OPERATION OF MULTIPLIER.

1. **Small markets.** This discourages further investments which limits or increase in output of goods and services resulting in small increases in the country's national income hence limiting operation of the investment multiplier.
2. **The political instability**. This discourages further investment which limits increase in output of goods and national income hence a small size of the investment multiplier.

3. **Low levels of accountability**. High rates of corruption and embezzlement discourages investment which limits increase in output and national income hence limiting operation of the investment multiplier.

4. **Poor state of infrastructure**. Poor transport and communication network discourage investment which limits increases in output and national income hence a small size of investment multiplier.

5. **Low level of entrepreneurship skills**. This discourages investment limits increases in output and national income hence small investment multiplier.

6. **Low population growth rate**. This discourages savings and investment which leads to increases in output and national income hence small size of the investment multiplier.

7. **Low level of income levels**. This leads to low level of savings and investment which limits increases in output and national income thus small size of the investment multiplier.

8. **Small level of capital stock**. This discourages investment which limits increases in output and also limits increases in national income hence a small size of investment multiplier.

9. **High rate of inflation in the economy**. This makes it difficult to investors to produce for example the prices of the commodities which discourage the investors thus limiting increase in output and national income hence a small size of investment multiplier.

10. **High level of capital outflows.** Through profit repatriation, investment is discouraged which limits increases in output and national income hence a small size of the investment multiplier.

a) What is meant by marginal propensity to import
b) This refers to the proportion or fraction of the additional or extra income that is spent on imports.
c) Mention three effects of marginal propensity to import.

- High outflow of foreign exchange
- Unfavourable balance of payment position
- Limited growth of local industries or decline of local industries
- Increased dependency on other countries leads to imported inflation
- Leads to underutilization of local resources
- Limited innovations and inventions
- Leads to erosion of social cultural values
- Leads to unemployment
- Increases tax revenue
- Provision of a variety of goods.

THE ACCELERATOR

A given increase in consumption in an economy results into an increase in investments but the increase in investments that results in usually bigger than the increase in consumption that led to it.

Accelerator refers to the number of times the initial change in consumption multiplies itself to give a final change in investment.

Accelerator = $\frac{change\ in\ investement}{Change\ in\ consumption}$ = $\frac{\Delta I}{\Delta C}$

Consumption

Consumption can be defined as the use of goods and services to get direct satisfaction.

OR

Is the expenditure on final goods and services from which direct taxation is derived?

Aggregate consumption is the total expenditure on final goods and services from which individuals get direct satisfaction.

DETERMINANTS OF CONSUMPTION

1. **Income levels**. High income levels lead to a high level of consumption because with high incomes people have enough money to spend on goods and services while low levels of income lead to a low level of consumption because people have less money to spend on goods and services.
2. **Level of taxation or subsidization**. A high level of taxation on the consumer's income leads to a low level of consumption because with high taxation the people are left with less disposable income for spending on consumption goods and services while a low level of taxation leads to a high level of consumption because the people are left with more disposable income to spend on goods.
3. **The marginal propensity to consume**. A high mpc leads to a high level of consumption because a big proportion of the consumers' income is spent on consumption of goods and services while a low M.P.C leads to a low level of consumption.
4. **The price level**. A high price level implies that goods are expensive and unaffordable forcing a large number of people to do without goods and services thus leading to a low level of consumption while a low price level leads to a high level of consumption because the tools are cheaper and easily affordable.
5. **The distribution of income.** An equitable (fair) distribution of income leads to a high level of consumption because majority of people have money and can afford to purchase goods and services while an unequal distribution of income leads to a low level of consumption because majority of people do not have income.

6. **Availability of credit.** Where credit or loans are readily available and affordable, the level of consumption is likely to be high because even people without cash are able to

acquire goods and services while where credit is not readily available, the level of consumption is likely to be low:

7. **Expectation about the future prices**. If prices are expected to be high in the future, the level of current consumption is likely to be high as the people want to avoid buying in the future at higher prices but if prices are expected to fall in future, current consumption is likely to be low because people prefer buying in the future at a lower price.

Qn.

a) Distinguish between consumption expenditure and consumption multiplier

b) Examine the factors responsible for the low level of consumption in your country

FACTORS LEADING TO A LOW LEVEL OF CONSUMPTION

1. Low levels of income. This refers to low levels of consumption because people have less money to spend on goods and services.
2. High level of taxation. This leaves consumers with low disposable income for spending on consumption of goods and services hence low levels of consumption.
3. Low marginal propensity to consume. This leads to low levels of saving because a small proportion of the consumer's income is spent on consumption of goods and services.
4. A high price level. This implies that goods are expensive and unaffordable forcing a large number of people to do without goods and services hence low levels of consumption.
5. Low population growth rate. This leads to levels of consumption because there are few people willing and able to buy the commodity
6. Unequal distribution of income. This leads to low levels of consumption because majority of the people do not have incomes.
7. Availability of low credit. This makes people without cash not to easily acquire goods and services thereby leading to low level of consumption.
8. Expectation of down prices in future. This implies that people keep their money and buy commodities in future at a lower price leading to low level of consumption.

THE CONSUMPTION FUNCTION.

This refers to a relationship between the level of consumption and the level of income in an economy. This relationship can be in form of a mathematical equation or a graph. By use of a given consumption function, we can find out the level of consumption that corresponds to a given level of income and vice versa.

The standard form of consumption is;

C = a + by

Where;

C is the level of consumption

Y is the level of income

a is the constant which represents the level of consumption increase income is zero.

b is the slope or gradient of consumption function is which is equal to

$\frac{\Delta c}{\Delta y}$ = mpc

ILLUSTRATION

The fraction of income which is spent on consumption is referred to as the average propensity to income

Or it's the ration of consumption to a level of income in an economy

Apc = $\frac{c}{y}$

SAVINGS

This refers to the proportion of income kept for future use

Or Refers to the proportion of income which is not used for current consumption but instead kept for future use.

TYPES OF SAVING

1. **Personal savings**. These are savings of individuals out of their income.

2. **Corporate/ company savings**. These are savings of corporations/companies out of the profits made in a given period of time.

3. **Compulsory savings**. These are savings that individuals are required by law to make out of their income at the end of each month. In Uganda, this applies to individuals employed in private companied or enterprise.

4. **Forced savings**. These are savings thus taxation where individuals are forced to forego consumption through paying taxes imposed on them by the government.

5. **Public savings**. These are the savings by the government out of the revenue from taxation of other sources.

REASONS FOR SAVING

1. To accumulate/ raise money for buying expensive commodities e.g. Car, bicycle etc.

2. To raise money that would cater for unexpected events e.g. Sickness, accidents etc.

3. To earn interests as the case is with saving in financial institutions.

4. For social security i.e. to raise money to be used in times of old age.

5. Some people save simply because they have more money than they need in the current period.

DETERMINANTS OF THE LEVEL OF SAVING

1. **Income levels**. High levels lead to high level of saving which low level of income leads to low level of saving.

2. **Rate of inflation/price level**. A high price level implies that goods are expensive which results into high expenditure thus leading to low level of saving while low price level leads to high level of saving.

3. **Marginal propensity to consume**. A high level of marginal propensity to consume implies that a large proportion of consumer's income is spent on consumption thus leading to low level of saving while a low marginal propensity to consume leads to a high level of savings.

4. **Rate of interest on deposits in financial institutions**. A high rate of interests on savings leads to high level of saving because the people want to benefit from the high interest rates while a low rate of savings leads to a low level of savings.

5. **Level of development of financial institutions** e.g. Commercial banks where people can deposit their savings. A high level of development financial institutions leads to a high level of saving while a low level of development of financial institution leads to low level of saving.

6. **The population growth rate**. A high population growth rate leads to high expenditure on consumption and a very low level of saving while a low population growth rate leads to high level of saving.

7. **The time preference/ spending habits**. Where people prefer to spend their incomes in the current period, a low level of saving results but they prefer to spend their incomes in future a high level of saving results.

8. **Level of taxation and subsidization**. A high level of taxation on people's income results into a reduction in disposable income results into a reduction in disposable income which results into a low level of savings and vice versa.

9. **Degree of accountability in the financial**. A low degree of accountability in the financial sector e.g. high rates of corruption and embezzlement discourages people from saving their money in the banks which results into a low level of saving while a high degree of accountability encourages people to save their money in banks hence high levels of savings.

10. **Government policies on savings**. Favorable government policies on saving e.g. compulsory savings through NSSF results into a high level of saving and vice versa.

11. **Existing stock of wealth**. Presence of large amounts of wealth results into high level of savings and vice versa.

12. **Degree of monetization/ commercialization in the economy**. A high level of monetization results into a high level of saving and vice versa.

FACTORS THAT LEAD TO LOW LEVEL OF SAVING.

1. Low income levels. This leads to low level of saving.

2. High rate of inflation. This implies that goods and services are expensive which results into high expenditure thus leading to low savings.

3. High level of marginal propensity to consume. This implies that a large population of consumer's income is spent on consumption thus leading to low savings.

4. High population growth rate. This leads to high expenditure on consumption hence low level of savings.

5. High level of taxation on people's income. This results into a reduction in disposable income which thereby leads to low level of savings.

6. Degree of accountability in the financial sector. High rates of corruption and embezzlement discourages people from saving their money in the banks which results into a low level of savings.

7. Low rate of interests on deposits in financial institutions. This leads to low levels of saving because few people benefit from the low interest rates.

THE SAVING FUNCTION

This is a relationship between level of saving and level of income in an economy.

A savings function can be inform of a mathematical equation or in form of a graph. By use of a given savings function. It can establish level of saving that corresponds to any given level of income and vice versa.

A savings function is usually of the from;

S = a + by

Where S = the level of saving

y = the level of income

a = a constant which represents the level of savings when income is on zero.

B = the slope of the savings function.

$\frac{\Delta s}{\Delta y}$ = mps

Negative savings

This refers to the process of using past savings for financing current consumption.

The function of income which is saved is referred to as APS or the ration of savings to income in an economy

INVESTMENT

This is a process of creating capita stocks or the process of devoting part of a person's/nations' income to create capital stock/capital goods.

OR

Process of devoting part of a country's national income to production of capital goods that are to be used in production of other goods.

FORMS/ TYPES OF INVESTMENTS

1. **Real/ Physical investment**; this refers to investments in form of tangible assets e.g. buildings, factories etc out of which income/ returns are expected.
2. **Financial investment**; refers to the investment in the financial market through purchasing financial facilities such as shares, bonds, treasury bonds etc from which people expect to get returns.

3. **Induced investment;** refers to investments that are influenced by changes in levels of income that is to say if income increases, induced investment increases and if income decreases, induced investment decreases. This is usually due to investments carried out by private individuals
4. **Autonomics investment**; refers to investment in an economy that is independent or not influenced by changes in income levels e.g. as income increases or reduces, the level of investment remains constant. This is usually true of investments carried out by the government.

5. **Cross investment**; refers to total amount of investment undertaken which induces that for replacing worn out capital and that increases the capital stock.
6. **Replacement investment**; refers to investment undertaken to replace and repair worn out capital (cater for depreciation or capital corruption)
7. **Net investment;** refers to investments undertaken which increases size of capital stock
8. **Public investment**; refers to investment undertaken by the state.
9. **Private investment**; refers to investment undertaken by private individuals.

REASONS FOR INVESTMENT

1. To replace worn out capital i.e. Replacement investment.
2. To increase on size of capital stock so as to increase output of goods and services.
3. To replace labour with capital e.g. purchasing machines to replace human beings in consumption.
4. To introduce modern technology e.g. through purchase of modern capital equipment to replace outdated capital equipments.
5. To earn profits as the case is with investment in a business establishment.
6. To earn interest as the case is with investments in the financial market through purchase of bonds, treasury bills etc.

DETERMINANTS OF LEVEL OF INVESTMENT.

Investors aim at maximizing profits. Therefore in order to maximize profits they try to produce as much output as possible and of a better quality and they also try to maximize costs.

Factors that lead to poor quality output lead to low output or those that lead to high costs of production discourage investments

1. **Income levels.** High income levels lead to high levels of savings and high levels investments while low income leads to low savings which leads to low levels of investment.

2. **Market size**. A large market for the commodity encourages the producer to produce more output which increases the level of profits hence encouraging investment while small market causes the producer to produce low output which leads to low revenue and low level of profits hence discouraging investment.

3. **The political climate**. Political instabilities disrupt productive economic activities which lead to low output produced by the firms hence leading to low levels of profits and thus low level of investment while a stable political climate encourages productive economic activities to go on smoothly leading to high level of output produced by the firm which leads to high levels of profits and thus high levels of investments.

4. **Level of development of county's infrastructure**. Poor infrastructure in an economy leads to low level of investment e.g. poor transportation and communication system makes transportation of products difficult and costly which reduces the profits thus discouraging investments. Inadequate power and energy causes the investors to adopt alternative sources of energy e.g. generators which is costly thus reduces the profits which discourages investment while well-developed infrastructure e.g. in form of adequate power and energy enables the firm to produce more and more output which leads to high costs thus encouraging investment.

5. **Level of entrepreneurship skills.** A high level of entrepreneurship skills result into organization of factors of production which leads to high level of output and profits made by the firm thus encouraging investments while low level of entrepreneurial skills results into poor organization of factors of production leading to low output that profits level thus discouraging investment.

6. **Level of technology**, (method of production) poor technology leads to low level of output produced by firm in addition to poor quality of output. This quality is sold at low prices which leads to low level of profits thus leading to low level of investment in the country while use of advanced technology results into high output in addition to good quality output which leads to high levels of investment.

7. **Level of taxation on investors**, high level of taxation of investors results into high costs of production. This reduces the level of profit made by the investor hence discourage investments and use of tax incentives, tax holidays, tax exemptions results into social costs hence low costs of production, high levels of profits thus encouraging investors in the country.

8. **Rate of inflation**. A high rate of inflation results into increased prices for the inputs which results into higher costs and lower levels of profits discourage investment while a low rate of inflation or price stability facilitates proper planning on side of investors' thus encouraging investment.

9. **The degree of corruption / level of accountability**. A high degree of corruption like asking for bribes from intending investors increase costs which discourages investment while a high level of accountability encourages investors thus leading to high investment levels

10. **Rate of interests borrowed money.** A high rate of interest on borrowed money implies high costs of borrowing which discourages investment while low rate of interest on borrowed money encouraged borrowing by the investor which leads to expansion of their investment hence a high level of investment.

11. **Profit levels in the country**. High profits levels to high level in an economy attract more and more investors which lead to high levels of investment while low profit levels discourage intending investors in the country thus leading to low level of investment.

12. **The existence of stock capital**. A high capital stock in a country enable the produce more and more equipment for production which leads to high level of output, high level of profits and thus high level of investment while low capital stock in the country leads to low levels of investment since with low capital stock producers cant purchase enough capital equipment.

13. **The marginal efficiency of capital**. High efficiency of capital leads to high level of profits which attract more and more investors thus high levels of investment while low marginal efficiency of capital leads to low level of output thus discouraging investment.

14. Size of market

15. Level of depreciation

QN. (i) What is meant by the term marginal efficiency of capital?

(ii) Mention three determinants of marginal efficiency of capital in your country

NB: **Marginal efficiency of capital** refers to the anticipated monetary returns on additional units of capital employed

FACTORS LIMITING INVESTMENT IN A COUNTRY

1. Low income levels; this leads to low levels of saving which leads to low level of investments.

2. Small market. This causes the producer to produce low output which leads to low revenue and low level of profits hence limiting investments.

3. Political instabilities. These lead to low level of output produced leading to low level of profits hence limiting investment.

4. Low levels of technology. Poor technology leads to low output produced leading to production of poor quality goods that are sold at low prices which leads to low profits hence limiting investments.

5. High level of taxation. This leads to low level of profits by interest thus limiting investments.

6. High rate of inflation. High rates of inflation results into increased prices for the inputs which results into higher costs and lower levels of profits which discouraged investment.

MEASURES FOR PROMOTING INVESTMENT IN AN ECONOMY

1. Expansion in the size of the market through joining economic integration .An increase in the market forces of production to increase the output which increases the level of profits hence encouraging more investors.

2. Encourage savings. Through increased voluntary and compulsory savings, people can emulate funds over time. These funds can be channelled into setting up more production units thus setting up an increase in investment.

3. Improvement in the political climate e.g. through encouraging peace talks or dialogue with rebels. A politically stable climate encourages producers to produce more output which increases profits which increase profits and increasing investment.

4. Improve the country's infrastructure e.g. through construction of roads which ease transportation of factor inputs and finished products. This lowers the cost of production thus increasing profits which increase the level of investment.

5. Improvement in the level of entrepreneurship skills. This is through encouraging entrepreneurship training which results into better organizations of the factors of production thus leading to an increase in the level of output and profits made by the firms which leads to the increase in the level of investment.

6. Undertake land reforms. This enables investors to get land and also enables them to expand their investments thus leading to an increase in investments

7. Extension of credit to individuals who want to carry out investment. This increases their size of capital stock for investment in the country which enables them to purchase equipment for production thus leading to an increase in the level of output and profits which increase the level of investment.

8. Population growth rate control. This is through encouraging use of family planning which reduces expenditure and thus increases on the level of saving and investment.

9. Provision of tax incentives to the investors e.g. tax holidays. These attract investors because they result into a reduction in the production costs and hence increase the level of profits and the level of investment.

10. Privatization of public enterprises. This increases the level of efficiency in managing and operation of the enterprises which increases on the level of profits and thus increasing investment.

11. Liberalization of the economy. This involves the removal of un necessary control of trade. This enables more investors both local and foreign to carry out investment without undue restrictions.

12. Efforts to fight corruption and embezzlement e.g. by imprisoning and sacking the corrupt government officials. This helps to ensure better accountability in the use of public funds which funds can be used to promote investment in the public sector.

13. Ensure macroeconomics stability e.g. stability in prices, interest rates etc. economics stability enables investors to plan and accuracy as they are sure of price of certain items e.g. raw material. This facilitates increased production of goods thus leading to increase in output and profits which leads to an increase in the level of investment.

14. Improve on technology. New methods of production like computerization automation can be undertaken. This new technology leads to an increase in output of goods and services thus leading to an increase in output and investment.

a) What is meant by the term investment?
b) Suggest measures that should be taken to increase investment in Uganda.

NATIONAL INCOME EQUILLIBRIUM

National income is said to be equilibrium when it neither increases or decreases at a given period of time. This happens when;

i) Aggregate demand is equal to aggregate supply. If aggregate demand is greater than aggregate supply then the level of the country's national income increases but if aggregate demand is less than aggregate supply then the level of a country's national income reduces.

ii) National income also happens to be in equilibrium when the total injections are equally to the total leakages in an economy.

Leakages;

There are elements that reduce the circular flow of national income.

They consist part of the incomes of the households that are not spent on goods and services produced by the business sector of the country's economy.

Example of leakages;

Savings, taxation, imports, capital outflow, injections

These are elements that add to the circular flow of national income

They consist of expenditures on domestically produced goods and services that arise out of the circular flow of income and expenditure i.e. they do not arise from the household.

Examples of injections include; investments, government expenditure, exports capital inflow

Thus national income is said to be in equilibrium when

I + E + X + KI =

If injections are greater than leakages, the country country's national income increase but if injections are less than the leakages, the level of the country's national income reduces.

CLOSED AND OPEN ECONOMIES

A closed economy is one which neither exports nor import goods and services from other countries. Such an economy is in a state autarky and does not exist in the real world. Thus in a closed economy there are no exports, no imports, no capital inflow and no capital outflow.

An open economy is one which exports and imports goods and services to other countries

Illustration of equilibrium in a closed economy

Illustration

Illustration of an equilibrium income in an open economy

Illustration

i) Distinguish between injections and leakages
ii) Mention two example of leakages in an economy
iii) Outline the forms of leakages and injections in a closed economy
iv) With examples, distinguish between injections and leakages from the circular flow of income in an economy.

NATIONAL INCOME DISEQUILIBRIUM

This occurs when aggregated demand is either greater or less than aggregated supply at full employment level of income. This implies that there is an inflationary gap or deflationary gap respectively.

THE INFLATIONARY GAP (NEGATIVE OUTPUT GAP)

This is a situation in which aggregated demand exceeds aggregated supply at full employment level of national income.

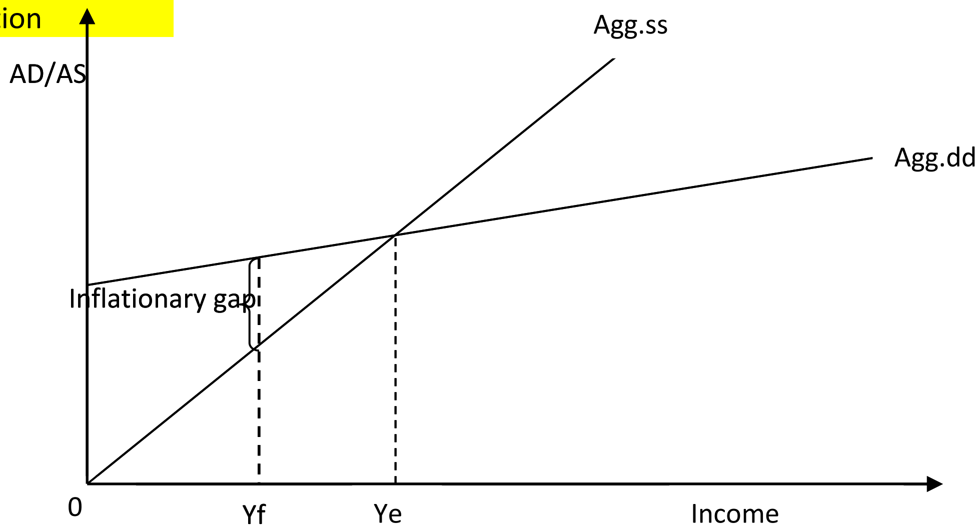
OR

This is where by aggregated demand is greater than aggregated supply at full employment level of income e.g. if at full employment level of aggregated demand is equal to 100bn but when aggregated supply is only 80bn dollars, then 100bn dollars – 80bn dollars = 20bn dollars.

Such an economy experiences high rates of unemployment and associated negative effects.

Diagram showing the inflationary gap.

Illustration



Ye = Equilibrium level of income (where aggregate demand = aggregate supply)

Yf = The full employment level of income attained when the country's resources are fully utilized/ exploited)

MEASURES FOR CLOSING OR REDUCING THE INFLATIONARY GAP

The inflationary gap can be reduced or closed by measures that reduce aggregated demand in the economy and these that increase aggregated supply of goods and services into the country from other countries. These include;

1. Increasing direct taxes or people income on people's incomes. This reduces disposable income, purchasing power of goods and services in an economy hence reducing aggregate demand and inflationary gap.
2. Reduction in government expenditure. This reduces the amount of money in circulation in the economy which reduces aggregate demand and inflationary gap.
3. Use of relative monetary policy e.g. through the sale of treasury bill by the central bank of the public. This also reduces the amount of money in circulation which reduces aggregate demand and the inflationary gap.
4. Reduction in exportation of goods and services. This reduces the aggregate demand for the country's goods and services that was arising from foreigners hence reducing the inflationary gap.
5. Encouraging importation of goods and services from other foreign countries. This increases aggregated supply of goods and services in the country's economy coming from other countries hence reducing inflationary gap.
6. Using income and wage control methods. This prevents further increase in wages and other forms of income thus controlling aggregated demand in the economy.
7. Maximum price legislation where the government fixes prices for commodities above which sellers are not allowed to sell them which prevents further increases in price.

Questions

a) What is an inflationary gap?
b) Mention two effects of an inflationary gap in your country.

- Increase in importation
- Persistent increase in prices/ upward pressure on prices of goods.
- Increased demand for factors of production.
- Increased/ high profits for the firm.
- Increase in exploitation of resources because of high aggregated demand that promotes investments

THE DEFLATIONARY GAP (POSITIVE OUTPUT GAP)

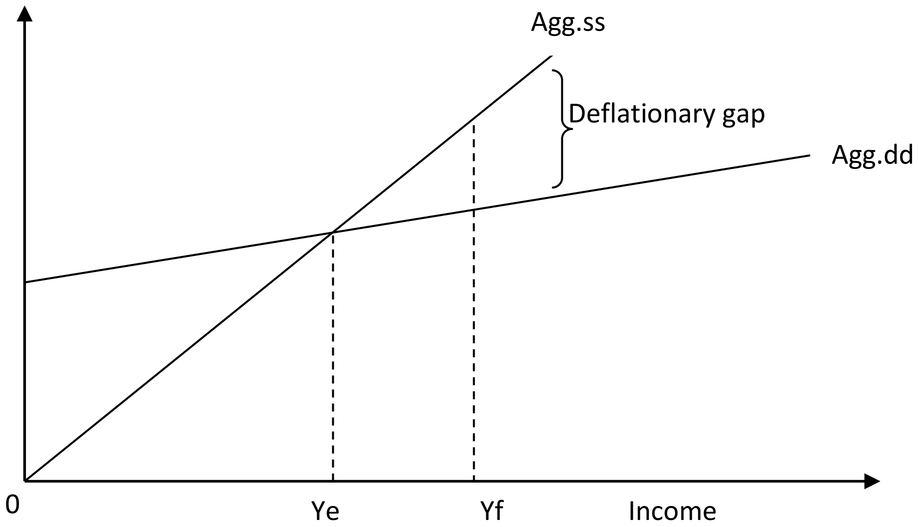
This is where by aggregate demand is less than aggregate supply at full employment level of income.

OR

This is a situation in which aggregated supply exceeds aggregate demand at full employment level of national income

Such an economy experiences deflationary tendencies or falling prices and the associated negative effects e.g. a decline in investment, employment, resource utilization etc

A diagram showing a deflationary gap



Ye = Equilibrium level of income

Yf = Full employment level of income i.e. the income realized when the country's resources are fully utilized.

MEASURES FOR CLOSING OR REDUCING THE DEFLATIONARY GAP.

1. The deflationary gap in an economy can be closed by use of measures that increase aggregate demand in the economy and measures that begin and measure that reduce aggregate supply of goods and services arising from other countries. These include;
2. Reduction in direct taxes or taxes on people's incomes. This increases the disposable income hence increasing aggregate demand.
3. Increase in government expenditure. This increases the amount of money in circulation in the economy hence increasing aggregate demand.

4. Use of an expansionary monetary policy. e.g. Through buying treasury bills from the public by the central bank. This increase the amount of money in circulation, which increases aggregate demand.

5. Encouraging exports. This increases the aggregate demand for the country's goods and services.

6. Discouraging imports. This reduces aggregate supply of goods and services that was coming from other countries.

INCOME DISTRIBUTION

This refers to the way incomes and wealth are shared among individuals, groups of individuals, sectors and regions in the country.

INCOME INEQUALITY refers to the uneven or unfair distribution of income amongst individuals or groups of individuals in a country.
It can be looked at as the economy gap or distance between the rich and poor. It implies that some individuals (minority) got very high income while majority get very low income or are very poor.

Unequitable distribution of income refers to a fair distribution of income in an economy implying that there is a smaller economic distance between the poor and rich in an economy i.e. the poor and rich get reasonable income

Income inequality where all individuals get the same level of income cannot be achieved in any country but what most countries strive to achieve is an equitable distribution of income.

FORMS OF INCOME DISTRIBUTION

1. **Personal/ individual inequality.**
   This is where some individuals in a country get high incomes while others get low income.

2. **Regional inequality.**
   This is where by some regions are more developed than others and therefore people in such regions get high compared to other counterparts in other regions e.g. the inequality between the rural and urban areas.

3. **Sectoral inequality.**
   This is where by some sectors of a country's economy are more developed than others and therefore people employed in those sectors get high income compared to their counterparts in other sectors e.g. the inequality between industrial and agricultural sectors.

4. **Intra-sectoral inequality**.

This is where by some individuals in a given sector get high income compared to their counterparts employed in the same sector e.g. the inequality between large scale and small scale farmers in the agricultural sector.

CAUSES OF INCOME INEQUALITIES/ DISPARITIES

Income inequalities arise out of the differences in opportunities income generating activities and other factors that determine people's level of income

1. **Difference in the level of education and skills.** Individuals with high levels of education and skills get high income because they are able to access better paying jobs while individual with low levels of education and skills are unable to access better paying jobs thus leading to low incomes.

2. **Difference in natural resource distribution and their level for exploitation**. Individuals that come from areas blessed with abundant natural resources accompanied by high levels of exploitation increase economic activities while those who come from areas with fewer natural resources attract less investment activities leading to low employment and income generation.

3. **Difference in accessibility to developed infrastructure**. Individuals in areas with well developed infrastructure tend to use the infrastructure to set up economic activities which result into employment and high income generation than their counterparts who come from areas with poor infrastructure.

4. **Difference in the family background.** People coming from rich families usually get high income than their counterparts from poor families. This is because some individuals inherit income generating property and invest from which they use to earn high income.

5. **Difference in natural abilities and talents**. People blessed with special talents and abilities get higher incomes because they do particular things in a distinguished way from other people while those individuals without such abilities and talents earn low income.

6. **Difference in the political climate**. Individuals coming from areas that are politically stable tend to set up various investment projects which increase economic activities hence leading to employment and higher income generation while areas that are politically unstable discourage investment which leads to low economic activities hence leading to low employment and income generation.

7. **Difference in the employer's ability to pay.** People employed in firms where the employer has high ability to pay have higher income than those employed in firms where the employers have less ability to pay.

8. **Difference in the nature of jobs and risks.** Individuals employed in jobs that are highly risky get higher income than their counterparts employed in jobs that are less risky.

9. **Difference in the number of hours worked.** Individuals who walk for more hours get higher incomes because they spend more time doing a given task while those who work for fewer hours earn low incomes because they spend less hours or time at work.

10. **Difference in accessibility to credit /contract**. People with access to credit and contracts are able to use the credit to invest which enables them to earn higher incomes while those individuals without accesses to credit are unable to acquire investment credit which makes them to earn low income.

11. **Difference in the level of experience**. People with greater experience in dealing with certain jobs; get higher incomes because they have acquired the skill to the job well over time while those individuals with less experience are unable to do the job well which leads to low income.

12. **Difference in the level of output produced**. Individuals that produce more output get higher income because they accomplish greater tasks i.e. produce more output while those that produce less output do less tasks and hence receive less income.

13. **Difference in elasticity of supply of labour**. Labour whose supply is inelastic get high income because such labourers are limited in supply while labour whose supply is elastic gets low income because the supply of such labourers is high.

14. **Difference in the cost of living**. Individuals working in areas where the cost of living is high, get high incomes e.g. in form of wages, allowances etc because they need more money to purchase goods and services while individuals working in areas where the cost of living is low tend to earn low incomes because they spend less to purchase goods and services.

15. **Discrimination in the labour market i**.e. basing on tribes, religion etc. individuals that are of the same tribe or religion as employers usually get high income than their counterparts who are of a different tribe or religion.

16. **Difference in ability of individuals to bargain for items**. Some workers have a stronger bargaining power and are able to convince their employers to increase their wages hence earn higher income while individuals with a weak bargaining power tend to earn low income.

17. **Difference in trade unions ability to bargain/ a well-organized trade union** always succeeds in getting higher pay for their members while weak and disorganized trade unions fail to secure an increase in wages for their members hence leading to low income and thus causing income inequality.

18. **Non matching wage policy by employers**. Some employers e.g. the government pays higher wages to some civil servants in some sectors while paying lower wages in other sectors thereby causing difference in incomes.

MERITS OF INCOME INEQUALITY.

1. It encourages efforts and hard work on the side of the low income earners because they are stimulated to work harder to increase income and live a better life like that of high income earners.
2. It leads to an increase in the level of creativity and innovativeness on the side of the low income earners because they will always work hard to increase their income as they look for better and different ways of raising their income.
3. It encourages labour mobility. The low income earners are likely to move from job to job, area to area as they look for better paying employment.
4. It awakens the government of its responsibility of fighting poverty and improving people's welfare through provision of services like medical care for the low income earners who cannot afford to pay for such services.
5. It encourages investment by the rich or high income earners. This is because high income earners have got a high mps which leads to high level of saving and investment.
6. It results into good working relationship between the employer and employees where the employer is high income earner and employees are low income earners.
7. It results into provision of cheap labour by the low income earners for the employer. This is because low income earners are desperate and are ready to supply efforts/ labour even where the employment is low.
8. It results into high revenue for the government from taxation where the high income earners are taxed at a higher rate e.g. through progressive taxation system.

DEMERITS/ NEGATIVE/ ARGUMENT AGAINST INCOME INEQUALITY.

1. It results into social evils and crimes in society e.g. theft, prostitution etc and other crimes committed by the low income earners against the high income earners.

2. It results into RUM e.g. regional inequality. This promotes movement of people from areas that are under developed to those that are more developed.
3. It results into low aggregate demand for goods and services as most of the low income earners cannot afford to purchase goods and services.
4. It results into low government revenue from taxation where most of the low income earners cannot afford to pay tax revenue to the government.
5. It results into social tension which sometimes results into political instability because the low income earners are usually disgruntles and frustrated.
6. It results into brain drain. This is because many of the low income earners who are highly advanced and skilled decide to go to other countries to look for greener pastures.
7. It results into misery and deprivation which leads to low standards of living for the low income earners who have to do without several goods and services.
8. It leads to the dependence burden in the country. This is because many of the low income earners have to depend on their rich relatives and government for education, feeding etc.

MEASURES FOR REDUCING INCOME INEQUALITY.

1. **Education reforms** e.g. through introduction of UPE and USE, vocation education to ensure that low income earners can get education and skills for employment and income generation.

2. **Land tenure reforms** i.e. changing the land tenure system to ensure that low income earners can get accesses to land, use it for productive economic activities that can lead to income generation. OR this involves the changing of the system of land ownership. This enables people without land to get accessed to land and use it for production process so as to increase on their income.

3. **Progressive taxation** i.e. taxation of the high income earners at a higher stat or higher rate compared to the low income earners. This leaves the low income earners with some for saving and investment.

4. **Improvement or development of the country's infrastructure** especially in the rural areas where there is poor infrastructure. This opens up such areas to economic activities, employment and income generation.

5. **Trade liberalization** i.e. this involves removal of unnecessary government control on trade. This encourages trade and investment which increases employment and incomes. OR This involves removal of unnecessary government on economic activities which increase investment in the economy, increases employment and income for the people.

6. **Population control measures** e.g. Through the use of family planning. This reduces expenditure on consumption which results into an increase in saving an investment hence an increase in income for the concerned families.

7. **Extension of credit or loans especially to the low income earners**. This enables them to start their own projects from which they can get income.

8. **Economic diversification** i.e. increasing the rage of productive economic activities where people can get employment so as to earn income.

9. **Agricultural modernization** e.g. changing the agricultural sector from the traditional subsistence production to modern commercial agriculture. This leads to increase in output, employment and income for the people employed in the agricultural sector who are usually low income earners.

10. **Subsidization of the low income groups/ earners** / poor when it comes to education on such services which enables them to save and invest to increase their incomes.

11. **Employment of the disadvantaged groups of individuals** e.g. the youth, women their access to employment and income generating activities.

12. Improve the political climate. This attracts investors because of the security which leads to an increase in economic activities, employment and income to the people.

13. **Encourage development of small enterprises**. These enterprises mainly use labour intensive techniques of production which result into creation of more employment and income generation.

14. **Improvement of the investment climate** e.g. through offering of tax holidays. These reduce the production costs charged by the investors which encourage investment, economic activities employment and income generation.

Questions;

Account for income disparities in your country
Explain the measures that have been adopted to minimize uneven distribution of income in your country.

- Liberalized the economy.
- Controlled population growth rates.
- Carried out education reforms.
- Undertaken land tenure reforms.
- Progressive taxation.
- Improved infrastructure.
- Diversified the economy.
- Modernized agriculture.
- Raised wages of low income earners.
- Improvement of the investment climate.
- Employment of disadvantaged groups.
- Increased government expenditure to develop disadvantaged groups.
- Subsidization of the poor.
- Improved political climate.
- Encouraged development of small scale enterprises.

Explain the causes of unequal/ uneven income distribution in your country.
What measures are being used to minimize uneven distribution of incomes in your country?

Improving infrastructure. The government is improving infrastructure especially in those areas where infrastructure is poor so as to open up such areas to the economic activities and income generation.

THE STRUCTURE OF UGANDA'S ECONOMY

It refers to the composition of salient or basic features of an economy which include the pattern of production, output levels, control and ownership of resources, major sectors and their composition, categories of resources, social economic organization of the economy and the general administration of the economy.

BASIC FEATURES OF UGANDA`S ECONOMY/TRAITS

1. Dominance of agriculture. Uganda`s economy is dominated by the agricultural sector in the following ways:

   i. In terms of its contribution to gross domestic product (GDP).
   ii. In terms of number of people employed in it over 80%.
   iii. In terms of its contribution to
   iv. Foreign exchange earnings.
   v. It's the major source of food in Uganda.
   vi. It's the major sour source of raw materials to agro based industries.
   vii. It is the major source of market to industrial output e.g. implements like hoes, pangs etc.

2. It is an open economy meaning that it participates in international trade to get market for its exports and buy what it cannot produce (imports).
3. It is a dual economy. Dualism is a state of an economy where there is co-existence of two contrasting or two mutually exclusive social-economic situations one being desirable, modern and superior and another one being undesirable, traditional and inferior e.g. rural and urban sector, barter exchange and monetary exchange, poor and rich.
4. It is a mixed economy i.e. having both elements of command and free enterprise economy e.g. Both the government and private sector participating in economic activities, however the role of the government has been reduced by privation of most of its enterprises and hence Uganda is moving towards almost private sector lead economy.
5. It's highly a dependent economy i.e. depend on other economies for resources for resources, skilled man power, technology and trade etc in order to survive.
6. It's characterized by high population growth rate relative to economic growth i.e. population growth rate relatively high of about 3.4% per annum there by putting pressure on the exiting resources.
7. Uganda`s economy is characterized by high levels of illiteracy. The economy is predominantly composed of the unskilled labour employed in primary activities like fishing, mining since the number of people who can read and write with trained skills is very low but improving year by year.
8. There is wide spread of unemployment and under employment caused by high illiteracy rate and population growth rate. The majority of the people in Uganda is unemployed and under employed There by explaining the existence of different types of unemployment i.e. disguised, open urban etc.
9. It is characterized by under developed infrastructure in Uganda are not well developed and this hinders economic infrastructure in Uganda are not well developed and this hinders economic growth since the since development of such infrastructures is pre-requisite for

growth e.g. there is unstable and inadequate power supply, poor road especially in rural areas where there is impassable feeder roads though main roads are being re-habilitated and expanded.

10. It is characterized by economic instabilities like depreciation of the value of country`s local currency inflation etc.
11. The import and export trend is largely unbalanced due to exportation of poor quality raw materials (sow) which fetch low incomes and importation of highly priced goods leading to unfavorable balance of payment deficit.
12. It is characterized by relatively large and growing informal sector with small scale processing industries like tailoring, maize milling, shoe repair, saloons etc.
13. It has a small but growing industrial sector. The sector is growing with re-habilitation of the old industries, privatization and setting up of new ones over the years. Its contribution to GDP is also steadily growing although it still remains smaller than that of agriculture.

ECONOMIC IMPLICATIONS OF THE STRUCTURE OF UGANDA`S ECONOMY:

NEGATIVE EFFECTS:

1. The structure promotes income inequalities due to existence of dualism i.e. in urban centers there is high level of income compared to rural areas.
2. It increases government expenditure due to diversion of government funds to provision of essential services to ever increasing population in terms of social services like health centers, schools etc
3. Little/unpredictable export earnings because agricultural production prices keep on fluctuating and due to protection from developed countries.
4. It leads to rural urban migration due to existence of regional dualism and its effects e.g. open urban migration, development of slums.
5. It implies production of low quality output due to poor technology and unskilled labour used leading to poor standards of people in the country.
6. It widens the dependence burden since Uganda depends on other countries for resources, skilled man power which is unpredictable and other advance effects.
7. It discourages investments in the country due to the existence of poorly developed infrastructures e.g. poor impassable roads, poor supply of power which scares away the would be investors and the economic instabilities.
8. It results in limited market for goods and services produced due to high levels of unemployment existing in the economy.
9. It leads to poor performance of agricultural sector due to land fragmentation resulting from the ever increasing population.
10. It also leads to high capital outflow since most of the enterprises in the economy are owned by foreigners who tend to repatriate most of the profits for their home countries.

POSITIVE IMPLICATIONS OF SUCH A STRUCTURE:

1. Provision of employment opportunities from the growing industrial sector thus increasing earning of the people in the economy.
2. Provision of food to the ever increasing population due to dominance of agriculture.
3. It promotes technology transfer and development which facilitates the production of high level of output and of good quality hence promoting economic growth and development.

4. It results in increased government revenue due to increased participation of the private sector in economic activities thus widening the tax base.
5. It promotes international trade and increased benefits e.g. increased foreign exchange earnings which can facilitate development programs in the country through exportation of goods and services.

AGRICULTURE SECTOR:

FEATURES

POSITIVE AND NEGATIVE IMPLICATIONS/MEASURES TO IMPROVE AGRICULTURE (REFER TO AGRICULTURAL DEVELOPMENT NOTES)

STRUCTURE OF THE INDUSTRIAL SECTOR:

The kind of industries found in this sector is mainly processing plants (agro based), import substitution and assembling plants. The following are the features of the industrial sector or manufacturing sector.

FEATURES OF THE INDUSTRIAL SECTOR:

1. They are mainly agro based industries which mainly depend on agricultural raw materials e.g. coffee processing, tea processing, grain milling
2. Manufacturing industries mainly produce consumer goods and are mainly necessities e.g. plastics, clothes, beverages etc
3. Most of the industries are urban based
4. Mainly medium and large scale industries with few small scale industries located in rural areas.
5. They mainly use labour intensive method of production i.e. the skilled and semi skilled although the recent trend shows increasing use of capital production techniques.
6. Most of the industries operate at excess capacity implying that they produce less than their installed capacities.
7. They mainly use imported raw materials and intermediate goods in their production process.
8. They mainly produce low quality goods due to use of rudimentary technology in their production process.
9. Most of the industries are privately owned with foreigners dominating the sector.
10. The industrial sector has low but rising contribution to GDP compared to agriculture.
11. Most of the industries are import substitution industries i.e. production goods locally which were formally imported e.g. dairy corporation Uganda.
12. Most of the industries are import substitution industries i.e. producing goods locally which were formally imported e.g. dairy corporation Uganda.
13. The industrial sector is mainly characterized with limited linkages with other sector of the economy i.e. it contributes less to the development of other sector like tourism.
14. Most of the manufacturing industries operate on small scale with few mediums and large sized ones.
15. Most of the industries are assembling plants i.e. using spare parts from other countries to produce goods and services.

ECONOMIC IMPLICATIONS OF THE INDUSTRIAL SECTOR:

NEGATIVE ECOMIC IMPLICATIONS:

1. Low contributions to national income since most of the industries are small scale under takings and operate mostly at excess capacity.
2. The sector contributes less to employment creation. This could be because of the many small scale industries and increased use of capital in large firms thus contributing less to economic development.
3. It promotes regional imbalance based in development since most of the industries are urban based. Most urban areas tend to develop at a faster rate compared to rural areas.
4. It also promotes income inequality since industries are not evenly distributed i.e. in urban centers workers are highly paid in these industries compared to workers in rural areas employed in rural areas employed in agriculture .Such a sector leads to profit repatriation since most of the industries are owned by foreigners thus leaving Uganda un developed.
5. Continued importation of capital goods leads to imported inflation since most of the industries mainly produce consumer goods necessitating importation capital goods.
6. It leads to foreign dominance of the economy since most of the industries are foreign owned which can undermine the political sovereignty of the country and using inappropriate policies to foster the development.
7. The sector leads to production of poor quality goods due to poor technology used leading to poor standards of living.
8. It leads to under utilization of resources thus retarding to the process of economic growth and development since most of the industries operate at excess capacity
9. It promotes rural –urban migration since most of the industries are based and it`s adverse efforts to the country like development of slums, congestion

POSITIVE IMPLICATIONS:

1. It results in increase on material standards of living for the citizens of the country due to increased production of goods and services.
2. It reduces inflationary tendencies in the economy i.e. imported inflation due to production of goods locally which were formally imported
3. It improves on BOP position though increased exports and foreign exchange earnings.
4. It improves on the country`s terms of trade since value is added to exports.
5. It promotes advancements in technology which improves labour skills and the quality of output.
6. Reduction in unemployment levels resulting out of increased investments and newly merging industries leading to high standards of living.
7. It promotes urbanization which improves people`s standards of living thus leading to economic development.
8. It provides a wide variety of goods and services which widens consumers' choice and hence improving the standards of living of people.
9. It promotes resource exploitation and this reduces excess capacity hence creating more employment opportunities.
10. It reduces the extent of dualism as all sectors and regions of the economy share the benefits of economy growth arising from industrialization.

11. It increases life expectancy and welfare since it is associated with literacy, improved welfare etc.
12. It increases tax revenue due to increased private participation in the industrialization process since most of them are privately owned.
13. It reduces monopoly tendencies in the economy due to setting up of different goods and services.
14. It promotes economic growth and development due to increased volume of goods and services produced by these industries.

REV QNS:

- Examine the role of industrialization in the development process of your country.
- Explain the implications of the industrial sector in your country.
- Considering the nature of the industrial sector in your country, why is it contributing less to employment creation in your in country.
- Despite the rapid growth of the manufacturing sector in Uganda, the sector is contributing less to employment creation. Give reasons
- What attempts could be made to increase the contribution of the industrial sector to employment creation.
- Describe the features of manufacturing sector in your country.
- Asses the consequences of such a sector.

MEASURES TAKEN TO PROMOTE THE INDUSTRIAL SECTOR

1. Liberalization of the economy. This involves removing unnecessary restrictions in trade to allow people participate in trade activities especially in the industrialization process.
2. Privation of public enterprises which involves transfer of ownership from government to private hands in order to promote efficiency in such enterprises and expand on their scale of operation.
3. Putting in place strong infrastructure e.g. adequate power supply in all parts of the country.
4. Rehabilitation of existing roads and construction of new ones to attract potential investors to set up industries in different parts of the country.
5. Provision of economic incentives to potential investors e.g. tax holidays tax exemptions, subsides etc in order to attract more investors and putting in place a predictable fiscal policy.
6. Economic integration can be carried out in order to expand the market of industrial output and to have a strong bargaining power in the world market through participating in different economic organization, EACM, COMESA etc.
7. Controlling inflation in the country can be done to facilitate with predictability of business in the industrial sector in order to attract more investors in this sector
8. Training of man power especially in vocational related fields can be done in order to facilitate growth of small scale industries.
9. Provisions of credit to small investors in order to enable them expand their scale of operation.
10. Ensuring political stability in all parts of the country in order to guarantee property and life of investors in the industrial sector.

11. Establishing institution to help investors i.e. identifying investable areas e.g. The Uganda Investment Authority.

INDUSRTIAL DEVELOPMENT:

It is the process of building a country's capacity to transform raw materials in to finished products and to manufacture goods for consumption and further production.

ROLES OF INDUSTRIAL SECTOR IN ECONMIC DEVELOPMENT:

1. Provision of employment opportunities of all stages of labour skills i.e. un, semi skilled labour which improves on people`s standards of living as a result of increased earnings thus promoting economic growth and development.
2. Provision of consumer and capital good as thus improving people`s welfare and promoting economic growth and development.
3. Industrial sector is a source of foreign exchange earnings through provision of commodities for export thus improving on the countries balance of payment position.
4. Industrialization is a basis for infrastructural development since its implementation necessities so e.g. adequate power supply, improved road network, health facilities which also improves peoples standards of living.
5. Generation of government revenue through taxes levied on the industrial products and industrial workers i.e. in form of VAT, pay as you earn, co-operate tax which taxes are used to provide social services to provide social services to people and to facilitate development projects.
6. Promotion of linkages with other sectors of the economy especially the agricultural sector through sector through providing market for the agricultural produce used by agro-based industries.
7. Promotion of training and labour skills which improves on the productivity of labour in the country.
8. Promotion of entrepreneurial skills by setting up small scale industries thus promoting the growth of indigenous technology.
9. Industrial development also promotes self reliance as it acts as a strategy for import substitution.

ARGUMENTS AGAINST INDUSTRIAL DEVELOPMENT

1. It requires a lot of capital which many LDCs lack thus it may accelerate borrowing and the problem of debt servicing.
2. It provides limited employment since it is capital intensive and requires skilled personnel
3. Inadequate market for industrial products can`t favour industrial development and this is caused by the general poverty in developing countries and the poor quality of output produced.
4. Concentration of production in particular regions because of industrial inertia causes unbalanced growth and rural urban migration hence a defect from industrialization.
5. Most industrial firms operate at excess capacity due to inadequate co-operant factors leading to limited exploitation of natural resources.
6. It promotes social costs like pollution which eventually degrades the environment.

7. It promotes imported inflation due to importation due to importation of inputs and intermediate products from countries affected by inflation.
8. It accelerates the problem of profit repatriation and foreign exchange outflow due to employing of foreign expatriates.

PROBLEMS FACING UGANDA`S INDUSTRIAL SECTOR

1. Limited capital to hire industrial machines, inputs
2. Poor infrastructure like inadequate power supply.
3. Limited skilled man power due to low levels of education
4. Inadequate entrepreneurial skills in LDC people in developing countries are risk aversive hence save little or no at all.
5. Limited market due to general poverty and poor quality output from the industrial sector fetching low earnings.
6. Low levels of technology limiting productivity in the industrial sector.
7. Unfavorable government policies towards industrialization in form of high taxes, lengthy produces in getting trade license, low subsidization etc
8. Political unrest in some parts of the country which scares away the would be potential investors in the industrial sector.
9. Poor performance of the agricultural sector leading to scarcity of raw materials to agro based industries.
10. High rate of corruption in the industrial sector leading to misallocation of resources meant for industrialization.

QN. Uganda should adopt agricultural development rather than industrialization if she is to achieve a faster rate of economic growth and development

DUALISM/DUAL ECONOMY/ECONOMIC DUALISM:

It is an economic situation characterized by the co-existence of two contrasting and mutually exclusive socio-economic situation one being superior, modern and desirable and another one being inferior, traditional, undesirable and backward.

CHARACTERISTICS OF A DUAL ECONOMY:

- There is lack of mutual dependence between the two sectors.
- There is widening gap between the two sectors.
- There is always traditional and modern method.

FORMS OF ECONOMIC DUALISM:

1. **Social dualism**: This is composed of the traditional sector and modern sector is composed of those engaged in communal production with limited specialization and attach high values of culture while the modern sector is composed of the literate who are rather individualistic in nature and to a greater extent

QN. Outline four indicators of social dualism in your country.

- Co-existence of the literates and illiterates
- Co-existence of communalistic and individualistic
- Specialization and limited specialization
- Co-existence of rich and poor.
- Co-existence of less and high level culture.

2. **Economic dualism**: This is where there is co-existence of rudimentary technology along side modern techniques of production e.g. use of hoes and tractors in agricultural sector, use of computers and type writers, milking machines and human labour.
3. **Sectoral dualism**: This is where there is a difference in development between sectors e.g. the co-existence of industrial sector with high income alongside the agricultural sector with low income, co-existence of formal and informal sectors.
4. **Intra –sectoral sector dualism**: This is the co-existence of tradition and modern situations within particular sector e.g. modern agriculture vases subsistence agric within the agric sector
5. **Regional dualism**. Refers to co-existence of progressively developed regions alongside the backward regions in the economy.
6. **Exchange dualism**. This is the co-existence of goods for goods and monetary exchange which involves the use of money as a medium of exchange.
7. **International dualism**: This involves the co-existence of MDCs and LDCs.

INDICATORS OF DUALISM IN UGANDA:

1. The co-existence of subsistence and commercial agriculture
2. Co-existence of rural and urban areas.
3. Co-existence of rudimentary and modern technology.
4. Co-existence of illiterate and literate.
5. Co-existence of barter exchange and monetary exchange.
6. Co-existence of formal and informal sector where by in the formal sector there are well established business with formal record keeping while in informal there are small scale business where most of them are un registered with limited or no record keeping and accountability
7. Co-existence of agric with low income and industrial
8. Co-existence of the rich and the poor
9. Co-existence of foreigners in big investments and local investors in small scale business.

Rev questions

Explain the effects of dualism in an economy.

Suggest workable measures to tackle the problems

SOLUTIONS TO 1

1. It promotes income inequality due to existence of the rich and the poor.
2. It creates regional imbalances which becomes as a result of regional dualism.
3. It promotes RUM (rural urban migration) and its associated effects like slums, poor performance of agric, congestion.
4. It promotes high profit repatriation if there is co-existence of foreigners investors engaging in investment activities
5. Low productivity of agriculture
6. It stagnates the process of economic growth and development
7. It widens the dependence burden
8. Exploitation of the poor by the rich

- Define regional dualism
- What attempts has your country taken to reduce regional dualism

- To what extent can your country be described as a dual economy?

To a larger extent Uganda is a dualism economy

1. Technological dualism i.e. rudimentary modern methods
2. Labour dualism
3. Social dualism
4. Market dualism i.e. commercial and substance
5. Sectoral development
6. Intra-sectoral development

However Ugandans economy is not specifically a dual one since there is secondary sector which exist between the modern and traditional sector i.e. the informal sector characterized by the following:

1. There exist small scale business
2. Exist between urban and rural areas
3. In this sector there is limited book keeping and accountability
4. Employment of mainly semi-skilled labour
5. Production of mainly consumer goods
6. There is use of simple technology in producing goods and services
7. It uses locally available inputs
8. Most of the firms are mainly semi urban based

SOLUTIONS:

1. Full monetization of the economy in order to eliminate elements of barter exchange.
2. De-localization of industries
3. Implementing rural development strategies like rural electrification
4. Provision of education to all people to reduce on the number of illiterates
5. Provision and development of social-economic infrastructures in all parts of the country to stimulate economic activity
6. Use of appropriate methods of production like to intermediate technology to eliminate the co-existence of traditional and modern
7. Land reform policies should be under taken to reduce agric and to cross the gap between the landlords and squatters
8. Modernization of agric can also be done to reduce the dualistic tendency of agric being superior, desirable and modern with incomes.
9. Diversification of the economy.

ECONOMIC DEPENDENCE AND ECONOMIC INTERDEPENDENCE:-

Economic dependence is the reliance of an economy on a particular sector of productive activity or on other countries for development resources and decision making in an attempt to foster development activities

OR. Is a situation where an economy relies either on some sectors or on other developed country`s decisions and resources for her economic survival as survival as well as stimulating economic growth and development.

Economic interdependence is a situation where countries rely on each other with respect to trade, technology, investments etc for their survival.

FORMS OF ECONOMIC DEPEDENCE IN UGANDA

SECTORAL DEPEDENCE: This is the reliance of an economy on one sector for most of its development activities. As earlier noted Uganda is an agro-based economy where by agric as a single sector plays a great role in the process of economic growth and development.

Effects:

- Fluctuation of incomes
- Low employment creation
- Low levels of revenue
- Over exploitation of resources

TRADE DEPEDENCE: Refers to the reliance of the country on few exports for foreign exchange and at the same time imports a wide range of both consumer and capital goods to meet domestic demands.

TYPES OF TRADE DEPENDENCE

Geographical concentration of trade: This refers to a situation where a country depends on a particular source of imports and a particular export market for her products. This occurs where the country exports to one or few selected countries and import from few countries.

Commodity concentration of trade: Is a situation where a country`s trading activities or exports are mainly concentrated on a few range of goods and services i.e. when a country depends on a few commodities for her exports earnings e.g. coffee in case of Uganda.

Effects:

1. Income instability as prices fluctuate at international level
2. Less income in case of any structural break down
3. It leads to structural unemployment if the market for the products is completely lost.
4. It worsens the balance of payment problem especially where prices of imports are higher than earnings from exports
5. It leads to imported inflation if imports are got from countries experiencing inflation

POSITIVE EFFECTTS:

- Steady market creation
- It improves the relationship between trading partners
- It encourages specialization with its associated advantages.

EXTERNAL RESOURCE DEPENDENCE

This is the reliance of an economy/a country on external factor services particularly capital inform of investable e funds e.g. skilled man power, private foreign investment capital like multi National Co-operation from MDCs for her economic growth and development.

PROBLEMS OF EXTERNAL RESOURCE DEPENDENCE:

- It leads to resource drains through profit repatriation by foreign investors
- It leads to use of inappropriate technology from MDCs
- It worsens the BOP position since imported man power is too expensive and costly to maintain.

- Technology transfer from developed countries discourages the growth of indigenous technology
- Leads to excessive exploitation of resources

DIRECT ECONOMIC DEPENDENCE: Refers to a situation where an economy relies on external decision, institution and foreign government for her economic survival. This implies foreign participation in supply of capital either by foreign capitalists or foreign governments and participation in the management and economic decision of a recipient country.

PROBLEMS OF DIRECT ECONOMIC DEPENDENCE/EFFECTS.

- It leads to implementation of inappropriate policies
- There are unpopular decision which cause disharmony in the country i.e. constant strikes and demonstrations.
- It widens dependence problem as donors only dictate decisions and politics to serve their interests
- It undermines the county`s sovereignty.
- It encourages dumping from MDCs
- It leads to high capital outflow
- Heavy reliance on little exchange for export earnings with coffee being the dominant commodity.

INDICATORS OF ECONOMIC DEPENDENCE:

1. Heavy reliance on few export earnings with coffee being the dominant commodity.
2. Heavy reliance on few countries for export market e.g. most exports are sold to Western Europe.
3. Dependence on few countries for import source. Most of the imports are from China, Dubai, Japan, and England etc
4. Heavy reliance on foreign assistance e.g. Uganda depends on foreign aid from donor institutions like IMF and World Bank and other countries like Norway.
5. Dependence on foreign investment firms i.e. dominance of foreign investors in the economy.
6. Reliance on technology transfer from the developed world i.e. all our technology is derived from the developed countries e.g. machines and spare parts.
7. Reliance on imported skilled manpower i.e. there is wide spread use of foreign man power in many sectors of the economy as expatriates, consultants etc
8. Dependence on imported capital goods due to lack of locally produced capital gods

EFFECTS OF ECONOMYIC DEPENDENCE:

1. It leads to external dominance of the economy where a country carries out direct economic dependence. This leads to implementation of inappropriate policies
2. It results in continued fluctuation of output and income due to dependence on few primary exports which are subjected to price fluctuation on the world market.
3. High dependence on foreign technology, manpower etc leads to under utilization of resources, local resources, local skills and limited growth of indigenous technology.
4. It leads to high capital outflow inform of repatriation if a country depends on direct foreign investments

5. It leads to brain drain. This is common with aid inform of scholarships which lead to loss of skilled manpower to foreign countries.
6. It discourages domestic savings and investments as people become expectants of foreign resources as the only engine of economic growth and development.
7. It results into persistent BOP deficits due to commodity concentration of trade which makes a country to depend on few exports and imports more from other countries
8. It leads to imported inflation if imports are bought from other countries experiencing inflation.
9. It results into structural unemployment most esp. incase of trade dependence if there is complete less of market for few exports.
10. It results into erosion of cultural values as a result of direct foreign influence like less of local language, dressing code.

Questions:

- Distinguish between economic dependence and economic inter-dependence
- In what ways is your country dependant
- Examine the consequences of economic dependence.

POSITIVE EFFECTS OF ECONOMIC DEPENDENCE:

- Foreign aid which can help to control shortages
- Provision of ready market which reduces the problems of fluctuations
- Improving on relationship between countries
- Creation of employment opportunities
- Production of high quality products
- It fosters economic growth and development due to increased output
- *It promotes infrastructural development like road construction*
- *In creased skills attained by local labour force like managerial skills given*

INFORMAL SECTOR:

Refers to a sector that exists between the traditional, backward sector and a modern sector. It is a sub urban sector comprising of small scale individually land business with limited formal accounting procedure. It consists of hawkers, cobblers, and shoe shiners, carpenters, roadside, sellers, tax drives, tailors etc.

It includes all those activities that have developed from the traditional sector but are not yet fully absorbed in the modern sector e.g. tailoring, metal works, carpentry, petty trading etc

FEATURES OF UGANDA`S INFORMAL SECTOR:

1. Most of the businesses are operating on small scale.
2. The sector mainly use unskilled and semi-skilled labour
3. There is limited government control in Uganda`s informal sector
4. The sector mainly uses local resources or inputs thus It is dominated by small scale firms which mainly use little capital engaging in simple production activities
5. The sector mainly uses simple production techniques which are more labour intensive rather than capital intensive
6. It is dominated by sole proprietorships implying that most of the businesses are individually owned

7. The sector mainly produces low quality goods due to use of simple production techniques and employing of semi and unskilled labour.
8. Most of the business in this sector are unregistered therefore operating illegally
9. The sector is sub-urban based lying between urban areas and rural areas
10. It is characterized by limited formal book keeping and record maintenance since the majority of the proprietors are semi or unskilled
11. It is characterized by low productivity in geinimising the use of scarce foreign exchange for importation of raw materials.
12. It produces mainly consumer goods and simple producer goods which can aid in the production of other goods but not capital goods

THE ROLE OF INFORMAL SECTOR IN THE DEVELOPMENT OF UGANDA:

1. Providing employment opportunities to many people because of the wide use of labour intensive methods and secondly the sector provides avenue for self employment
2. Promotion of technological development which in the long run may lead to development of an appropriate indigenous technology
3. It acts as a training ground indigenous entrepreneurs and it is considered to be a good ground for the development of local skills and managerial capacity building
4. Provision of government revenue through taxing most of the business and individuals employed in the sector
5. It supplies cheap and affordable consumer goods for their consumption thus improving people`s standards of living leading to development of an economy.
6. It helps to improve on the productive capacity of the economy thus contributing to the country`s national income by increasing output of goods and services leading to economic growth and development.
7. Promotes indigenization of the economy as local entrepreneurs carry out most of the productive activity in the industrial sector thus leading to self sufficiency in the country
8. It encourages exploitation of local resources because the sector is characterized by use of local resources thus saving the scarce foreign exchange which would have been used to import raw materials and can be used to develop other sectors
9. It enhances a fair distribution of income which reduces social unrest
10. The sector is considered to be a vehicles of economic transformation as it helps to increase the size of the commercial sector
11. It reduces RUM in the country thus facilitating the development of agricultural sector

NEGATIVE ROLES/CONTRIBUTIONS:

1. The sector slows down the process of economic growth and development because most of the business are operating on small scale
2. It encourages external dependence due to production of consumer goods since most of the goods i.e. capital are imported from outside the country
3. Reduction of welfare of individuals in the country because of production of low quality goods leading to under development.
4. Promotion of unbalanced growth and development since most of the businesses are sub urban
5. Promotion of under employment and disguised unemployment since the sector mainly employs semi-skilled labour force.
6. It reduces government revenue since most of the businesses are unregistered and there is high tax evasion and avoidance.

PROBLEMS FACED BY THE INFORMAL SECTOR:

1. Inadequate capital stock due to limited collateral security hindering properties to access loans easily so as to expand their business
2. Lack of permanent premises. Most of the proprietors in this sector lack pre-established areas of operation hence making business temporally
3. Inadequate infrastructural facilities e.g. unstable power supply, poor developed road networks, uneven distribution of banking systems etc hindering effective operation of economic activities in this sector
4. Harassment by corrupt government officials esp. the town and city council inspectors and tax collectors since the sector has limited legal barking.
5. Limited market for the locally produced goods and this is partly due to stiff competition from high quality imports and partly as a result of limited purchasing power in the country.
6. Poor management due to insufficient skills since most of the proprietors are semi or unskilled leading to collapse of business in this sector.

SOLUTIONS/POSSIBLE MEASURES TO PROMOTE THE INFORMAL SECTOR:

1. Lowering taxes on inputs and possibly proving subsidies in order to increase the scale of production and output levels
2. Construction of permanent working premises for participants by the government e.g. market stalls, market shades etc
3. Provision of physical and social infrastructure like stable and adequate power supply, water supply, improved road networks and other social amenities which would promote production in the sector
4. Training of management and record keeping should be held frequently to sensitize entrepreneurs on business aspects. Education should be vocational oriented to
5. Loans should be made more accessible and other economic incentives should be directed to the informal sector
6. Potential market opportunities should be identified to avoid unnecessary losses through forming co-operatives, carrying out research, regional co-operatives e.g. participating in COMESA,
7. Use of import substitution policy. This will reduce competition from foreign products.

REVISION QUESTIONS:

- Describe the current traits of Uganda`s informal sector.
- Explain the features of informal sector in an economy
- Uganda should sustain her informal sector if she is to achieve a faster rate of economic growth and development
- Discuss the advantages and disadvantages of informal sector
- Examine the roles of the informal sector in the development of your country
- Trace the problems facing informal sector in your country and suggest workable measures to increase the contribution of informal sector to the development of your country
- Explain the advantages of informal sector in an economy
- What steps are being taken by the government in your country to reduce such problems?

THE STRUCTURE OF UGANDA`S TRADE SECTOR:

EXPORT TRADE:

1. Exports are mainly agricultural products e.g. coffee, tobacco, tea etc
2. There is limited variety or commodity concentration of trade i.e.
3. Basically semi process or un processed goods are exported
4. Uganda`s export trade is characterized by limited range of export markets or geographical concentration on trade i.e. depending on a particular source of imports and a particular export market for high products
5. Few services are exported e.g. tourism and hydro electric power e.g. Kenya, Rwanda
6. Prices for exports are mainly low or fluctuating in international markets
7. Uganda`s export trade is characterized by few trading partners mainly COMESA countries and European union which take about 31% of total exports
8. New export products are emerging like flowers, maize
9. Increasing re-export [involves exporting commodities which are imported from other countries e.g. most of the durable consumer goods are exported to Sudan
10. There is emergence of new export markets like Southern Sudan and DRC
11. It is made up of few consumer goods like plastics

IMPORT TRADE

1. Mainly capital equipments, intermediate goods, machinery
2. There are few services imported e.g. insurance, banking etc
3. Expatriates' and consultants are mainly imported in key economic sector e.g. The service sector, industrial etc
4. Durable consumer goods and luxurious constitute a big part on Uganda`s import e.g. mobile phones, clothes, plastics etc
5. There is limited diversity of imports sources i.e. most of them are from COMESA and some few from Asia and European Union countries
6. There is still very limited trade between Uganda and African countries
7. Most of the imports are highly priced leading to BOP deficits

EFFECTS OF UGANDA`S EXPORTS AND IMPORT SECTORS

1. Increased foreign exchange earnings due to emergence of new exports and increasing volume of exports
2. Improved standards of living/quality of life due to importation of high quality goods and services
3. Provision of revenue to the government inform of taxes imposed on import duties and export duties
4. Employment opportunities are created e.g. importers and exporters services which improves their standards of living resulting from increased earnings.
5. It improves international relationships between countries thus enabling such countries to achieve political stability
6. Improved infrastructural development through services imported e.g. banking
7. It enhances technological improvement development and transfer leading to production of high quality goods and services
8. Diversification of exports reduces risks on depending on few commodities e.g. huge losses in terms of catastrophes

NEGATIVE EFFECTS OF SUCH A STRUCTURE

1. It leads to economic instabilities especially in export earnings due dominance of agricultural exports subjected to price fluctuations

2. Detraining terms of trade due to declined prices of primary products exported relative to prices of imported manufactured goods
3. High chances of imported inflation because of buying from countries experiencing inflation
4. It increases unemployment especially to skilled labour because production of primary products creates less white collar jobs
5. Limited diversity of exports because of relying on a small range of products leads to low export earnings
6. Low government revenue due to large informal exports which are not reduced
7. It creates demand pull inflation as most of the products are exported to new markets [Southern Sudan and DRC]
8. It results in reduced importation of capital goods due to consumer goods constituting a big percentage. This limits investment in the country
9. It implies limited markets for exports due to lack of geographical concentration of trade between Uganda and neighbouring countries
10. Limited diversity of import sources leads to low bargaining power of Uganda thus leading to unfavorable balance of payment position

REVISION QUESTIONS:

- Describe the features of the structure of exports in your country
- Suggest measures to increase export earnings in your country
- Describe the structural features of Uganda`s export and import trade
- What are adverse social economic implications of such a structure of the economy of Uganda?

THE PUBLIC SECTOR

The public sector is a section of a country`s economy under the direct control and influence of the government. Such establishments called the state enterprises may take the forms of local authority, public corporation or parastal body.

LOCAL AUTHORITIES:

A local authority is a body set by a local government for the provision of essential services within a township/municipality or a city which private individuals cannot provide e.g. deference, road maintenance, street cleaning etc

Examples of local authorities in Uganda

- Kampala City Council Association
- Town councils like Mityana Town Council, Kampala Town Council
- Municipal Councils like Hoima, Mukono

PUBLIC CORPORATION:

This is a joint stock company in which the government holds either all the shares or a majority of its share capital. The corporation is created by an act of the parliament which clearly defines their aims and objectives

These corporations are expected to run as commercial enterprises though not putting much emphasis on maximization of profits.

Examples in Uganda include:

- Uganda Railway Corporation
- National Water and Sewerage Corporation
- National Housing and Construction Corporation
- Dairy Corporation Uganda
- National Insurance Corporation [NIC]

PARASTAL BODIES:

A parastatal body is a business organization set and run by the government to perform certain functions on commercial basis but not necessarily putting emphasis on maximization of profits. Parastatal bodies do not have any share capital since they are fully financed by the state.

FORMS OF PARASTATALS:

Marketing parastatal bodies: Are trading organizations set by the government to buy agriculture produce from farmers and either sell it directly to the consumers or sell it through agencies. They may also buy other products

Examples include:

- Produce Marketing board
- Lint Marketing board
- Uganda Tea Authority
- Coffee Marketing board

Finance parastal bodies: Are institutions set by the government with the intension of mobilizing financial resources to facilitate the process of development in the country. E.g. Development Banks i.e. Bank of Uganda, URA [Uganda Revenue Authority]

NSSF [National Social Security Fund]

Service parastals: These are parastals set by the government to provide essential services to people on commercial basis and the small profits made are used for the running of institutions.

- They provide utilities like water and power
- Transport services
- Wide range of merit goods

Examples:

- National Council for Higher Education [NCHE]
- Uganda National Roads Authority [UNRA]
- Uganda National Drug Authority[UNDA]
- Uganda National Bureau of Standards [UNBS]
- Electricity Regulatory Authority[ERA]
- UNEB
- National Curriculum Development Centre

How PARASTALS BODIES ARE FORMED/HOW TO WIDEN THE PUBLIC SECTOR

- **Unilateral/government action**: This is where a public enterprise is established via the act of the parliament.
- **By Nationalization** most of private enterprise to statutory control and management.
- **State participation**: This involves establishment of jointed ventures by the state and private sector with the state owning majority of the shares i.e. 51%or above

JUSTIFICATION OF THE PUBLIC CORPORATIONS/SECTOR/WHY PUBLIC SECTOR OR THE NEED FOR PUBLIC SECTOR OR THE NEED FOR PUBLIC SECTOR/REASONS FOR GOVERNMENTS PARTICIPATION IN OWNERSHIP OF COMMERCIAL ACTIVITIES/ROLES OF PUBLIC SECTOR/ACCOUNT FOR NATIONALISATION OF PRIVATE ENTREPRISES:

1. To provide essential public goods which are non excludable and therefore non profitable to the private individuals at a subsidized rate. E.g. garbage collection, water supply, defense [UPDF].
2. To protect consumers from exploitation inform of high prices, wrong weights and measures and low quality products from the profits driven private individuals e.g. UNBS.
3. To provide certain activities which are too risky to be left in hands of the private individuals for security purpose e.g. gun production or atomic energy production [UPDF]
4. To ensure efficient and optimal utilization of resources. The public sector is established to minimize wastage of resources resulting from wasteful competition .This also reduces duplication of resources since they can be provided by one company e.g. UNEB,UDA
5. To control private monopolies and their associated adverse effects like exploitation of consumers inform of wrong measures, restriction of producing at excess capacity, duplication of resources.
6. To attain a fair distribution of income/reduce income inequality. Parastal bodies/enterprises help to ensure equitable distribution of resources between regions and individuals by evenly distributing them ,through progressive taxation by URA, construction of roads in all parts of the country by UNRA, in order to reduce disparities which can result in to social tensions
7. To promote economic growth and development through mobilizing savings and investments. This is done through financial parastatals like Development Banks, NSSF,URA.
8. To facilitate development economic planning .The public sector is necessary for economic planning so as to minimize budgetary deficit and to achieve development goals that can ensure effective use of resources.
9. To create employment opportunities .Public enterprise are set up to provide jobs for many u8nemployed people e.g. auditors ,accountants in different parastatals like URA,ERA ,UNBS etc which improves on the welfare of people because of the increased earnings.
10. The need to revive some strategic but declining industries e.g. coffee processing industries, textiles industries etc necessities the need for public sector.
11. To attract foreign capital. Projects which are initiated by the government to attract foreign capital more than those which are under taken by the private sector which capital can be used to facilitate other development

12. To reduce foreign control and dominance in the economy .The government may get involved in commerce most especially in LDCs in order to reduce their dominance in the economy and its adverse effects.
13. To generate government revenue in form of taxes charged on public enterprises ,license fees ,fines etc which can be used to extend social services in form of road construction ,water supply etc to people.
14. To protect consumers from undesirable commodities which can be produced by private individuals.

DEMERITS IN GOVERNMENT PARTICIPATION IN COMMERCIAL ACTIVITIES:

1. It leads to delays in policy implementation due to beaucracy and red tape associated with public enterprises. This makes some projects to fail
2. They promote statutory monopoly due to the absence of the private sector which may lead to inefficiency inform of charging high prices ,operating at excess capacity etc
3. Many such enterprises usually face diseconomies because of their enormous size which may lead to their collapse like managerial diseconomies, marketing diseconomies of scale etc
4. It increases government expenditure on public enterprises which is shifted to the public in form of high taxes.
5. Existence of state interests in business may be a disincentive to private initiative in the private sector thus limiting inventions and innovations in the country which contribute to high unemployment rate
6. Interference from government officials and politicians usually over ride the decision of technical experts and these delays decision making process and less of money by the government
7. Poor accountability by public officials due to high degree of corruption and embezzlement of funds resulting into more losses.
8. Public enterprises are slow to respond to rapid structural changes like incase of catastrophes like rapid, increase in population which leads to increase in demand for public goods and services because of the many procedures to be followed.

PROBLEMS FACING THE PUBLIC SECTORS

1. Corruption and embezzlement of funds. There is use of funds by the top management to satisfy private interest in public bodies resulting into huge financial losses
2. Poor infrastructure i.e. poor transport networks ,banking system ,storage facilities inadequate and unstable power supply which lead to poor services delivery of most of the public enterprises
3. Excessive pressure from World Bank and IMF with their unfavorable conditionalities towards the public sector like privatization, retrenchments etc .This force the state to privatize some of the public cooperation in order to get financial assistance from these lending institutions.
4. Political instability and unrest in some parts of the country affect the smooth running of the state enterprises.
5. Shortages of skilled man power due to poor education system that emphasizes theoretical work rather than emphasizing technical and practical skills. This leads to scarcity of planners, evaluators ,auditors etc
6. In sufficient funding and capital leading to low service delivery
7. Ignorance of people about activities of public enterprise is a big set back to their operation

8. Poor supervision and monitoring of the activities of state enterprise

HOW TO IMPROVE THE PUBLIC SECTOR:

- Through establishing centralized planning
- Training more skilled man power
- Adequate financing of the sector i.e. subsidizing them
- Maintaining political stability in all parts of the country
- Infrastructural development
- Putting in place strict anti corruption laws

REVISION QUESTIONS:

Explain the reasons of poor performance of the public sector in your country

1. What is meant by nationalization?
2. Account for nationalization of firms in your country
3. Briefly explain the advantage and disadvantages of parastal body in an economy.
4. Asses the role of public sector in the development of your country

The following are the roles of public sector in the development of my country.

ROLES OF PUBLIC SECTOR IN THE DEVELOPMENT OF THE COUNTRY

Positive roles:

1. Creation of employment opportunities to people
2. Development of infrastructures that can enchase development in the country like ERA,URA,UDR [Health facilities]
3. Raises large capital and thus undertaking large scale corporations
4. Promotes economic growth and development since most of them aim at improving people`s welfare
5. Provision of essential services to the public at subsidized prices
6. Provision of non pr5ofitable but essential goods and services e.g. garbage collection ,merit goods
7. Provision of revenue to the government
8. Ensures consumer`s protection against undesirable goods [UNBS]
9. They help in controlling private monopoly
10. Promotion of fair distribution of resources/balanced regional development

Negative roles:

1. They strain the government budget i.e. high government expenditure and publishing public corporations
2. Provision of poor quality goods and services
3. Bureaucracy in decision making and implementation of policies negatively affect their efficiency
4. Poor accountability by public officials due to high corruption and embezzlement of funds leads to huge losses
5. They tend to discourage private investment /discouraging private investments.
6. Large scale operation results into discouraging private investments
7. Large scale operation results into diseconomies of scale
8. Discouraging consumer`s sovereignty
9. The slow adaptation to structural changes

10. Public corporations lead to shortages in terms of breakdown.

THE PRIVATE SECTOR AND PRIVATIZATION

PRIVATIZATION:

This is an act of transferring ownership and management in business from the public or government to individuals or private bodies.

OR

It is the transfer of ownership of public assets /state enterprises to individuals or private investors.

FORMS/TYPES/WAYS OF PRIVATION:

1. **Divestiture:** This is the total sell of a parastal body to the private investors. In this form a private individual have full control and ownership of the solid public enterprise e,g Uganda Air line to Air Uganda, Uganda Commercial, Stanbic Bank
2. **Partial Sale**: This involves selling a proportion of government`s ownership in a given business while another own is owned by the private individual .This is common with business that have diversified activities such that a line of activity is retained by the state while the other by the private sector
3. **Joint Venture**: This involves the government running business units jointly with the private entrepreneurs where by the government holds at most 49% of shares in every joint venture with at least 51% share holding belonging to private individuals e.g. Dairy Corporation Uganda
4. **Contracting:** This is a form of privatization that involves selling of business management to private entrepreneurs for a specific period of time as per agreement after which control of the business may be returned to the government
5. **Mortaging:** This is the temporary sell of public enterprises to the private sector with the aim of repossessing them by the state

REASONS FOR PRIVATIZATION /SELLING OF PUBLIC ENTERPRISES:

1. To reduce government expenditure and hence reduced public debts and debt servicing .Privatization inform of retrenchment reduces government expenditure on civil servants and the danger of contracting debts to finance non performing parastal bodies
2. It encourages production of high quality goods and services which improve on the welfare of people since most private firms are more effective and efficient.
3. It is seen as a form of retrenchment to countries with high public expenditure on parastal bodies because it reduces the number of civil servants, bills on utilities like electricity, subsidization of some of the public enterprises.
4. To increase productivity and efficiency or to promote economic growth .Public enterprises have been privatized in order to increase the level of opportunity since private individuals are profit driven leading to increased contribution to GDP and reducing structural inflation in the country.

5. To create more employment opportunities in the long run. This is because when public enterprises are privately owned they become liable to expansion thus creating more employment opportunities with its advantages like improving of standards of living of people.
6. The need to create government revenue through taxation with privatization formerly state owned business become liable to paying taxes and this will increase the taxable base hence increasing public revenue inform of corporate tax ,license fee, pay as you earn etc
7. To fulfil the conditionality of international lending institution like IMF and World Bank. The current privatization drive in developing countries like Uganda is due to conditionalities of IMF and World Bank of creating a private sector led economy in order for such countries to access financial assistance.
8. To encourage foreign investment .By privatizing their parastals developing countries encourages foreign investment thus bringing the investment gap from such countries and experiencing high capital inflow.
9. To attract private initiative /encourage the development of entrepreneurial skills with its multiplier effects like promotes investment, high quality output etc. This is because under the private sector there is high degree of inventions and innovations which facilitate the process of economic growth and development because of the stiff competition existing.
10. To encourages technological transfer and development which leads to production of high level of production and of a good quality .Privatization is seen as a means of technology transfer and development in the developing countries because as foreign investors and multinational corporation buy these public enterprise, they try to rekindle their performance by changing the methods of production by advanced ones.
11. To reduce corruption tendencies and embezzlement of funds which are rampant in public enterprises .This is because under the private sector there is high degree of accountability leading to efficiency in private enterprises
12. To reduce bureaucratic tendencies and resultant negative effects like slow decision making ,discourages the would be potential investors ,wastage of resources
13. To improve on country's Balance of payment position .Most of the public enterprises are being sold to private individuals in order to increase on the volume of exports and to avail adequate goods and services in the domestic economy in order to reduce imports thus improving the country`s BOP.
14. To encourage economic diversification because private enterprises engage in various economic activities in order to experience huge profits.
15. To encourage competition in the country thus leading to production of high goods and services.

BENEFITS OF PRIVATIZATION:

1. It widens the tax base and hence increased tax revenue thus enabling the government to provide social services to the people inform of constructing roads, extending power in most parts of the country thus improving on their welfare.
2. It reduces government expenditure and hence reduced public debts and debt servicing .Privatization inform of retrenchment reduces government expenditure on civil servants and the danger of contracting debts to finance non performing parastals bodies

3. It encourages production of high quality goods and services which improve on the welfare of people since most private firms are more effective and efficient
4. It promotes exploitation of idle resources due to large scale operation of private enterprises thus leading to high economic growth rate
5. It encourages foreign capital and investment in the economy under taking privatization .More of such resource inflows have multiplier effects like accelerating the process of economic growth and development ,increasing foreign exchange earning etc
6. It encourages technological transfer and development with its positive resultant effects like high volume of opportunities and a good quality ,variety of goods and services etc
7. It reduces dependence on imports due to increased local production thus leading to a self sustained economy.
8. It reduces inflation rates in developing countries caused by supply rigidities through high supply of goods and services in the domestic economy
9. It promotes innovations, creativity and entrepreneurial ship skills since it encourages self drive and personal initiative in the economy resulting into limited government intervention in the economy activities in the country thus failing to implement strategic plans.
10. It leads to resentment of the public by government which can promote political instability in the country
11. It widens consumer`s choice due to a variety of goods and services produced under the private sector ,a consumer is able to chose from very many alternatives thus improving on his/her welfare
12. It reduces corruption and embezzlement of funds associated with public enterprises since employment and promotion is based on merit in most private enterprises
13. It improves on relationship between the privatizing country and international community especially donors with its advantages like widens the market ,fosters political stability
14. It reduces Bureaucratic tendencies associated with public enterprises .Since private enterprises aim at quality services delivery thus easing the process of decision making

DISADVANTAGES OF PRIVATION:

1. Pollution inform of air, water and their quick depletion.
2. It increases labour exploitation in the country inform of low wages given to workers and working conditions since most of the private enterprises aim at maximizing profits and minimizing costs.
3. It leads to loss of money by the government in the long run due to under valuation of the sold public enterprises.
4. It promotes emergency of private monopolies and their associated disadvantages like exploitation of consumers inform of wrong measures, restriction of output, pressurizing the government.
5. It encourages wastage of resources through wasteful competition existing among private enterprises thus losing some of the productive resources in the country
6. Essential services become too expensive for the poor to afford because private investors are profit driven

7. It worsens the problem of unemployment most especially in the short run when many workers are laid off in sold enterprises in order to reduce production costs and due to use of capital intensive technology in private enterprises leading to technological unemployment
8. Encourages foreign dominance in the economy since there are few local people who can afford to purchase the floated parastal which can lead to cultural values and brain drain
9. It worsens the problem of income inequality since the majority poor in LDCs is left out and the few who can afford to buy the sold enterprise earn abnormal profits.
10. It leads to profit repatriation since many of the floated parastals are purchased by foreigners thus leaving the country under developed
11. It leads to provision of public goods since most of them are unprofitable though important leading to poor standards of living in the country under developed
12. It makes government planning difficult since it is intended to create a private economy resulting into limited government intervention in the economic activities in the country thus failing to important strategic plans
13. It leads to results into high social costs due to irrational exploitation of natural resources leading to

FACTORS THAT ARE STAGANATING THE PROCESS OF PRIVATIZATION IN LDCs/PROBLEMS ENCOUNTED IN PRIVATIZATION OF PUBLIC ENTERPRISES:

1. Opposition from the public .This is due to fear that privatization will lead to loss of economic control to foreigners while others oppose if on political grounds as they may not be in favour of the ruling government while others are just ignorant about the advantages of privatization .
2. Under developed capital and money markets have acted as a big impediment to privatization drive in LDCs .Because for successful sale3 of the publically owned businesses there is need to have well developed exchange stock market where public enterprises thus making privatization an un successful policy.
3. General poverty in LDCs leading to very few individuals who are capable of purchasing shares in the solid public corporation is also a big setback in the privatization drive
4. High illiteracy rates in LDCs making a big proportion of the 3rd World countries not willing to joint ventures due to mistrusts thus delaying the process of privatization
5. High uncertainty surrounding parastals especially when there is change in government policy or frequent changes in regimes which discourage many potential buyers of the floated enterprises
6. High degree of corruption involved in the selling of some of the public enterprises which discourages many potential buyers
7. Poor valuation of public enterprises that are on sale which leads to loss of money by the government and public.
8. Ideological differences in the country i.e. socialism vis-à-vis capitalism thus creating resentment most especially from the socialist blocks
9. Political sabotage e.g. blocking a bill in the parliament for the sale of public enterprises

REVISIONS QUESTIONS:

- Distinguish between denationalization and nationalization
- Explain the objectives of selling parastals bodies in your country
- ✓ To reduce corruption
- ✓ To foster economic growth and development.

Denationalization

Transfer of ownership of previously public owned /nationalized enterprises to the rightful owners e.g. the return of Asian property to their rightful owners

Nationalization

Is the act of transferring ownership of private enterprises or individuals to direct control and management by the government.

THE PRIVATE SECTOR:

It refers to that sector of the economy where economic activities and decision are under taken by private individuals and firms. In Uganda private sector is dominated by foreign Multi-national Corporation, foreign private investors and a few local investors.

FEATURES OF UGANDA`S PRIVATE SECTOR:

Large enterprises in the sector mainly use imported raw materials.

ROLES OF PRIVATE SECTOR IN ECONOMIC DEVELOPMENT OF UGANDA

1. Po Economic activities are done by private individuals.
2. The sector mainly operates on small scale enterprises and they are growing at a very faster rate.'
3. dominated by foreigners engaging in most of the big establishment e.g. tea estates
4. The sector is profit driven /profit maximization is the major aim
5. It is dominated by sole proprietorship
6. It is controlled by government
7. The sector is characterized by stiff competition e.g. skilled labour ,raw materials
8. Mainly produce consumer goods e.g. food stuffs, detergent
9. It is mainly characterized by small or low productivity
10. Employment and promotion is based on merit in most of the private sector because of the inefficiency
11. Operation price mechanization in the private sector where resources are allocated by forces of demand and supply
12. They are mostly urban based with some few enterprises in rural areas attracted by raw materials
13. There is quick decision making /limited bureaucracy and red tape
14. Resources are economically utilized in this sector since profit maximization is the major objective

Positive roles:

1. It is the source of government revenue inform 0f taxes charged on private enterprises which increases governments income thus improving on infrastructural development like construction of hospitals ,road rehabilitation among other

2. Generates employment opportunities to people which enchases their earnings hence increasing on their savings to meet their basic necessities of life
3. Encouraging exploitation of idle resources which increase the country`s productivity which leads to a faster rate in economic growth and development
4. Widening of consumers choice due to provision of a variety of commodities thus improving on people`s standards of living
5. Reduction of governments expenditure on producing goods and services which may be produced by private sectors thus maintaining the would be money and development sector
6. Increasing country`s foreign exchange resulting from the high/increased output produced by private sector
7. Provision of capital both local and foreign which facilitates further capital accumulation thus accelerating the rate of economic growth and development
8. Pro motion of infrastructural development inform of road construction ,setting up financial institutions etc which facilitate economic activities in the country
9. It facilitates on job facilitating which increases labour skills thus its productivity increase
10. Improving on a country`s BOP position due to increased volume of exports produced by private enterprises and reduced imports resulting from availing goods in the domestic market by private individuals
11. Promotion of commercialization of the economy. The private sector promotes commercial production in the economy by carrying out economic activities for market thus reducing subsistence production in the economy.
12. Promotion of industrialization of the country. It promotes industrial development due to the need to produce goods and services to satisfy the domestic and foreign markets.

QUESTIONS:

- Explain the salient features of Uganda`s private sector.
- Discuss the adverse effects of such features.

Negative roles

1. It promotes RUM since most of the enterprises are urban based .This is a result of an open urban unemployment.
2. It promotes private monopolies with their adverse effects like exploitation of the consumers, use of wrong weights etc since most of the business activities are carried out by rich people.
3. It leads to profit repatriation since most of the private enterprises are owned by foreigners who tend to repatriate the profits earned thus leaving Uganda un developed.
4. It promotes over exploitation of resources since activities in the private sector are profit driven thus leading to their quick depletion and making the vulnerable future generation experience scarcity.
5. It leads to under provision of public goods and services which are very essential but not profitable e.g. garbage collection, construction of roads
6. It worsens the problem of income inequality and its adverse effects like high social tension about the poor verses the rich
7. Worsens dependence problem in the country since it mainly produce consumer goods implying that the country will continue importing capital goods thus worsening BOP.

8. Exploitation of labour inform of low wages , exposing poor working conditions like working conditions like working for long hours, which all reduce of their welfare.
9. It promotes imported inflation leading to deteriorating terms of trade
10. It leads to wastage of resources due to wasteful competition that result into duplication of goods and services.
11. Regional imbalance in the long run can lead to political instabilities when most areas struggle to be economically like others.

PROBLEMS FACING THE PRIVATE SECTOR:

1. Inadequate capital needed to set up set up enterprises and run business organization
2. Limited entrepreneurial skills in the country which makes many business to operate on small scale
3. Small market size due to low purchasing power of the victims
4. Low level of technology. This limits productivity and yields production of poor quality goods and services which can`t compete favorably on the world market.
5. Poor infrastructural development most especially the unstable and inadequate power supply which is the engine of most enterprises
6. Unfavourable government policy inform of fair taxes
7. Poor land tenure system
8. Unstable prices/high rate of inflation
9. Ineffective enforcement of copy rights
10. Stiff competition from imports
11. Shortages of raw materials
12. Limited skilled man power in the country.

MEASURES TO IMPROVE THE PRIVATE SECTOR:

1. Privatization of public enterprises so as to allow more private enterprises to carry out different economic activities
2. Liberalization of the economy involves removing un necessary restrictions so as to widen the capital base of private enterprises thus expanding the private sector
3. Putting in place/establishing strong and sound infrastructure e.g. adequate power supply ,good road networks ,modern banking system etc to facilitate the activities of private enterprises.
4. Favourable government policies should be undertaken so as to attract more private entrepreneurs in the economic activities carried out in the country .Such government policies include subsidization of private enterprise, tax incentives like tax reduction exemptions and holidays.
5. Improvement in the level of technology used through research and technology transfer so as to increase productivity in the sector
6. Expansion of markets both local and foreign should be taken through regional integration ,international public campaigns /advertising plus increasing the purchasing of the local people
7. Formation of more investment bodies so as to identify investable opportunities and to guide private individual on how and where to invest their resources e.g. Uganda investment Authority etc
8. Maintaining a stable economic climate so as to make business environment predictable i.e. Making private entrepreneurs able to predict the returns on their

investments. This involves stabilizing prices of goods and services and ensuring adequate foreign exchange in the economy

9. Under taking land reforms by re-distributing land from un productive private entrepreneurs thus expanding the private sectors
10. Fighting corruption through anti corruption legislation so as to attract more potential private investors
11. Man power training should be under taken so as to reduce the problem of inadequate skilled labours

REVISION QUESTIONS:

- ✓ Discuss the role of private sector in the economic development of your country.
- ✓ Asses the setbacks limiting productivity of the private sector in your country.
- ✓ Explain the contribution of private sector to industrialization in your country
- ✓ 3) What steps are being taken by the government in your country to increase the contribution of the private sector to economic development?

STRUCTURAL ADJUSTMENT PROGRAMME SAP`s

1. These are polices of IMF and World Bank to transform the backward economies of developing countries into self sustenance.
2. The SAPs of IMF and World Bank which have been implemented in Uganda are:
3. Privatization :The government of Uganda has sold off public enterprises to private sector e.g. Uganda Electricity Board, Uganda Commercial bank ,Uganda airlines
4. Retrenchment .The government of Uganda has reduced the number of public workers in order to reduce its expenditure on civil servants inform of paying wages and other allowances
5. Demobilization of the army. This involves reducing the number of soldiers so as to reduce government expenditure on defense and to allocate such resources on other developmental projects.
6. Agricultural modernization. This is being done through different institutions like PMA[Plan of Modernization of Agriculture, National Research Agriculture Organization[NARO] ,NADDS so as to transform the agricultural sector from subsistence to commercial agriculture of high earning since it is the back born of Uganda
7. Improvement in tax collection and administration .This has been done through establishing an autonomous body called the Uganda Revenue Authority to ensure that there is transparency in tax collection ,introducing new e.g. local services tax, scraping of some taxes like sales tax[vat],graduation tax, putting in place tax tribunals
8. Promotion /encouraging export diversification .This involves encouraging export diversification or multi activities in the sector i.e. introducing new plant varieties that are resistant to hostile climatic condition like GMS[Genetically modified sector],processing industries of Agro based products, putting in place export institutions like [EAD] export promotion Desk
9. Devaluation of the Uganda`s currency :This is the condition of IMF bank intended to attract investors in developing countries like Uganda since it makes exports cheap and

imports expensive .It refers to the legal lowering of values of the country `s currency in relation to other currencies

10. Provision of enough elementary education to all Ugandans in developing economies. In Uganda this is being done through Universal Primary and Secondary Education to increase on the literate role or the number of people educated and makes them more productive.
11. Liberalization of the economy most especially trade. This involves eliminating unnecessary trade restrictions such that every potential trader is free to participate in economic activities taking place in his or her country. This policy is intended to increase productivity in the domestic economy
12. Establishing political stability in all parts of the country for example restoring peace in Northern Uganda and rehabilitation the damages caused by the war ,organizing peace talks with opposition members so as to foster stability in developing countries.
13. Democratic government. This has been implemented in the country through holding elections for presidency and parliamentarians ,allowing all political parties to take part in politics parties to take part in politics ,creating conducive environment for human rights association to operate and other charity organization like red cross
14. Accountability and transparency in financial management .Financial budgets are being prepared annually ,anti corruption laws have been put in place and imprisonment of criminals in order to ensure to ensure accountability and transparency in public organization
15. Rural transformation .This has been done through extension of feeder roads, rural electrification, and provision of water facilities e.g. constructing boreholes.
16. Environmental conservation and sustainable development .This has been implemented through putting in place institutions like NEMA[National Environment Management Authority]meant for conserving the environment and regulating exploitation of resources in the country.

POSITIVE IMPLICATIONS OF SAPs:

1. Expansion of the private sector with its associated benefits like pro vision of a variety of goods ,employment opportunity provision
2. Creation of more employment opportunities
3. Accelerated rate of economic growth and development
4. Enhancement of political stability and its positive effects like encouraging investment ,widening the market etc
5. Reduction of rural urban migration
6. Increased accessibility to services
7. Reduced government expenditure because of high foreign aid given by IMF.
8. Reduced income inequality and equitable distribution of resources.

NEGATIVE EFFECTS:

- Un employment caused by retrenchment
- Foreign dominance of the economy because of privatization.

REVISION QUESTIONS:

a)Explain the structural adjustment programmers of IMF that have been implemented in your country

b) Distinguish between retrenchment and liberalization
c) 2b) Explain the structural adjustment programs most LDCs are under taking.
d) Explain four ways in which IMF policies have been implemented
e) Discuss the positive implications of such reforms

AGRICULTURE

This is the growing of crops and rearing of animals for consumption and sale.

Agriculture is broadly divided into:

A) **Commercial agriculture**. This is the growing of crops and rearing of animals for commercial purposes or for sale.

Arguments for commercial agriculture

I. It produces high levels of out put which increases the volume of exports ensuring more foreign exchange earnings
II. The quality of products improves due to industrialization in the sector. This improves on the standards of living of the people
III. Commercial production creates employment opportunities of both the unskilled and skilled workers
IV. It is a basis for man power development through training
V. It encourages development of infrastructures in areas practicing commercial agriculture like adequate power supply, improved road net work, better storage facilities etc
VI. It international trade since it produces for both local and foreign markets
VII. Economies of scale are enjoyed where commercial production
VIII. It puts to use the would be idle resources especially land
IX. It promotes technological development due to use of machines thus leading to increased productivity
X. and of good quality

Arguments against commercial production

I. It requires a lot of capital which LDCs lack
II. It results in over production which may lead to price fluctuation
III. It results in profit repatriation since most of the firms are owned by foreigners
IV. It requires trained man power which LDCs lack
V. It leads to income inequality especially if it is on large scale and capital intensive
VI. It requires extensive research which is hardly developed in LDCs

b) **Subsistence agriculture**. This is the growing of crops and rearing of animals for own consumption.

FEATURES OF SUBSISTENCE PRODUCTION

1. Food production basically for domestic consumption but if there is any surplus realized it can be sold to get other necessaries

2. Use of traditional tools or poor methods of production
3. It organization is on small scale for small peasant holdings
4. Mainly use of family labour

WEAKNESSES OF SUBSISTENCE AGRICULTURE

1. It discourages capital accumulation and specialization
2. The law of diminishing returns is prominent in this economy and its associated defects
3. It produces low out put thus contributing less to GDP
4. It produces poor quality out put thus fetching low foreign exchange earnings and poor standards of living of people
5. It does not encourage labour training because it almost needs no skills
6. It leads to under utilization of resources particularly land and labour
7. It discourages development of infrastructures since it produces for home consumption

CHARACTERISTICS OF AGRICULTURE IN LDCs.

1. Mainly dependant on nature, agriculture in LDCs relies on weather and climate since artificial agricultural practices are rarely applied.
2. Mainly use of simple and rudimentary tools, there is less mechanization in the agricultural sector hence less technological application.
3. Mainly/ predominantly subsistence in nature, Agriculture majorly involves production for own consumption. The commercial production is still and production is mainly concentrated on traditional crops
4. Largely practiced on small scale, agriculture is carried out on a basis of small land holdings.
5. Predominantly use of family labour, agriculture is labour intensive and its dominated by women and children.
6. Low productivity, the total output from the agricultural sector is too low due small scale production.
7. Mainly dominated by low quality out put, this is due to use of poor breeds and low quality seeds which are non yielding and substandard.
8. Agriculture is rural based; Agricultural practices are widely spread in villages compared to towns.
9. Uneven distribution of cash crops, Cash crops are concentrated in a few areas.
10. Dominancy of poor land tenure system, the agricultural fields are privately owned hence absence of land consolidation.

ROLES OF AGRICULTURE IN ECONOMIC DEVELOPMENT.

1. Source of food, Agriculture provides the daily nutritional requirements of citizens since it is dominated by food crops. It saves foreign exchange on importing foreign food.
2. Provision/creation of employment opportunities, being the largest sector of the economy, agriculture provides jobs to the largest section of the economy for example herdsmen, farmers, and veterinary personnel's.
3. Source of raw materials, agriculture provides factor in puts required in the development of other sectors of the economy for example agro-based industries.
4. Provision of market for other products, The sector provides market for industrial out put which facilitates industrialization hence promoting economic development for example market for fertilizers, hoes, pan gars.

5. Source of government revenue, Agriculture provides revenue to the government through taxation of farmers and agricultural out put traders,. The revenue is sued to finance development programs.
6. Promotion of rural transformation, agriculture transforms rural areas through construction of feeder roads, rural electrification and extension services to farmers.
7. Provision of foreign exchange, forex is earned through the exportation of agricultural out put for example fish, tea, tobacco, coffee etc
8. It encourages inter-sect oral linkages; Agriculture facilitates sectoral interdependence through backward and forward linkages.

NB **Forward linkage** is an economic situation where out put from the primary sector is used as inputs by the secondary sector.

Backward linkage. Is an economic **s**ituation where out put from secondary sector is used as input in the primary sector.

Promotion of eligaterian income distribution, agriculture minimizes the income inequalities since employs the largest number of people in developing countries.

Promotion of technological development, this is through agricultural research and technological transfer.

NEGATIVE ROLES AGRICULTURE.

1. Promotion of seasonal unemployment, being dependant on nature, agriculture leaves a substantial number of individuals unemployed during the dry seasons.
2. Creation of balance of payment deficits, this is due to low earnings from the poor quality agricultural exports compared to the extensive industrial imports.
3. Fluctuation of incomes, farmers' income fluctuates due to agricultural product price fluctuation.
4. Fluctuation of government revenue, Due to unstable farmers' income from agriculture, there is unstable tax revenue collection from the sector.
5. Vulnerable to be outcompeted by growth of synthetic fibres this results in unfavorable TOT
6. Agriculture takes a lot of land which may not be available in some countries
7. Long gestation period limits capacity to Increase output
8. Limits transformation of economy due to poor attitude towards development

Problems facing agricultural sector in LDC (Reasons for low agricultural productivity in LDCs)

1. Insufficient capital, There is inadequate funding of the agricultural sector and misuse of government remitted agricultural resources e.g. NAADS funds and plan for modernization of agriculture. This has limited agricultural modernization in a country resulting into low productivity.
2. Poor production techniques, the use of simple and rudimentary tools has resulted into limited acreage hence low productivity. There is also less mechanization which has hindered agricultural modernization.
3. Insufficient market, the marketability of agricultural products is low due to excessive competition between farmers and from synthetics. This has discouraged massive production hence hindering agriculture modernization.
4. Price fluctuation continuous increase and decrease of agriculture products. Prices for agricultural products have been progressively reducing which has discouraged farmers.eg

coffee prices forced farmers to cut down coffee plantations. The un curtainity of prices therefore has hindered profits and modernization.

5. Hostile climatic and weather conditions. Heavy rainfall, prolonged droughts, landslides, earthquakes, floods etc have limited agriculture activities is some parts of the country. For example drought has resulted into death of a number of animals hence low harvests.
6. Existence of pests and diseases, pests and diseases like ticks, Nagana, tsetse flies, cassava mosaic, render pest, swine fever. Yellow wilt weevils have resulted into low yields and low harvests hence limiting agricultural productivity and modernization
7. Poor land tenure system, There is private ownership of land and land fragmentation which limit agricultural productions. Land fragmentation discourages mechanization hence low productivity and low modernization.
8. Political instabilities. The continuous political unrests have brought agriculture to a stand still resulting into low productivity and limited modernization
9. Rapid population growth rate. This increases pressure on agriculture because most land is being used for settlement and this reduces cultivable land thus limiting the development of agriculture. The population growth rate of Uganda is too high in some parts of the country and this has led to land fragmentation
10. Conservatism and a strong social cultural bond in most developing economies limit agriculture modernization. This refers to unwillingness of farmers to change from traditional agriculture practices to modern methods like irrigation, use of high quality and resistant crops and breeds results in low quality and quantity out put. For example most of the karamongs resisted to change from their poor quality breeds to cross bleeds
11. Rural-urban migration. The continuous movement of people from rural to urban areas reduces labour supply to the agriculture sector as young energetic men go to towns. This results into inadequate harvests and declining agricultural activities
12. Existence of poor quality seeds and breeds also hinders the development of agriculture in most developing countries. The local breeds of plants and animals are non productive hence low out put
13. Unfavorable government policy of high taxation and low subsidization. High taxes on agriculture produce and implements discourage farmers and absence of extension facilities like veterinary services, free improved breeds and seeds leads to poor yields thus low contribution to GDP

SOLUTIONS/REMIDIES TO PROBLEMS FACING AGRICULTURE

1. Land reform policies should be undertaken for example land consolidation, in order to facilitate agricultural modernization, empowering land tenants by removing private ownership of land (land lords). This will increase the productivity of land
2. Providing credit facilities to farmers should be done. Farmers should be given soft loans to increase their capital base be able to buy high quality seeds, practice better farming methods and buy farm implements like fertilizers, tools etc. this will increase the performance of agriculture
3. Providing extension services to farmers, this will help to equip them with modern agricultural techniques hence increasing their yields. This can be done through NAADs program, National Agriculture Research Organization (NARO) and Plan for Modernization of Agriculture (PMA)

4. Establishment of demonstration firms. These should be set up to act as centre of agriculture research in order to improve the quality of seeds and breeds for example Kabanyoro research centre, Kawanda research centre etc. This can be done in every sub county
5. Educational reform can be undertaken by vocationalising it through incorporating agriculture into the school curriculum at all levels and making it compulsory. This will equip students with necessary skills and will eliminate the negative attitude towards agriculture among students i.e. it is a punishment and foe uneducated people thus enhancing agriculture development
6. Rural transformation drive should be undertaken to reduce rural-urban migration. This can be done through rural electrification, construction of feeder roads, extension of better health and educational facilities etc in order to encourage farmers to remain in agriculture activities without moving to towns for better facilities. Thus improving the productivity of agriculture
7. Expansion of the market should be done through regional economic integration and being signatories of International Commodity Agreements like Coffee International Agreement. This can expand the market of agricultural produce due to free movement of goods and services among member countries and it will encourage farmers to produce more leading to increased foreign exchange earnings. For example through formation of East Africa Common market, being a member of COMESA, European Economic Community etc
8. Through diversification of agricultural production. This involves creating a number of activities with in the agriculture sector. Farmers should engage in a variety of agriculture activities like crowing crops, rearing animals, processing agricultural produce etc to reduce dependence on a single crop
9. Establishment of ago-based industries should be undertaken. This will help to process agriculture which increases their value thus fetching high export earnings, reduce perishability and bulkiness. For example coffee processing industries, textile industries, milling industries, fish processing industries etc
10. Price control measure should be undertaken to reduce fluctuations in prices of agricultural products which discourage farmers from carrying out agriculture. This can be done through fixing prices for agricultural products i.e. setting a minimum price legislation
11. Irrigation farming can be undertaken to reduce dependence on nature. Artificial supply of water to crops will ensure continuous production even in the dry seasons. Several irrigation schemes have been put in place for example selele irrigation scheme, mubuku irrigation scheme, kibimba irrigation scheme etc
12. Improving the state of infrastructure should be done to ease transportation of agriculture produce from production units to market centers and storage during plenty. This involves expanding main roads, rehabilitating feeder roads in rural area, constructing modern storage facilities, ensuring constant power supply to ensure productivity of processing industries etc. this will increase the productivity of land
13. Agriculture mechanization should be emphasized to eliminate the use rudimentary technology like simple hoes, pangs etc and encourage the use of modern machines like tractors, combine harvesters, ox-ploughs etc

REVISION QUESTIONS

1. Distinguish between subsistence agriculture and commercial agriculture

2. Explain the features of each
3. Explain the features of Uganda's agriculture sector
4. Examine the implications of such a structure
5. How is agriculture dominate in LDCs
6. Trace the problems facing agriculture in the economies of most LDCs
7. Assess the role of agriculture in the development of your country
8. Explain the objectives of modernizing agriculture in your country
9. Discuss the role of agriculture in the development of industries in your country
10. Why is agriculture contributing less to employment creation in your country?
11. What steps are being taken to increase the contribution of agriculture to employment creation?
12. Explain the objectives of stabilizing prices of agricultural products in your country
13. What have been the steps taken by the government reduce fluctuation of prices of agricultural products

LAND TENURE SYTEM

These are rights regarding land ownership and use or it refers to how land is owned and utilized in an economy for instance arrangements governing the relationships between landlords and tenants

a) **Communal land ownership** (**Customary tenure**): This is where every member of the society has aright to ownership and use of land without restrictions for example the Karamoja region
b) **Private (Individual) land ownership**: this is where ownership and use of land is restricted to a particular individual who owns a title for it for example peasant land title holders (Bibanja owners)
c) **Mailo land ownership**: this is where use and ownership of land is entrusted to members from privileged families for example Kabaka's land
d) **Land lease or holders system**: this is where land is bought to a specific period of time after rights to ownership and use is lost. Land is usually leased for 44years or 99 years
e) **Alienated land system**: this is where land is sold to foreigners who acquire tittles for its ownership

Problems of mailo land

I. Displacement of people: the squatters lack security of tenure yet originally the land may have been theirs from time to time immemorial. Such people usually end up displaced in case the deed holder decides to develop or sell the land to other parties
II. Absentee land lords: most of the land owners do not stay in the lands nor use them yet the squatters who were even born there do not have any right over the land
III. It leads to underdevelopment and wastage of land since squatters are not allowed to make permanent development on the lands
IV. It constantly leads to conflicts between the squatters and land lords over the rights and usage of land

Merits of individual ownership of land

I. Facilitates consolidation and rationalization of small plots

II. Safeguards position of the local community if land has become scarce
III. Makes it easy to pass on land to next kin
IV. It settles and avoids demarcation disputes

Problems of communal land ownership

a) Land fragmentation: as population increases, the land is divided into pieces which become gradually too small for efficient utilization
b) It limits mechanical cultivation because plots of land are too small and scattered
c) Consolidation and enclosure of land becomes difficult due to opposition based on grazing rights of others
d) It discourages investments due to lack of permanent ownership
e) It leads to underdevelopment of animal husbandry due its associated communal grazing and watering of animals
f) People lack legal security of tenure

Benefits of customary ownership

I. It guarantees unchallenged ownership and use of land
II. It guarantees access to land or it is a means of liveli hood to all
III. It avoids the hoarding of land
IV. It avoids losing of land through collateral mortgage
V. It ensures grazing rights to all

LAND REFORM POLICY

Land reform refers to deliberate changes in the system of land tenure to increase productivity of land. It involves either of the following:

a. Redistribution of land ownership especially the state land
b. Change in legal and contractual arrangements affecting the use of land which could be aimed at addressing the following

- The level of rent paid to landlords or the manner of their assessment
- Security of tenure relating to either change in the powers of landlords to evict tenants for example by granting longer leases or to change from communal to individual rights overland
- Right to sell land as opposed to the right to use it
- Consolidation of small, scattered plots into single larger plots

Reasons for land reform

1. To promote fair distribution of income through giving equitable share of plots to every individual
2. To increase security of tenure so as to encourage investments on a long term basis
3. To encourage large scale production so as to enjoy economies of scale
4. To avoid land fragmentation which leads to reduced incentives
5. To ensure proper land utilization and discourage absentee land lords from hoarding land
6. To reduce disputes, social conflicts and migrations which increase resource wastage?
7. To reduce discrimination in ownership so as to make optimal use of land
8. To encourage extension of social and economic infrastructure by increasing public land since some people do not allow public projects on their land

FORMS/TYPES OF LAND REFORM

1. **Land consolidation**: This refers to bringing together (amalgamation) of the formerly fragmented pieces of land in order to improve its productivity
2. **Land redistribution**: This refers to the practice of transferring land from non productive individuals to productive individuals. It is the giving of land to landless. It is necessary where there is friction between landlords and tenants and where state firms are idle
3. **Land reclamation**: This refers to the effective use of wetlands for agriculture for example swamps and rivers
4. **Land registration**: This involves the determination of land ownership so that the owners are known. It involves a change from peasant communal ownership to private legally recognized ownership
5. **Land nationalization**: Is the transfer of ownership of land from non productive private individuals to the government
6. **Land improvements**: this relates to measures aimed at increasing the productivity of land for example irrigation which is the artificial supply of water to land during dry seasons
7. **Establishment of land market**: This calls for establishing a place from where land can be bought and sold or establishing a place from where such information pertaining to land transaction can be obtained e.g. Jomayi property consultants
8. **Resettlement schemes**: This involves moving people from areas of land shortage to area of sparse population
9. **Land control use**: This involves controlling misuse of land for example over cropping, indiscriminate burning of bushes, need to control soil erosion, encroachment on wetlands etc

Conditions necessary for the success of land reform policies

i. Should be accompanied by the education of the farmers
ii. There should be a re-organization of the system of production egg eliminating peasant production and replacing it with cooperative productive
iii. There should be provision of farm facilities e.g. tractors, seeds, fertilizes etc
iv. It should not lead to social friction, migration and insecurity
v. There should be improved marketing facilities
vi. Supportive policies should be put in place e.g. prices
vii. There should adequate and proper infrastructure to support agricultural productivity

Advantages of land consolidation, registration and demarcation

i. Land demarcation leads to easy planning and management of livestock and crops within one area
ii. Consolidation saves time due to reduce to reduce movement from one plot to another
iii. It encourages mechanization at a lower cost on a big scale of land than on a small one
iv. A title deep gives security of tenure which increases the incentives to invest in the land
v. It minimizes disputes about ownership and demarcation of boundaries are minimized
vi. A title deed entitles a farmer to extra income through leasing part of the land or the whole of it
vii. The land title acts as a security for bank loans which can be used for various purposes

Short comings of land reform

i. It involves displacement of people at times which is very expensive
ii. May lead to the creation of the landless especially where private ownership is emphasised
iii. May lead to loss of communal grazing land for the land landless people who are forced to roadside grazing which may cause accidents
iv. Leased land may be left idle

The current land tenure system in Uganda has the following effects

i. It has resulted into land fragmentation
ii. It has resulted into land conflicts
iii. It has limited agriculture productivity
iv. It has discouraged agriculture mechanization

Revision questions

- ✓ Distinguish between land consolidation and land demarcation
- ✓ To what extent is poor performance of agriculture being caused by the current land tenure system?
- ✓ Distinguish between land tenure and land reform policy
- ✓ State four land reform policies in your country
- ✓ Distinguish between land registration and land reclamation
- ✓ Explain the objectives of land reform policies

AGRICULTURE DEVELOPMENT APPROACHES

These are broad policy guidelines designed to promote agriculture from subsistence to commercial level

APPROACHES TO AGRICULTURE DEVELOPMENT

These are the approaches to agriculture development namely

i. Improvement approach
ii. Transformation
iii. Mechanization approach
iv. Agriculture diversification
v. Land reform

IMPROVEMENT APPROACH

Is an approach designed to encourage agriculture development within the existing system without changing the current farmers' systems. It may mainly involves extending advisory services to firms, provision of better quality seeds, breeds , provision of credit facilities and marketing strategies, extension services etc

Advantages of improvement approach

i. The system is highly acceptable to farmers which minimizes resistance
ii. It requires less capital since it operates with existing system
iii. It ensures improved quality. This is through provision of better quality seeds and breeds which yield high quality output
iv. It increases agricultural output, output increases as a result of technical and extension services to farmers
v. It facilitates growth of appropriate technology,
vi. It leads to improvement of social infrastructure in the area like roads, power supply, water supply etc

vii. It improves the quality of labour as the unskilled work force is trained on the job

DISADVANTAGES OF THE APPROACH

i. It limits the level of output compared to transformation
ii. Maintenance of local breeds and seeds results into low quality output

THE TRANSFORMATION APPROACH

Is an approach to agricultural modernization to enhance agricultural productivity involving complete changing of production techniques, existing culture and transfer from peasantry to commercial agriculture

ADVANTAGES OF TRANSFORMATION APPROACH

1. Production of high quality products, it is due to improve production techniques as well as improved seeds and breeds
2. Increased agricultural output, the use of modern and improved techniques increases the quantity of output realized from agriculture over time
3. It promotes technological advancement due to change from traditional means of production to modern means of production
4. It facilitates skills development amongst farmers. Farmers are introduced to new means and methods of carrying out agriculture
5. The approach increases the government revenue through taxes charged on increased out put from agriculture as a result of agriculture transformation
6. Creation of employment opportunities in agriculture sector, the approach requires involvement of more farmers in the agricultural sector

DISADVANTAGES OF THE TRANSFORMATION

1. The approaches requires huge capital which is lacking in development
2. The application of capital intensive technology of production may result into technological unemployment
3. The approach is limited by the current tenure system; this is due to private land ownership and land fragmentation
4. There is opposition by farmers to the approach; they are un willing to change from their traditional methods of farming to modern methods

THE MECHANISATION APPROACH

Is an approach to agriculture which involves use of machines, equipment and modern scientific skills and techniques

It involves use of tractors, combined harvesters, irrigation schemes, ox-ploughs etc

CONDITIONS NECESSARY FOR SUCCESS OF MECHANISATION

1. Physical conditions should permit the use of machines (tractors) the ground should not be exclusively hard, stony etc
2. The topography should be relatively flat otherwise in hilly areas; it will be difficult to use tractors
3. Land should be plentiful so that mechanization can lead to increased acreage and output

4. Labour should be scarce so as to minimize wastage and the opportunity cost involved mechanisation should be accompanied by provision for better yielding varieties of crops and preparations
5. The type of crops grown should permit the use of machines; crops like tree crops do not permit the use of tractors directly
6. The acreage under cultivation should be big and manageable

ADVANTAGES OF AGRICUTLURE MECHANISATION

1. **It results into high level of out,** which increases the volume of exports and therefore, foreign exchange earnings.
2. Costs of production become low in a long run due to large scale operation and economies of scale.
3. It improves on the quality of out put and therefore ensures better terms of trade.
4. It promotes labour training thus increased productivity.
5. It put to use the other wise would be idle land and this increases employment opportunities.
6. It increases government revenue in form taxes charged on agricultural exports
7. It improves on the balance of payment problem due to continued foreign exchange earnings from high quality agricultural out put produced
8. It eliminates land fragmentation because it is carried out on a large scale thus increased agricultural productivity
9. It saves time; use of machines is more efficient compared to labour intensive techniques. This there fore saves time compared to improvement and transformation approach
10. The system encourages commercialization of agriculture which transforms the sector from subsistence hence increased earnings from agriculture

DISADVANTAGES OF AGRICULTURE MECHANISATION.

1. It is not possible at all for agricultural stages especially where human judgment is important e.g. coffee picking.
2. It is also limited to particular areas due to nature in land scape and land fragmentation.
3. It creates income inequality since it is mainly capital intensive, therefore a few have access to employment. This widens the gap between those employed in it those who are un employed
4. It creates landlessness if it on a large scale this subject the displaced to poverty thus leading to low standards of living.
5. It's expensive to carry out since it requires a lot of capital which is lacking in most LDCs.
6. It leads to rural-urban migration since it displaces people with its associated adverse effects like open urban unemployment, development of slums, congestion etc
7. .It is suitable for large schemes and therefore it's uneconomical to use in LDCs where people are on small peasant holdings.
8. The approach requires a lot of skills which are lacking in developing countries
9. It results in high government expenditure since it involves purchasing agriculture equipments and machines which require a lot of money. This can subject the country to external borrowing

LIMITATIONS TO AGRICULTURE MECHANISATION.

1. Limited capital.
2. Nature of landscape or terrain.
3. Land fragmentation.
4. Limited research.
5. Inadequate skilled man power.
6. Limited market to dispose off their surplus out put.

7. Poor land tenure system.
8. Poor geographical relief characterized by hill and ragged terrain does not favour the use of machines
9. Limited entrepreneurial skills
10. Conservatism of some our farmers
11. Political instability
12. High rates of corruption in developing countries
13. Poor/under developed infrastructure

AGRICULTURE MODERNISATION.

This refers to the transformation/improvement of the agriculture sector from subsistence production to commercialized high yielding sector

Or

It is the policy of increasing the output and incomes of the agriculture sector through measures such as mechanization/use of better production techniques, use of improved breeds etc

METHODS OF AGRICULTURE MODERNISATION

1. Rehabilitation and extension of infrastructure i.e. extending power in all parts of the country, increasing water supply,, rehabilitating main roads and expanding the, expanding feeder roads from rural areas and establishing better storage facilities to enhance agricultural productivity
2. Land reforms to increase productivity of land for example land registration, land reclamation, land improvement (irrigation) etc
3. Carrying out scientific research in agriculture to come up with better quality seeds and breeds
4. Provision of in puts to farmers like seeds, equipments like tractors, fertilizers etc
5. Diversification of the agriculture sector by creating a number of economic activities in the sector for example rearing animals, growing crops, processing crops, marketing etc
6. Mechanization of agriculture to increase its productivity through use of machines like tractors to carry out agriculture on a large scale
7. Industrialization within the agricultural sector to add value on the produce and to earn high foreign exchange
8. Development of the co-operative movement for easy marketability of agriculture produces
9. Ensuring political stability in all parts of the country to ensure continued agriculture
10. Training of man power through extension services to farmers and through training colleges
11. Provision of credit facilities to farmers in form of soft loans
12. Developing appropriate pricing policy for agricultural products as an incentive to the farmers

ADVANTAGES OF AGRICULTURE MODERNISATION

1. It promotes exports thus high export earnings which stabilizes the BOP position
2. Reduces the dominance of the subsistence sector hence increased contribution to GDP
3. It creates employment opportunities especially in rural areas, this increases their earnings hence improved standards of living
4. Diversifies the agricultural sector hence reducing risks of specialization like huge losses in case of catastrophes
5. It helps to improve infrastructure in form of transport, storage facilities etc

6. It encourages industrialization of agriculture sector thus adding value to agriculture output
7. It encourages research which yields better quality output
8. It reduces dependence on nature hence making agriculture a year round activity

AGRICULTURE DIVERSIFICATION

This is the creation of a number of economic/productivities in the agricultural sector. It involves the introduction of various crops so that if one crop is affected others may help in raising farmers' incomes. It also includes livestock rearing to supplement crop production and setting up of processing industries

REASONS FOR DIVERSIFICATION OF AGRICULTURE SECTOR

1. To reduce dependence on a limited range of crops in order to minimize risks and uncertainties common in the sector
2. To reduce seasonal unemployment arising directly or indirectly from the limited range of activities
3. To increase supply of raw materials to the industrial sector thus promoting industrialization
4. To reduce rural urban migration due to various activities that keep the rural work force employed
5. To limit the effects of price fluctuations and hence the social economic effects of such instabilities
6. To guard against economic instabilities for example inflation, unstable incomes and highly demanded commodities
7. To diversify the markets of commodities produced so that should there be a fall in the market for one commodity other commodities can get access to the market
8. To increase government revenue by way of taxing agricultural produce more especially when there are several agricultural produce to be taxed
9. To increase foreign exchange earnings particularly when most agriculture products are exported hence improving the balance of payment position
10. To improve the terms of trade of countries that export primary products by exporting varieties

BENEFITS OF AGRICULTURAL DIVERSIFICATION

We use the same points above but presented in present tense for example:

1. It increases farmers' incomes by selling varieties of crops thus improving farmers' standards of living
2. It stabilizes the export base by ensuring a steady supply of a variety
3. It creates more employment opportunities and eliminates seasonal unemployment because farmers are kept busy throughout the year
4. It eliminates food shortages because production of a variety of food ensures that a country has adequate food and can then save its scarce foreign which would otherwise have been spent on importation of food
5. It leads to development of new areas due to introduction of crops that are resistant to hazards paves way for development e.g. sorghum and eggplants and cotton by irrigation in karamoja thus development of that region
6. It reduces rural-urban migration and its associated effects like congestion, development of slums, high crime rates etc because of keeping farmers busy throughout the year

7. It expands the domestic markets because as farmers' income increase, their purchasing power also increases leading to increase in aggregate demand for goods and services in the economy
8. It leads to equitable distribution of income due to reduced price fluctuations in agricultural products and more chances of income from various crops
9. It improves BOP position due to increased foreign exchange earnings from various crops thus accelerating economic growth and development
10. It increases government revenue due to expansion of the tax base resulting from various crops taxed. This enables the government to extend social services to its people in form power supply, rehabilitation of roads etc

CONSTRAINTS TO AGRICULTURAL DIVERSIFICATION

1. Hostile climatic conditions like heavy rain fall' earthquakes' land slides, prolonged droughts etc
2. Conservatism of farmers to change to new breeds and crops
3. Large subsistence sector
4. Inadequate capital
5. Poor infrastructure especially roads, unstable power supply
6. Inadequate skilled labour force
7. Limited market
8. Weak commitment by the government
9. Corruption and embezzlement of funds for agricultural diversification

REVISION QUESTIONS

- Distinguish between subsistence agriculture and commercial agriculture
- Explain the merits and demerits of commercial agriculture
- Account for existence of subsistence agriculture in your country
- Explain the objectives of reducing large subsistence sector
- Define agriculture mechanization
- Explain the constraints to agriculture mechanization in your country
- Distinguish between agriculture modernization and agriculture diversification
- Explain the methods of agriculture mechanization in your country
- Explain the advantages of agriculture modernization over agriculture mechanization
- Outline any four approaches to agriculture development in your country
- Distinguish between transformation approach and improvement Approach as strategies of agriculture development
- Explain the advantages of each
- Why is your country reluctant to implement agricultural mechanization?

- Under what circumstances may agriculture mechanism succeed in your country?

ECONOMIC GROWTH AND DEVELOPMENT

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2011

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This topic is intended to expose economics students to features of under development in their country, causes of underdevelopment, poverty and its dangers, stages of economic growth, economic growth theories. This will enable students to become stake holders in spearing the process of economic growth and development

DEVELOPMENT AND UNDERDEVELOPMENT

UNDERDEVELOPMENT

This refers to the state of under utilization of resources there by resulting into low production. It is that state of the economy where by there is a greater possibility to increase production and real per capital income by utilizing more of the existing resources

It is characterized by:

- Low per capita income
- Absolute poverty
- Low rates of economic growth
- Low consumption levels
- Poor health services
- High death rates and birth rates etc

DEVELOPED COUNTRIES: this refers to the rich and industrialized nations for example Japan, USA, France, Canada, Britain etc

LESS DEVELOPED/DELOPING COUNTRIES: these are lower income countries whose level of productivity is low e.g. in Asia, Africa, South and Latin America

CHARACTERISTCS OF UNDERDEVELOPMENT IN LDCs

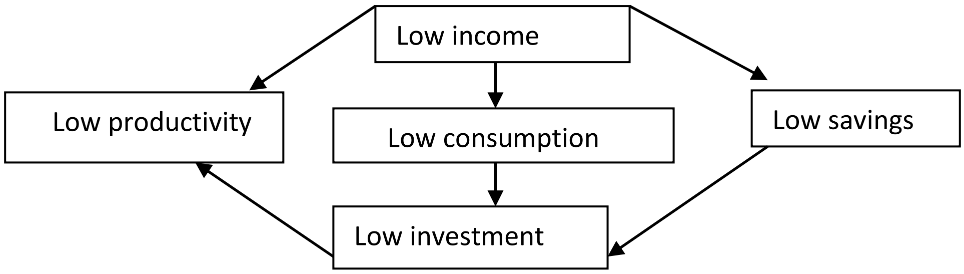
LDCs portray all features of underdevelopment. The main characteristics of LDCs are as follow:

Economic characteristics:

1. **LDCs have low income compared to MDCs**; this low income level limits specialization and purchasing power. Low incomes are attributed to a low rate exchange or trade which is mainly barter if any
2. **The large proportion of the active labour force is engaged** in the primary industries where there is little use of capital goods in the production process. This leads to low savings and finally limited capital accumulation
3. **There is an under/un/mis utilization of natural resource**; this is mainly due to inadequacy of technical knowledge and capital which makes some of the natural resources even inaccessible. For example gold is Karamoja region is un utilized, cobalt and copper deposits at kirembe
4. **Dominance of subsistence agriculture**; agriculture is the major sector for most of the LDCs because it employs over 80% of the population. However this sector is under developed compared to that of MDCs because the sizeable proportion of this agriculture is of subsistence type, there is use of poor methods of farming and limited fertile land resulting into diminishing returns
5. **There is poor developed or under developed socio-economic infrastructure** like banking system, poor road network, poor storage facilities etc which leads to low savings, inaccessibility to raw materials and market centers

6. **Social characteristics;** LDCs are characterized by low standards of living due to poor nutrition, poor housing, poor sanitary services, etc all these indicators lead to a low life expectancy i.e. about 45 years on average
7. **Demographic characteristics;** LDCs have high population growth rates of about 3.4% per annum. This is due to high birth rates and declining death rates. This has resulted into problems of dependence because the largest proportion of the total population is below the age of 15 years, insufficient medical care, etc
8. **There is wide spread unemployment in LDC**s and the major types being open urban unemployment, disguised un employment, structural unemployment etc. this is due to abundant supply of un skilled labour and semiskilled labour in LDCs, limited entrepreneurship abilities, limited skilled personnel making it difficult to acquire jobs that require certain level of training
9. **There is high conservatism and cultural beliefs in LDCs**. The behavior of the majority is based on traditional other than market trends which retards development as new ideas are not easily accepted. They believe in superstition, norms and beliefs for example in Karamoja men are not supposed to work because this is a responsibility of women (women are bread winners), in Buganda most people do not work on Wednesday because it is walumbe's day, some do not work when they first meet a dog or a women very early in the morning
10. **Politically most LDCs have military governments** unlike in MDCs and are mostly un stable which scares away new investors because such governments, committee corruption, violate the basic fundamental human rights, under mine constitutions etc. this prevents faster economic growth and improvements in peoples' wealth
11. **LDCS are characterized by use of poor technology** i.e. there is limited use of scientific knowledge in production and there is hardly any serious research that goes on in LDCs. They mostly use out dated technology which in most cases inappropriate for example use of second hand computers, vehicles etc, pangs, hoes in agriculture instead of tractors, combine harvesters etc hand milking instead of using machines. This is due to limited capital, illiteracy and lack of skilled labour
12. **LDCs are foreign trade oriented** this is reflected through the exports of primary products as main source of foreign exchange which are faced with un favorable terms of trade due to low value addition and the importation of most consumer goods, capital goods and military hard ware
13. **Weak industrial sector**. LDCS have weak and underdeveloped industries which mainly process primary products for export to earn foreign exchange for the economy. Apart from processing, assembling and consumption of consumer goods are common features of the manufacturing sector
14. **Poverty,** LDCs are characterized by majority of their population being poor i.e. they can not afford savings, not even the basic necessities. The poverty rate is 26% according to Uganda Bureau of Statistics (UBOS), 9million Ugandans are in chrolonic poverty and 37% below the poverty line. LDCs are thus characterized by the existence of the vicious cycle poverty due to low levels of production, incomes and investments making it difficult for them to save. Low savings limits investment and thus low productivity leading to incomes and consumption

i. **Perpetual poverty**



15. **Existence of small markets** due to limited specialization in production. Production in most LDCs is at a subsistence level as most of the people try to meet their basic minimum requirements profit driven in production is rare as majority is poor and purchasing power is low
16. **Over reliance on foreign aid**. Developing economies are faced with continuous need for foreign assistance because of the need to supplement their development resources. This has contributed to high rates of capital outflows in form of debt servicing and profit repatriation
17. **Dualism,** this is the coo-existence of two contradicting socio-economic situations one being modern, superior and desirable and another one traditional, inferior and undesirable. Developing countries are characterized by a dual economy with predominantly traditional subsistence agricultural sector and a small modern one that produces mainly for export markets, barter trade v^s monetary exchange, etc
18. **Commercial and private sector**, foreign investors and multinational corporations control or dominate most of the commercial and private sectors in a number of developing countries. This has resulted into under development of local entrepreneur skills in LDCs
19. Most economies of LDCs are characterized by **high rates of inflation and other economic instabilities** like foreign exchange shortages. The rampant inflation is due to economic mismanagement like excessive government spending on un productive activities like on large cabinets and parliaments, from supply rigidities leading to structural inflation
20. LDCs are characterized by **high rates of corruption and embezzlement of public funds**. This is common in government institutions and offices which retards the process of economic growth and development

- **NB. Multinational corporation corporations**. Are those whose activities extend across the boards of more than one nation. They have headquarters in one country but put many branches in different countries e.g. MTN, Coca-Cola etc

CAUSES OF UNDERDEVELOPMENT

There are a number of factors that contribute to the disparity between countries in terms of development. Underdevelopment in most countries is attributed to both internal and external factors

Internal factors are those which are within the economic system while **external causes** are those which are due to interaction of an economy with other countries

Possible internal factors include

1. **High degree of conservatism/cultural factors**: many LDCs have failed to take off because of the absence of the argument to adopt new ideas of development, the traditions and customs of a number of societies have tended to hinder their take off e.g. considering women inferior, in karamoja men are not supposed to work, most cash crops are not in line with norms of ancestors and hence are rejected. This is due to high illiteracy rates of Labour 32% of the population can not read and write
2. **Limited supply of basic natural resources** for example mineral deposits like gold, iron or coal petroleum to work as growth poles. LDCs import most of these resources for their industrial development that is too expensive leading to BOP deficits hence leading to persistent underdevelopment in LDCs
3. **Limited entrepreneurship abilities**, few people are willing to take risks in business partly due to high degree of un certainty that surrounds investment in these economy and as a result of limited training in business management and poor education system which is too theoretical. This has led to under utilization of resources leading to underdevelopment
4. **High population growth rates** in most LDCs. Most of these countries have high population growth rates of about 3.4% per annum. This has led to increased internal and external dependence because it is dominated by the young consisting of 45-50% between 0-15 years. This leads to low standards of living to working population and increased government to support the increasing population hence persistence underdevelopment in such countries
5. **Small markets in LDCs**: Due to low incomes, LDCs have found it difficult to develop large markets to support a massive production system which leads to under utilization of resources thus causing underdevelopment in LDCs
6. **Dual nature of developing countries** has hampered the rate of economic growth. Dualism makes it difficult for governments to carry out integrated planning for comprehensive development. Contrasting social, economic situations that are associated with dualism means drawing separate sets of plans which LDCs can not afford thus retarding the process of underdevelopment
7. **Low income levels/high rates of poverty** have made it difficult for LDCs to make initial investment in order to take off into self sustaining growth thus leading to persistent underdevelopment in such countries.
8. **Underdeveloped socio-economic infrastructures in LD**Cs for example poor state of roads especially impassable feeder roads in rural areas which has hindered the development of agriculture, underdeveloped banking system to mobilize savings and provide credit facilities to potential investors, un stable and inadequate power supply which has hindered the growth of industries etc all of which cause underdevelopment in LDCs
9. **High levels of unemployment and underdevelopment** also causes underdevelopment in LDCs. This is because it leads to low incomes of people which results in low purchasing power and poor standards of living which is and indicator of underdevelopment
10. **High level of dependence on subsistence production** causes underdevelopment in developing countries. This is because production is meant for own consumption and surplus

if any for sale this leads to low foreign exchange earnings which can be used to support development programs thus hindering the process of economic growth and development

11. **Poor land tenure system** also contributes to underdevelopment in LDCs because land ownership is in hands of few individuals (landlords) who are financially weak yet tenants are not allowed to utilize the land without seeking permission from land owners. This has made development programs to fail for example agriculture modernization
12. **Persistent political instabilities** and unrest in LDCs make development programs to fail. Most LDCs' governments are militaristic in nature and are characterized with power struggles because of the integrated societies in one country. This makes plans for development to fail hence leading to underdevelopment for example in Zimbabwe, Somalia, Iraq,
13. **Low levels of technological development** in LDCs cause underdevelopment because it results in production of low out put and of poor quality which fetches low foreign exchange earnings and thus slow growth rates. This is because the use rudimentary tools in production
14. **Natural hazards** like land slides, earthquakes, epidemics like Ebola, cholera etc, floods, prolonged droughts and heavy rains also hinder the process of economic growth and development in such countries. This is because it diverts a country's development resources to such catastrophes and makes some development plans to fail
15. **Low levels of industrialization in LDCs**. The industrial sector in LDCs is weak and operate on a small scale this implies low value added on exports thus earning low foreign exchange due to un favorable terms of trade. Hence leading to underdevelopment in these countries
16. **Economic mismanagement and corruption in most LDCs'** governments leads to underdevelopment. There is misappropriation of public funds intended to facilitate development programs most especially by government officials to serve their interests thus retarding the process of economic growth and development
17. **High rates of inflation** and other economic disturbances in LDCs also cause underdevelopment. Most of the LDCs economies are characterized with high inflationary tendencies for example in Uganda it was 21.4% in august 2011 this discourages investments because the business environment becomes unpredictable leading to underdevelopment

Possible external factors include the following:

18. **Colonialism or neo-colonialism**. This has deprived societies of raw materials in form minerals to MDCs and subjected them to dependence on MDCs thus leading to persistent underdevelopment in these countries
19. **Brain drain.** The flow of skilled labour force from LDCs to MDCs has deprived them of possible skilled labour force necessary for take off into sustainable development. This is caused by low wages in LDCs, poor working conditions, unemployment and underemployment.
20. **Over dependence on foreign aid and loans** with conditions and high rates of interest from MDCs have increased foreign capital outflow in form of debt servicing. This makes such countries to leave their development programs in favor of repaying debts hence leading to underdevelopment

21. **High rates of profit repatriation in LDCS**: LDCs are dominated by foreign investors who repatriates most of the profits earned in LDCs to their countries hence leaving such countries underdeveloped
22. **Poor terms of trade** due to protectionism from MDCs in the world market make LDCs to benefit less from international trade. MDCs impose tariff barrier and non tariff barriers on from products from LDCs like quotas, total ban, sanctions, high import duties etc which makes them to earn low foreign exchange that can be used to facilitate development programs like infrastructural development

POSSIBLE MEASURES TO REDUCE THE LEVEL OF UNDER DEVELOPMENT IN UGANDA

1. **Diversification of the economy** through creating a number of economic activities to reduce risks of specialization i.e. industrialization, developing the service sector, agriculture etc
2. **Educational reform**s can be undertaken so as to make education vocational oriented by making vocational subjects compulsory at all levels i.e. primary, secondary, tertiary etc to create more job makers than seekers
3. **Improving and maintaining political stability** in all parts of the country so as to attract potential investors in the economy. This will read to creation of more jobs in the country
4. **Population control measures** should be undertaken to reduce dependence on foreign countries to support the increasing population and also to encourage domestic savings as a result of reduced dependence on the working class
5. **Modernization** and diversification of the agriculture sector to improve on the country's terms of trade. This can be achieved through introducing good quality breeds, resistant crops and irrigation to reduce dependence on nature
6. **Technology development and transfer** should be encouraged so as to improve on the quality of out put produced and exported. This can be done by investing more in Information Communication Technology (ICT ministry) and research
7. **Economic regional integration** should be undertaken by the government to expand the markets for exports. For example participating in East African Common Market, COMESA, European Economic Community etc. this will fetch high foreign exchange needed in facilitating development programs. The government can also increase aggregate demand in the country to expand the domestic market
8. **Monetarisation** of the economy through encouraging commercial production and discourage barter trade system. This can be done by reducing or removing taxes on exports to encourage production for external markets
9. **Improving the state of infrastructure** should be undertaken i.e. rehabilitating the impassible feeder roads in rural to enhance agricultural development, expansion of the main roads, steady power supply to facilitate industrial development, banking system to mobilize savings etc
10. **Liberalization of the economy** can be undertaken to allow all people to take part in economic activities in the country. This would increase employment opportunities and thus improving peoples' incomes and S.O.L
11. **Privatization of non performing state enterprises** to increase efficiency in production and reduce government expenditure on such enterprises

12. **Price control measures** should be undertaken to reduce fluctuation of prices in the agriculture sectors and motivate farmers and also to control high inflationary tendencies in developing countries like Uganda. This attracts more investors due to predictability of the business
13. **Encouraging the development of local entrepreneurs** to reduce dependence on foreign investors and high profit repatriation. This can be done through organizing workshops, seminars intended to inculcate entrepreneurship skills in local people
14. **Ant corruption laws should** be put in place with penalties to reduce high corruption rate for example imprisonment of any one found in the act of committing corruption sentencing to death government officials found embezzling public funds meant for development etc
15. **Import substitution industrial development** should be encouraged to reduce dependence on imported consumer goods, raw materials and capital goods other countries. This can be done through utilizing locally available materials and protecting local industries by imposing high taxes on imports to discourage their consumption
16. **Land reform policies** should be put in place to empower tenants this facilitates the development of agriculture and other economic activities e.g. through nationalization of land, land registration and holding leases
17. **Providing elementary education to all Ugandans** through universal primary and secondary education so as to break the high degree of conservatism and reduce on illiteracy rates

POVERTY

Is a situation where a proportion or section of the population is able to meet only its bare subsistence essentials of food, clothing and shelter in order to maintain the minimum level of living

It **is defined by poor people** as more than just lack of income but also lack of means to satisfy basic social needs as well as a feeling of power less to break out of it

Poverty may be absolute or relative

Absolute poverty is a state where by the proportion or section of the population is only able to meet the bare minimum essentials of life and no more

Relative poverty is a situation where by a section or proportion of the population is able to meet bare minimum necessities of life and a beat of luxuries

FEATURES OF POVERTY/INDICATORS OF POVERTY

1. Inadequate food supplies and malnutrition
2. Poor shelter and housing conditions
3. Insufficient supply of clean water
4. Basic source of fuel is firewood
5. Poor means of transport
6. Low life expectancy
7. High mortality rates both infant and maternal
8. Wide spread illiteracy where many can not read and write
9. Low incomes such that majority go without essential commodities

10. Diseases which could easily be prevented still stand as common killer diseases
11. Majority of people are subsistence producers

DETERMINATION OF POVERTY

Poverty is determined by an international poverty line which is just an arbitrary international real measure usually expressed in constant dollars. This poverty line is used as a basis for estimating the proportion of the world's population that exists at bare subsistence level. The poverty line in Uganda is 37% and the poverty rate is 26% according to Uganda Bureau of Statistics (**UBOS)**

CAUSES OF POVERTY

1. Low levels of income leading to small markets which can not induce investments thus causing perpetual poverty
2. Limited basic or strategic natural resources which are necessary for massive investment and development foe example inadequate hydro-electricity power supply in Uganda
3. High population growth rates that have tended to stagnate the process of capital accumulation in most LDCs since it is dominated by the young between 0-15 years who constitute over 45% of the population. This implies continued dependence
4. Over ambitious economic policies of LDCs i.e. there is lack of harmony between planners, government and politicians. This widens the gap between formulation and implementation of development policies e.g. PEAP 1 AND PEAP2 failed to eradicate poverty, Entandikwa scheme also failed etc
5. Lack of committed leadership. Some leaders tend to pursue personal power and hence lack a sense of nationalism in such cases leaders fraud national resources leading to perpetual poverty
6. Political instabilities and unrest which has tended to stagnate major productive sectors like agriculture and industry as a result these unstable economies continue in continuous poverty
7. Inappropriate technology which is basically foreign based like capital intensive technology causing high technological unemployment
8. Inappropriate education system which puts limited emphasis on vocational, technical and practical education leading to limited skills which promote self employment and instead produce job seekers
9. Weak position of LDCs ion international trade as reflected in the poor terms of trade and ever worsening BOP position due to exportation of raw materials and of poor quality instead of finished products
10. Hostile climatic conditions like floods, heavy rainfall, prolonged droughts, earth quakes, landslides etc this has hampered the development process of most agro based economies due to low out put
11. Over reliance on foreign has made 3rd world economies quite vulnerable to underdevelopment due high debt servicing and making of people expectants
12. Existence of class exploitation in most African societies i.e. the elites and semi elites tend to be attached to foreign capitalists a process that has resulted into inequalities and exploitation of the poor in LDCs

SOLUTIONS TO POVERTY REDUCTION

The following are the measures that can be undertaken to eradicate poverty in Uganda

1. By attracting foreign investment to supplement their capital resources so as to break through the vicious cycle of poverty
2. Economic integration or regional cooperation can be undertaken by the government to expand the small markets which discourage commercial production e.g. East African common market, participating in COMESA, European Economic Community etc
3. Importation of basic raw materials needed for industrial development in refined form should be undertaken. This would create more jobs and increase peoples' income
4. Controlling population growth rates to insure a steady per capita income leading to better standards of living and reduced dependence ratio
5. Making structural adjustments in LDCs economic policies in order to make them more realistic for example farmers should be paid fair prices to motivate the agro-based industries, rural transformation etc
6. Governments in LDCs should mobilize their resources for saving to avoid over dependence on foreign capital through encouraging and putting in place banking systems. This will break the vicious cycle of poverty
7. Improving and maintaining political stability so as to facilitate economic development because of the conducive environment for investment
8. Avoiding social evils like corruption, nepotism, tribalism etc so as to foster equity in the country in terms of development
9. Adequate policies concerning trade should be adopted so as to increase gains from international trade for example strengthening the bargaining process through exporting products with high value addition
10. Adoption of educational reforms aimed at making the type offered in schools relevant to the requirements of underdeveloped countries e.g. by emphasizing technical, practical and vocational education
11. Taming hostile climatic conditions through irrigation, increased mechanization and extensive use of farm inputs like fertilizers, pesticides, insecticides etc
12. Stabilizing economic variables of demand and supply in order to stabilize prices which encourage investment, employment thus increased income

ECONOMIC GROWTH

Is the persistent increase in the country's volume of goods and services in a given period of time

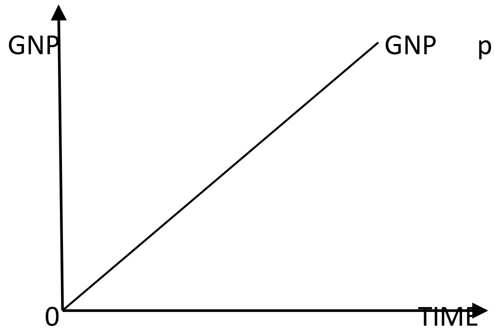
Or

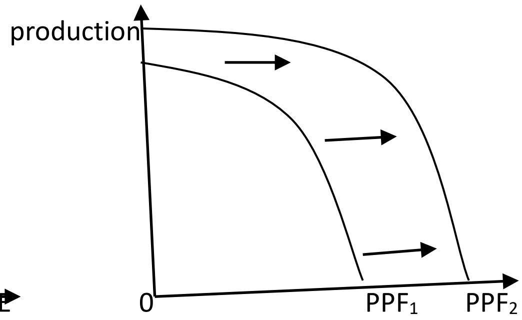
Is the persistent quantitative increase in the volume of goods and services produced in an economy during a given period of time

Or

It is the persistent quantitative increase in the GDP/GNP of an economy over time

It can be illustrated using steady rise in GNP or PPF-curve





Outward expansion of the PPF from PPF1 to PPF2 illustrates economic grow

DETERMINANTS OF ECONOMIC GROWTH/FACTORS THAT INFLUENCE THE RATE OF ECONOMIC GROWTH IN AN ECONOMY

There are a number of factors that determine the rate at which an economy grows overtime. These factors are economic, social and political as they include the following:

1. **Availability of natural resources** i.e. stock of factor inputs the more available the natural resources or raw materials which are full utilized, the higher the economic growth rate and countries with less productive resources experience slow growth of national income and thus low economic growth rate
2. **Level of capital stock (capital accumulation**). This goes hand in hands with the level of savings and investments. Greater stock of capital encourages massive productivity and foster growth while a low capital stock implies low productivity and thus low growth rate
3. **Level of technological progress**. High level of technology implies high productivity and accelerated economic growth process but poor technology implies high production costs, limited productivity and slow growth rates
4. **General organization of the economy**. An economy with systematic planning and good governance experiences increased productivity and a faster economic growth rates while an economy with uncoordinated system of resource management tends to have low productivity thus low economic growth rates
5. **Political atmosphere**. Political stability makes it possible to implement development programs as well as the day to day growth and development policies. On the other hand political insecurity in form of wars is a big disincentive to production and thus slows down economic growth process
6. **Terms of trade**. Favorable terms of trade means high rate of resource inflows and thus increased production leading to increased economic growth while poor or unfavorable

terms of trade implies limited resource inflow, limited domestic production and hence a slow growth process

7. **Quality and size of labour force**. Big and highly skilled labour force encourages production and thus higher growth rates while a small and less skilled labour force is less productive and there fore slows down the economic growth process
8. **Investment levels both domestic and foreign**. High investment rate increases growth while low investment rate results into low productivity and growth
9. **Government action and direction**. Proper growth directives in accordance with investment tend to increase production but unfavorable government policies towards investment like high taxation hinders the economic growth process
10. **Level of infrastructural development**. Well developed infrastructure encourages investment and greater productivity thus faster growth of the economy well as poor infrastructure implies poor foundation for investment and poor production thus slower economic growth
11. **Level of entrepreneurial abilities**. A country with high entrepreneurship abilities implies increased economic activities leading to high economic growth rate while a country with low entrepreneurship abilities has low economic activities leading to low growth rate
12. **Rate of inflation.** Mild inflation promotes investment in the country which increases economic growth while hyper inflation discourages investments thus leading to low economic growth rate

INDICATORS OF ECONOMIC GROWTH AND DEVELOPMENT

There a number of economic, political and social factors that shows the rate of growth of a country's National product. A growing economy portrays the following features:

1. **Increased capital accumulation**, economic growth is evident by an increase in physical capital goods (basic infrastructure) such as roads, railways, increased energy supply. Indirectly productive capital or social infrastructure should also increase like more schools, hospitals, better water systems more houses in both rural and urban areas for an economy to be considered a growing economy
2. **Increased labour force**, both skilled and semi skilled labour force should show an up word movement in number over time. Increased supply of skilled labour in production is an indicator of a growing economy since it increases productivity than the unskilled one
3. **Increased use of modern and appropriate technology**, growth in an economy is noticed by an increased application of new scientific knowledge in production in the form of intensive mechanization in agriculture and wide use of capital intensive methods in the industrial sector which leads to high productivity
4. **High growth rate GDP and per capita income**, economic growth rate is shown by the ever rising GDP and per capita income bigger over time
5. **Low population growth rates**, growing economy is characterized by a low population growth rate i.e. less than 2% per annum on average
6. **Increased life expectancy** is an indicator of economic growth and it is associated with low mortality rates

7. **High energy consumption per head**, this implies increased productivity due to many small scale industries that can be started using energy
8. **High adult literacy rate** is also an indicator of a growing economy because it implies increased production of goods and services due to high labour productivity
9. **Rapid urbanization and rising employment levels** are also indicators of a growing economy. Because this implies increased incomes which increases investments and production of goods and services
10. **Expansion of markets** which is indicated by increasing demand and high purchasing power
11. **High rates of social,** political and economic transformation of society or an economy

BENEFITS OF ECONOMIC GROWTH AND DEVELOPMENT

1. In general the benefits of economic/development include the following:
2. It results in improved standards of living due to availability of variety of goods and services. This improves on their standards of living because economic growth involves the persistent quantitative increase in goods and services
3. It leads to creation of employment opportunities due to increased investment this increases the earnings of the people thus improving on the standards of living of the people
4. It results in improved BOP position through increased exportation and foreign exchange earnings and reduced imports
5. Reduce income inequalities due to wide spread employment opportunities as a result of increased investments in the country
6. Increased government tax revenue due to large taxable capacity resulting from increased economic activities which can be used to extend social services to people like education, hospitals etc
7. It results in development of basic infrastructure in the country for example construction and rehabilitation of roads, increased power supply, developed banking system which improves on capital accumulation, standards of living of people etc
8. Economic growth results in reduced inflationary tendencies like demand pull inflation due to increased supply of goods and services in the economy
9. It leads to increased humanitarian activities because of high volume of goods and services a country is able to assist other economies facing catastrophes like earthquakes, landslides, floods famine etc
10. It leads to optimum utilization and exploitation of resources there by reducing excess capacity hence increasing employment opportunities
11. It results in increased enjoyment of leisure due to high income levels which improves on their standards of living
12. It results in improved technology which results in production of good quality products thus improving peoples' standards of living
13. It leads to improved labour skills due to wide spread education and on-job training services offered to employees
14. It leads to removal of obstacles to growth like breaking of conservatism among the people through wide spread education
15. It results in reduced external dependence due to increased production of goods and services in an economy

16. It results in increased life expectancy due to consumption of good quality products
17. It promotes political stability in the country due to improved standards of living of the people

COSTS OF ECONOMIC GROWTH AND DEVELOPMENT

1. Despite having the benefits discussed above, economic growth/development has a number of costs which include the following:
2. It leads to social costs for example pollution, congestion etc which increases government expenditure in fighting such costs
3. Rapid economic growth leads to rapid urbanization which in turn leads to rural-urban migration with its associated evils like development of slums, open urban migration etc
4. It leads to over exploitation of resources hence their quick depletion especially those which are non renewable e.g. minerals thus making the future generation vulnerable
5. It widens income inequalities/promotes dualism. Economic growth widens the gap between holders of wealth and the poor which results in social unrest
6. It leads to technological unemployment as producers put much emphasis on increasing out put using capital intensive technology at the cost of employing labour
7. It involves fore going current consumption and leisure to investment. The argument for increased production and more income may make workers fore go leisure or postpone current consumption. This implies low welfare of the productive population
8. It leads to erosion of social-cultural values due to adoption of foreign values at the cost of promoting the local ones
9. Inflationary tendencies are likely to occur when most of the goods produced are exported. This would mean scarcity of consumer goods in the domestic market yet consumer's purchasing power has increased thus leading to demand pull inflation
10. Economic growth and development results in displacement of people in favor of setting up factories is such places this result in poor standards of living of people
11. It leads to profit repatriation where investments are by foreigners thus leaving most developing economies underdeveloped
12. It increases debt burden due to increased borrowing in order to produce more goods and services

STAGES OF ECONOMIC GROWTH

A number of economists have tried to explain the path of economic growth one of them is Professor WW Rostow who has tried to explain it in a historical perspective by classifying societies at their different levels of economic growth/developments

WW ROSTOW'S STAGES OF ECONOMIC GROWTH

Professor WW Rostow is one of the economists who have tried to explain the path of economic growth. Rostows outlines a historical approach to the process of economic development. He distinguishes five stages of economic growth/development through which an economy passes and these include the following

i. Traditional state
ii. Pre-condition for take off (transitional stage)
iii. Take off stage
iv. Drive to maturity
v. High mass consumption stage

TRADITIONAL STATE

This is the first stage of economic growth according to Rostow characterized by low productivity and use of rudimentary technology. In the traditional society family and clan connections play a dominant role in the social structure

FEATURES OF THIS STAGE

1. The economy is stagnant with very low incomes leading to low savings thus un noticeable capital accumulation
2. Subsistence agricultural production is the main source of income with more than 75% of the working population engaged in it
3. There is high degree of communal organization (work is done communally)
4. Producers are not profit motivated
5. Traditional beliefs, cultures and attitude for values are still upheld
6. The rate of economic growth is small and negligible
7. Society is closed and there are no external forces to influence its activities

PRECONDITIONS FOR TAKE OFF (TRANSITIONAL STATE)

This is a period where the society lays down the necessary institutional frame work to sustain growth

There is severe social and economic transformation and the economy experiences relatively high rate of economic growth

CHARACTERISTICS

1. Financial institutional develop to mobilize savings e.g. banks, microfinance, saving co-operatives etc
2. Improvement of technology in the strategic sectors of the economy e.g. agriculture and industry (use of some simple machines)
3. Transformation of peoples' briefs, cultures and transitional and attitudes i.e. the role of education in transformation of society becomes paramount
4. The spirit of adventure develops that leads to new discoveries and inventions and so new entrepreneurships come up in the private economy
5. Dualistic tendencies emerge due to un even distribution of benefits of growth
6. Rise in resources exploitation in the economy due to emergence of entrepreneurs
7. International trade increases due to transformation of the people's attitude
8. There build up of social over head capital especially in the transport sector (construction of roads and rehabilitation)
9. There is increased imports including capital goods mainly financed by efficient production and marketing of natural resources for exports

Why is Uganda considered to be at this stage?

TAKE OFF (SELF SUSTAINED GROWTH) STAGE

This is the 3rd stage in Rostow's stages of economic growth. It is the most important stage which involves severe structural transformation in the economy. It is a period when the obstacles to steady growth are finally over come and the economy is moving towards a self sustained one

FEATURES OF TAKE OFF STAGE

1. There is arise in the rate of productive investment from 10 – 15% of the national income/GDP/GNP
2. There is high savings i.e. from 10- 15% of GDP/NY/GNP
3. The economy attains self sustained growth
4. There is high level of employment opportunities
5. There is a high level of industrialization/ a leading sector appears
6. Emergency of new markets both domestic and foreign
7. There is high level of urbanization
8. There is a high level of technological development/high levels of innovations and inventions
9. There is social transformation due to wide spread education/high literacy rates
10. There are high levels of infrastructural development
11. The economy become monetarised with almost no subsistence production
12. There is exploitation of resources that were un exploited before
13. There is increased variety of goods produced which widens consumer's choice
14. Emergence of a new class of entrepreneur

WHAT SHOULD UGANDA DO IN ORDER TO ATTAIN TAKE OFF

1. By adopting population control measure to raise savings for investments

2. By adopting an expansionary monetary policy to raise the amount of money in circulation hence raise investment
3. Through economic diversification through activities like small scale industries, crop diversification, widening the industrial base
4. Developing infrastructural facilities like banks, power supply etc
5. Technological improvement to facilitate production and quality of out put
6. Industrialization through import substitution and export promotion industries to increase foreign exchange earnings
7. Modernization of agriculture
8. By encouraging modernization of agriculture
9. Political stability attempts
10. Development of entrepreneurship skills through training
11. Regional integrations to widen the market

DRIVE TO MATURITY

This is a relatively more advanced stage with economically advanced and highly innovative personnel characterized by high level of research and discoveries. This is the stage where the economy demonstrates that it has the technological and entrepreneur ability to produce anything it may choose

FEATURES OF DRIVE TO MATURITY

1. Rising productivity in all the major or leading sector of the economy
2. Heavy industrialization starts
3. Increased employment opportunities more especially in the modern industrial sector
4. High/ advanced technology is used in the production
5. Production shifts from capital goods to durable consumer goods
6. Long sustained economic growth
7. The rate of investment ranges from 10-20% of national income
8. The economy is able to withstand unexpected internal and external shocks
9. The work force becomes skilled

10. Real wages rise
11. The rate of urbanization increases
12. Society's taste and preferences change
13. Efficient managers emerge replacing the old inefficient ones

HIGH MASS CONSUMPTION STAGE

This is the final stage of development. At this stage the leading sector of the economy shifts from producing capital goods to durable consumer goods and services. In this stage real income per capita for the majority rises beyond the level necessary for subsistence which consequently expands the market size

OTHER CHARACTERISTICS

1. High urbanization reflected by a big proportion of those who stay in urban areas than in rural areas
2. Highly specialized technology in the economy
3. High per capita income shown by people improved welfare
4. Complete elimination of the vicious cycle of poverty
5. A large proportion of the population is employed in tertiary sector than in primary sector
6. A country starts carrying out external investment i.e. foreign countries start giving donations, aid and grants
7. There is more equitable distribution of income through increased social security and progressive taxation

LIMITATIONS AND CRITICISM OF ROSTOW'S STAGES OF GROWTH

1. It is difficult to demarcate one stage from the other especially 1and 2 and 3 and 4. There is considerable over raping in different stages i.e. one stage is taking the characteristics of another
2. Some stages may not be necessary because some economies skip some stages in their development process like USA and Canada where born free of the traditional stage
3. Capital accumulation is not the only engine of economic growth as the theory assumes since there are other factors such as markets, skills, technology etc
4. It assumes continuity in the road of development yet there could be discontinuity/delays/decline in economic growth
5. It does not consider the nature of distribution of income i.e. emphasis is on the leading sector only yet all sectors can be at the same level
6. High levels of savings may not necessarily lead to economic growth because some countries have already achieved high savings of 10-20% but they have never taken up
7. According to Rostow massive industrialization in the production of capital goods is the only indicator of maturity but the experience of some countries is that development of agriculture has continued even to maturity stage e.g. News land, German and Denmark
8. Sectoral linkages and balanced growth encourages development of simultaneous sectors which Rostows under estimated

DEVELOPMENT

Is the process of improving the quality of all human lives. It is a multi dimensional phenomenal that involves quantitative increase and quality changes in the productive capacity and improvement of the structure of the economy

Development has three cores or important aspects namely

I. Raising peoples' living levels i.e. improving their incomes and consumption levels, employment levels medical services, education and training facilities
II. Establishment of social, political and economical systems and institutions to promote human dignity
III. Increasing peoples' freedom to choose by widening their range of choices/variables for example increasing variety of consumer goods and services

ECONOMIC DEVELOPMENT

This refers to the quantitative and qualitative increase in the productive capacity of the economy and it involves positive structure changes in the political, social and economic set up of the country

OBSTACLES TO ECONOMIC DEVELOPMENT

1. Low levels of savings. LDCs are unable to mobilize sufficient domestic resources due to wide spread poverty as a result, investments are low besides the little savings are misallocated into non productive projects
2. Vicious cycle of poverty. This is one of the most widely known theories based on the idea that lack of capital is the key factor preventing growth and development in most LDCs. Because it means low productivity resulting in low income leading to limited investment
3. Predominance of subsistence agricultural sector. Generally the agriculture sector in LDCs has not played its proper role in development i.e. providing enough foreign exchange for importing capital goods which can be used to set up industries, neither does it provide enough raw materials as well as food yet it is the leading sector
4. Poor performance of the export sector leading to foreign exchange constraints. This is because LDCs export a few primary commodities which are faced with unfavorable terms of trade
5. High population growth rates resulting into high dependence on ratios. This leads to high government expenditure on provision of social services at the expense productive investment
6. Poor government policy on resource allocation. Most LDCs governments misallocate resources into non productive projects e.g. buying military equipment which has almost no multiplier effects on the economy.
7. High level of corruption and embezzlement of public funds also hinders the process of economic growth and development in most LDCs
8. External forces. Foreign countries tend to exploit LDCs most especially through un equal exchange for example the foreign man power in LDCs which is too expensive to maintain, foreigners invest in LDCs and repatriate most of the profits to their home countries consequently resulting into low savings, low investment etc
9. Political instability and unrest. Governments of LDCs are unstable which discourages investment and political instabilities are also associated with mass destruction of both lives and property
10. Underdeveloped infrastructure e.g. poor road network, unstable power supply, poor developed banking system which stagnates the process of development
11. Poor technology used. LDCs use poor techniques of production which do not generate enough out put per capita resulting into limited development. Most LDCs import technology from developed countries which turns out to be inappropriate, expensive and less productive
12. Limited skilled man power which reduces labour productivity as a solution LDCs normally import personnel who are paid foreign currency and repatriate most of their earnings
13. Brain drain. There is a high rate of loss of high skilled man power from LDCs to developed countries which has robbed developed countries of human capital they need for development

14. Conservatism and high level of illiteracy. Majority of the poor in LDCs are illiterate and this has made them to resist a number of changes

REQUIREMENTS OF DEVELOPMENT

1. Indigenous effort and initiative. The initiative in carrying out development must arise from indigenous people. This is because can not be implemented from outside
2. Cultural changes. There is need to change certain traditional and cultural values if development is to be achieved. This is only possible if education becomes wide spread to make the local population adoptable to changes and new ideas
3. Efficient system of administration. The administration should be committed to development and there should be proper allocation of resources into productive projects
4. Capital accumulation. This involves increase in the volume of savings, an efficient banking systems to mobilize savings and provide credits and increase in investments
5. Political stability in all parts of the country
6. Improved infrastructure
7. Technological advancement
8. Large size and good skilled labour force
9. Optimum population. The population must match with the available resources in the country
10. Modernization of agriculture
11. Economic diversification

WHY ECONOMIC GROWTH MAY NOT NECESSARILY MEAN ECONOMIC DEVELOPMENT

1. When it is accompanied by un even distribution of income among people because this implies poor standards of living which is an indicator of underdevelopment. A country may experience an increase in the volume of goods and services when such volume is produced by few rich people
2. Persistent quantitative increase in volume of goods and services may be accompanied by production of poor quality goods and services which affect peoples' standards of living hence underdevelopment
3. It may be accompanied by increased production of capital goods like machines at the expense of consumer goods. Capital goods do not directly improve peoples' standards of living which is a core of development
4. Quantitative increase in the volume of goods and services may be accompanied by increasing levels of unemployment in the country. Unemployment leads to low levels of income and poor standards of living
5. Persistent quantitative increase may be accompanied by high inflation rates which forces fixed income earners and low income earners to consume inferior goods and services leading to underdevelopment
6. Economic growth may be accompanied by over working of people leading to low quality of life. This is because economic growth involves working long hours at the expense of enjoying leisure
7. Persistent quantitative increase in the volume of goods and services may be associated with high social costs like pollution, congestion etc which degrades the environment and negatively affect human lives through spreading diseases like cancer
8. Quantitative increase in the volume of goods and services may be accompanied by unfavorable government policies like high taxes which reduce the disposable income of people, retrenchment which make people un employed leading to low standards of living
9. Economic growth may be accompanied by high illiteracy rates/conservatism. A country may experience increase in the volume of goods and services when people have not changed

their traditional, beliefs and norms due to high illiteracy rates thus making the irresponsive to changes that can enhance development like commercialization of the economy

10. It may be accompanied by non productive government expenditures like organizing expensive state functions, buying military hard ware which do not improve on peoples' standards of living
11. Economic growth may be high when the country is experiencing political instabilities which lead to destruction of peoples' lives and property. Insecurity also discourages investment leading to underdevelopment
12. It may be accompanied by poor developed infrastructure like poor road net work, poorly distributed banking institutions, inadequate health facilities etc which all reduce the well being of people

Under what circumstances may economic growth not necessarily mean economic development?
Use incase/if/when on the above points

UNDER WHAT SOCIO-ECONOMIC CONDITIONS MAY ECONOMIC GROWTH LEAD TO ECONOMIC DEVELOPMENT IN YOUR COUNTRY

Use when/incase/if on such a question

1. When it increases the per capita income
2. When it reduces absolute poverty
3. When there are high levels of consumption
4. When it provides better health services
5. When there is reduction in death rates and birth rates as a result of economic growth
6. When there is reduction in dependence on foreign economies as a result of economic growth
7. Incase it increases peoples' freedom to choose in a variety
8. Incase it is accompanied by reduction in illiteracy rates
9. Incase it creates more employment opportunities
10. When a country achieves greater price stability as a result of economic growth
11. When economic growth reduces income inequality
12. In case it promotes balanced growth
13. Incase it is accompanied by better working conditions like high wages, use of protective equipments etc

THEORIES OF ECONOMIC GROWTH AND DEVELOPMENT/GROWTH MODELS

These theories are about the choice of the sector to begin with if economic growth is to be attained. They include;

I. The balanced growth theory
II. The unbalanced growth theory
III. The big push theory

BALANCED GROWTH THEORY

This is a growth strategy which states that "there should be simultaneous development of all sectors of the economy such that they growth at a more or less the same pace". Ti also states that there should be simultaneous and harmonious development of different sectors of the economy so that all sectors grow in unison. It was established by Ragner Nurks

The main purpose of balanced growth is to create interdependence in the economy so as to ensure linkages between the different sectors

For this, balance is required between demand and supply side. The supply side lays emphasis on the simultaneous development of all interrelated sectors which help in increasing the supply of goods. On the other hand demand side relates to the provision for larger employment opportunities and increasing incomes so that the demand for goods and services may rise on part of the people

There is a need for balance between manufactured consumer goods and capital goods i.e. a balance within the industrial sector itself. Because increase in production of capital goods at the expense of consumer goods can lead to poor standards of living and production of only consumer goods means continued importation of capital goods

The need for a balance between direct productive activities (agriculture and industrial) and social overhead capital (power, roads, railway etc) because one can affect the development of the other

There is need for a balance between production for domestic economy and production for export promotion industries and import substitution industries

There should be a balance between rural and urban areas. The theory emphasizes regional equality where all regions are developed at the same time

ARGUMENTS FOR BALANCED GROWTH THEORY (ADVANTAGES)

1. The theory increases the number of markets in the economy due to the number of projects that are being developed at the same time for example development of industries will increase the markets for agricultural output in form of raw materials
2. The theory quickens the rate of development. This means that a country may easily pass through the stages of economic growth
3. It increases employment opportunities due to an expansion of sectors that provide jobs for example industries and agriculture thus improving people's standards of living
4. The volume of exports increases and this is due to a balance between import substitution and export promotion industries, mass production which will increase on foreign earning and thus improving the BOP position in the economy
5. The strategy promotes utilization of idle resources like minerals and forestry and a country finds itself with all resources productive as a result of the investment put in
6. The theory encourages the development of technology meaning that the indigenous skills may be integrated and improved. The local labour may be trained and generally their skills may improve as a result of critical minimum efforts
7. There strategy promotes self reliance because of increased production of capital and consumer goods thus reducing external dependence
8. The theory reduces regional inequalities in development. This is because all regions are developed at the same time
9. It widens the tax base due to various economic activities that are taxable this enables the government to extend social services to its people in form of infrastructure like roads, power supply
10. Infrastructural development is encouraged i.e. better roads, power supply, medical facilities, storage facilities which are cardinal in industrial development
11. A variety of goods are produced hence widening consumers' choice since it involves production of goods and services from various sectors

12. Promotion of intersectoral linkages in an economy resulting into an integrated and self sustaining economy that reduces the risks of depending on one sector

13. It encourages training of various labour skills which will increase labour efficiency in the long run

ARGUMENTS AGAINST BALANCED GROWTH THEORY/DEMERITS

1. It may lead to over production which may encourage wastage. This is due to production with no reference to demand. Some goods may there fore lose market locally and excess may be dumped in other countries
2. It results in exhaustion of resources due to their over utilization in the short run that few or no resources are reserved for the future hence failing to achieve sustainable development
3. It requires too much expenditure and there fore too costly to implement this could lead to inflationary financial policies and excessive borrowing from the central bank
4. The theory encourages dependence on other countries for funds and any other inputs especially in the first stages in most LDCs
5. It may involve harsh measures imposed on the people for example encouraging voluntary and involuntary savings, high taxes, deduction in wages, increase in interest rate etc in order to raise enough funds for capital accumulation which may have a negative effect on the well fare of the people
6. It leads to economic dualism because it involves imposition of an entirely self contained modern industrial sector upon stagnant and equally self contained traditional sector. This is not growth
7. It results into losses incase some projects fail
8. It does not consider planning. Balanced growth theory is primarily related to private enterprise economy where the need for planning does not promote simultaneous investment in all sectors requiring planning, direction and co-ordination by the government

APPLICATION OF BALACED GROWTH THEORY IN LDCS/LIMITATIONS/CONSTRAINTS TO THIS THEORY

Due to the following problems. This theory is not applicable in LDCs

1. Inadequate basic raw materials in LDCs does not favour simultaneous development of all sectors of the economy hence the theory is inapplicable
2. Inadequate capital necessary to buy funds for simultaneous development of all sectors of the economy
3. The theory assumes that there is a relation ship between industries of complementary nature (forward and backward linkages which is not true in LDCs as industries may have to complete for capital, skilled man power and raw materials many other supplies
4. The theory does not consider the comprehensive planning exercise which may be involved. It only suggests equilibrium expansion of the sectors so that the demand and supply of resources are the same
5. The theory does not for see the problem of small markets in LDCs. It is a fact that the absorptive capacity in LDCs is very low i.e. the rate at which commodities are bought and consumed is very low. All this is due to weak purchasing power at sectoral level
6. High population growth rates in LDCs i.e. high population pressure forces a country to spend too much on supplying social services e.g. transport, health care, education etc yet high expenditure reduces the availability of funds to implement a balanced growth theory

7. Political instabilities which makes some areas warzones such that they cannot be developed like other areas hence the theory won't be applicable
8. Inadequate foreign exchange which is due to poor earnings from exports which limits the importation of necessary in puts to implement a balanced growth e.g. importation a advanced technology
9. Deficit budget and general poor performance in international trade i.e. LDCs are characterized by borrowing to finance deficit budgets and this leaves no funds for balanced growth theory. Again what they pay in terms of imports is greater than what they earn from exports leading to balance of payment problems thus making the theory inapplicable
10. Economic dualism which is common in LDCs for example the subsistence economy exist together with the monetary economy; literacy versus illiteracy, poor versus the rich. Such groups therefore will give assistance to balanced growth because the undesirable nature or group may require heavy attention in order to be at the same level with the desired ones. This may be impossible due to inadequate finance
11. Low incomes and some times the viscous cycle of poverty can also hinder the applicability of balanced growth theory
12. Limited entrepreneurship skills in LDCs limit the operation of the theory because it necessitates the simultaneous development of all sector of the economy which requires large class of entrepreneurs

UN BALANCED GROWTH THEORY

This strategy was developed by professor **Albert Hirschman** and states that "leading sectors with strategic importance be selected and expanded first so that they pull up or develop other sectors through linkages

According to this strategy, growth has to proceed, proceed from the leading sectors which would provide linkages to other factors which would follow later thus industries with both back ward and forward linkages should be given priority since they can promote development of other industries

A forward linkage is a situation where the establishment of an industry results into establishment of another where the new industry uses the out put of the former as its inputs e.g. establishment of a sugar industry resulting into the development of sweets industry

A backward linkage is a situation where the establishment of an industry results into establishment of the other which provides inputs for the former industry e.g. a sugar industry leading to the establishment of a sugarcane plantation

ADVANTAGES OF UN BALANCED GROWTH THEORY

1. It encourages linkages between various sectors of the economy thus increasing the level of investment and capital accumulation
2. It is more realistic for developing countries considering the limited natural resources that these countries have
3. It brings about optimum utilization of resources. This is because resources are allocated first in priority sectors and then others follow. This enables LDCs to concentrate on leading sectors which can help in development of others
4. It minimizes the need for foreign aid since LDCs allocate their idle resources in particular sectors and others follow hence encouraging self reliance
5. It favors the inadequate skilled labour and capital in LDCs

6. It encourages specialization in the economy which helps to increase both the volume and quality of commodities produced
7. It is easy to plan for un balanced growth since it is only a few sectors that are catered for and others later
8. It provides a basis for industrialization of developing countries because industries have more linkages than primary producing sectors thus contributing to national income of the country
9. It favors the limited market in LDCs as it would be wastage of resources to produce goods that are not currently demanded

DISADVANTAGES OF UN BALANCED GROWTH THEORY

1. There is a problem of identifying the sectors or industries that have maximum forward and backward linkages
2. It encourages rural-urban migration which brings problems like open urban unemployment because rural areas are usually neglected so can not be identified as priority areas leading to poor performance of agriculture
3. It is associated with inflation as resources are invested in production of few commodities leading to scarcity of others in the domestic market leading to structural inflation
4. It worsens the problem of income inequality and uneven regional development. This is because sectors and areas which are invested into grow at the expense of others
5. It increases foreign dependence as LDCs won't be able to produce all that they need thus the need for imports leading to high capital outflow
6. It can lead to unemployment in the sectors and areas that are ignored by investors leading to persistent underdevelopment in LDCs
7. It increases the problem of BOP position since it increases imports and reduces exports because a country concentrates on the leading sector which means foregoing some products
8. It advocates for specialization which involves risks i.e. concentrating on one or a small number of products can make a country suffer from effects like fluctuations in the world demand and supply
9. It may encourage subsistence production which is an indicator of poverty. This is because places and regions which are not of priority may remain on a subsistence basis in production
10. The narrow domestic consumer market may not permit the effective operation of the strategy

THE BIG-PUSH THEORY

The theory of big push states that massive investment should be done in a variety of industries and economic infrastructures in order to transform the economy into a self sustaining economy. The theory advocates for a sharp and sudden increase in the rate of investment in order to transform the backward agricultural economies to self sustaining economies with in a short period of time

It calls for a certain minimum level of investment (critical minimum effort) in order to break through the vicious cycle of poverty and achieve development

Critical minimum effort refers to the minimum investment required to attain massive capital stock necessary for an economy to take off

ADVANTAGES OF BIG PUSH THEORY

1. It bridges the gap between the poor and the rich due to jobs being created by the industrial sector
2. The theory encourages planned industrialization which increases the national revenue and hence reduces heavy dependency on external borrowing
3. It promotes development of labour skills due to a wide range of industries emphasized which accelerates the process of economic growth and development
4. The forward and back ward linkages are stimulated through establishment of complementary industries. This minimizes the problem of finding markets of the industrial output
5. It creates more employment opportunities because of the emphasis on labour intensive industries. This improves on the standard of living of people in the country
6. External economies of scale are enjoyed due to proximity of large numbers of industrial establishments. This will promote economic transformation
7. The big push strategy cal lead to increase in export earnings thus improving the country's BOP position
8. It facilitates the diversification of the economy necessary for economic development due to industries established to provide a variety of products
9. It leads to increase to an increase in GNP as more goods and services are produced

DISADVANTAGES OF THE BIG PUSH THEORY

1. It encourages dependence in terms of raw materials, foreign skilled man power since these are lacking in LDCs
2. It causes over production of the industrial products leading to dumping
3. It leads to income inequalities since most of the industries are urban based
4. The massive investment and expenditure causes excess money supply in the economy leading to inflation
5. It ignores investment in agriculture since it emphasizes establishment of industries and economic infrastructures hence it's inapplicable in LDCs which are dependant on agriculture
6. Incase of uncertainties and misfortunes the losses are enormous
7. It ignores the role of private sector in mobilizing savings and local investment because it relies more on public sector investment
8. It might be inflationary as it emphasizes massive investment and expenditure which stimulate excessive aggregate demand

LIMITATIONS OF THE BIG PUSH THEORY IN LDCS

1. The inadequate capital to finance the strategy is an obstacle towards the success of the program
2. Limited markets in LDCs limit the theory to operate
3. Political instability in LDCs limits the theory
4. Limited entrepreneurship skills in LDCs
5. Low level of technology in LDCs limits the theory
6. Underdeveloped infrastructures like un stable power supply, poor road net work etc

Revision questions

1. "***Developing countries should adopt un balanced growth strategy if they are to achieve a faster rate of development". Discuss***
2. ***Developing countries should adopt un balanced growth theory rather than a balanced growth strategy if they are to achieve a faster rate of development. Discuss***

DEVELOPMENT GOALS /MELLENIUM DEVELOPMENT GOALS (MDGs)/MACRO ECONOMIC GOALS

A development goal is a target or objective which is economic, social or political to be achieved in a specified period of time

Or

It the intended growth and development objectives a country aim at achieving in a given period of time

The following are the millennium development goals that most economies strive to achieve

1. Achieving a high rate of economic growth/GDP. Most economies strive to achieve the rapid steady and self sustaining expansion in the per capita required to in the production of goods and services
2. Achieving full employment. Generation of substantial increase in employment opportunities is what most economies work hard to achieve i.e. they strive to completely eliminate involuntary un employment through setting up projects that can provide jobs to people
3. Achieving price stability/reducing inflation. Frequent changes are big disincentive to investment; make governments un popular and also make planning for most economies difficult that is why most governments strive to keep price levels stable
4. Achieving favorable balance of trade, terms of trade and balance of payment position. This is attained through improved terms of trade, building strong foreign exchange reserves, maintaining stable exchange rates and closely monitoring the foreign exchange sector etc
5. Creating a fairer distribution of income and wealth. Through proper allocation of resources irrespective of the region, sex' tribe, race etc
6. Building an independent, self-sustaining economy through increasing the volume of exports and reducing imports in the country
7. Reduction of poverty and ignorance. Majority of the people in LDCs are below the poverty line and this explains why most developing countries strive reduce poverty
8. Reduction of HIV/AIDS and malaria. There is high prevalence rate of malaria and HIV in most developing countries that is why most economies strive to prevent the spread of such diseases through massive sensitization of people about the danger of such diseases
9. Indigenization of the economy i.e. creating a mechanism that enables the country to be managed by citizens of the country
10. Infrastructural development such as improved road network, well developed banking system, adequate power supply etc
11. Transformation of the economy from one dominated by agriculture to one dominated by industrial sector particularly manufacturing and service sector
12. Achieving political stability in all parts of the country

REVISION QUESTIONS

1a) Distinguish between economic development and economic underdevelopment

b) Account for low levels of development in your country

2a) what is meant by the term economic growth?

b) Examine the implications of economic growth in your country

c) Why most LDCs have stagnant economic growth rates

3a) explain the traits of poverty in your country

b) Account for high poverty rate in Uganda

4a) Uganda should adopt unbalanced growth strategy if she is to achieve a high rate of economic growth and development. Discuss

5a) Describe the Rostowian stages of economic development each progressive economy must pass through to achieve sustainable development

6a) Distinguish between critical minimum effort and Big push theory of economic growth

b) What are constraints to the effective operation of big push theory in LDCs?

7a) explain the macro economic development goals that an economy strives to achieve

b) What factors may hinder an economy from achieving these macro economic development goals

8a) Distinguish between underdeveloped countries and least developed countries

b) To what extent are the Rostawian stages of economic growth relevant?

c) In what Rostowian stage does your country fall? Give reasons

9a) Account for persistent under development in your country

b) Suggest workable ways of stimulating the rate of economic growth and development

10a) Economic growth does not necessarily mean economic development. With reference to your country justify the statement

b) Discuss the millennium development goals your country is striving to achieve

11a) To what extent are external factors responsible for low levels of economic development in your country.

b) Uganda should adopt a balanced growth theory rather than unbalanced growth theory if she is to achieve a faster rate of economic growth and development. Discuss

DEVELOPMENT PROCESS AND CHOICE OF DEVELOPMENT STRATEGY

A development strategy is abroad policy guideline that a government follows in formulating and executing long term policies for national development.

Development process refers to how the existing factors of production are combined within the limits of existing technology to raise people's standards of living I,e adopt methods of production which use the existing resources efficiently.

In away of achieving development goals, a development stratergy has the following components or elements;

Choice of techniques of production (methods of production)I.e. labour intensive or capital intensive

Choice of a leading sector i.e. agriculture or industrial

Resource ownership i.e. private or public sector or both

The objectives to be achieved, this could be an increase in employment opportunities, a reduction in income inequality, diversification, etc.

Identification and use of available resources

Choice of the nature of the economy i.e. outward looking (open economy) or inward looking (Closed economy)

IMPORT SUBSITUTION STRATEGY (INWARD LOOKING DEVELOOPMENT STRATEGY)

Is an industrial development strategy that aims at establishing industries to produce goods locally which were formerly imported so as to minimize outflow of capital of foreign exchange and increase the volume of goods in the domestic market.

Therefore it is a situation where a country tries to produce most of its requirements which were formerly imported so as to participate less in international trade

It is aimed at achieving self reliance in a wide range of consumer goods by replacing imports with products produced locally

It a policy that stresses economic self reliance and reduced foreign dependence through the use of locally available resources and technology

OBECTIVES OF IMPORT SUBSITUTION DEVELOPMENT STRATEGY

1. To increase the volume of goods and services in the domestic market
2. To increase government revenue through taxation
3. To increase employment opportunities in the country
4. To improve the country's BOP
5. To achieve a faster rate of economic growth
6. To save the scarce foreign exchange
7. To promote development of local skills thus reducing imported expatriates
8. To reduce imported inflation

REQUIREMENTS FOR A SUCESSFUL IMPORT SUBSITUTION STRATEGY

1. Availability of basic raw materials in form of minerals, agricultural produce and intermediate goods
2. Skilled labour, highly skilled manpower is necessary for faster development of the industrial sector
3. Energy facilities or stable and adequate power supply facilities.

4. Adequate transport and other physical infrastructural facilities. This is because import substitution strategy succeeds where there is supportive infrastructure inform of good transport and communication, banking facilities, insurance etc
5. Protectionism especially for the new home industries. Infant industries meant to produce substitutes to imports must be protected to give them an opportunity to grow
6. Fiscal incentives like tax holidays and exemptions in order to help the high cost infant firms
7. Local or indigenous appropriate technology. Appropriate production techniques encourage high expansion of the manufacturing sector since such production method make use of the local resources
8. Developed class of entrepreneurs in order to encourage development of local firms
9. Expansion of domestic market since a wide market is an attraction to expanded production
10. Sufficient capital stock to facilitate development of appropriate production techniques, research and massive

Revision question:

Explain the factors that limit successful implementation of import substitution development strategy in LDCs

Examine the factors that lead to successful implementation of the strategy

ADVANTAGES (ARGUMENTSFOR) IMPORT SUBSITUTION STRATEGY

1. It leads to economic growth as the volume of goods and services increases leading to high standards of living
2. Creation of employment opportunities arising from the setting of infant industries hence generating directly employment opportunities with in the industrial sector or indirectly in supplementary sectors which have linkage with the manufacturing sector like agriculture
3. It saves the scarce foreign exchange. This is because the strategy ensures limited capital outflows thus attainment of favorable BOT position in the long run
4. It promotes the manufacturing sector since this strategy emphasize setting of industries locally and this finally leads to economic transformation since most LDCs are basically agro-based in nature
5. It is cheaper to implement since the raw materials are locally available e.g. cotton for textile industries, animal feeds etc
6. It promotes research which results in better production techniques and new goods and services in order to meet the market requirements
7. It promotes the development of basic infrastructure, the establishment of local industries calls for strengthening of infrastructural facilities in the economy inform of transport and communication, power supply, modern storage facilities, banking systems etc
8. Import substitution strategy promotes development of local skills through intensive training and thus reducing dependence on imported expatriates hence saving foreign exchange further
9. It increases government revenue through taxation of local industries and tariffs imposed by government to protect the infant industries
10. At an advanced stage import substitution industries can be developed into export oriented industries as well as serving the domestic needs e.g. sugar processing industries and beer industries in Uganda
11. If industries are evenly distributed, it will promote both regional development and equal income distribution through creating of many employment opportunities

12. It brings about self sufficiency in the long run hence reducing on the dependence problem
13. It reduces on the rate of imported inflation because it uses locally available resources
14. It facilitates inflow of foreign capital especially brought in by the foreign investors engaged in the manufacturing process

DISADVANTAGES OF IMPORT SUBSITUTION DEVELOPMENT STRATEGY

1. It may result into high capital outflow through importation of intermediate inputs required in the manufacturing industries
2. Poor quality products are locally manufactured since most of the import substituting firms tend to be protected thus less competition from foreign products
3. It leads to rural urban migration since most industries are urban based in LDCs with its adverse effects like congestion, high crime rate, and poor performance of agriculture

4. It may result into high domestic prices due to high production costs of goods
5. The strategy tends to limit consumers' choice since its implementation involves restricting imports leading to low standards of living of the people
6. It leads to profit repatriation since most industries in LDCs are owned by foreigners thus leaving such countries under developed
7. Import substitution strategy involves the use of capital intensive technology and technology transfer which results in technological un employment as human labour is replaced by machines like tractors, computers etc
8. It results into wastage and over utilization of resources as consumers in LDCs have a demonstration effect by referring imported goods to those produced locally
9. import substitution development strategy increases government expenditure in terms of implementing it which may result in contracting debts to meet the expected costs
10. import substitution development strategy tends to over concentrate on consumption goods e.g. beverages, detergents etc implying that LDCs shall continue importing capital goods which may result in imported inflation
11. it may create monopoly tendencies in an economy and their adverse effects serious shortages during industrial break down due to high level of protection and limited competition
12. it may result into production at excess capacity due to limited domestic consumer market due to low levels of income and purchasing power
13. it leads to increased social costs in form of pollution like air, water and noise pollution which results into diseases like cancer, environment degradation etc

Revision questions

To what extent is import substitution development strategy ideal to your country?

Explain the implications of import substitution development strategy in LDCs

Examine the advantages and disadvantages of import substitution development strategy in an economy

PROBLEMS/OBSTACLES/CONSTRAINTS TO IMPLEMENTATION OF IMPORT SUBSITUTION DEVELOPMENT STRATEGY

1. Inadequate capital. LDCs are faced with capital constraints due to poverty and limited credit facilities hence they can not easily cope up with the industrial processes
2. Insufficient skilled personnel due to the poor education system. This implies dependence on foreign man power which is too expensive to maintain
3. Poor infrastructures in general making it difficult for these industries to takeoff e.g. the poor state of roads, inadequate and unstable power supply

4. Limited market since most of the population in LDCs is poor and below the poverty line. This limits production on large scale and even the industrial out put is not of a good quality to be taken to the world market
5. Demonstration effect i.e. most people prefer foreign goods which are cheaper and of high quality to local produce
6. Political instability and unrest in developing countries. This limits investment in the industrial sector hence an obstacle to industrial development
7. Limited entrepreneurial class. The existing entrepreneurship class is small making it hard for most developing economies to implement the strategy
8. Inadequate basic inputs needed in industries limits the implementation of the strategy. Most LDCs lack basic raw materials needed for import substitution industries to operate for example minerals, fuel etc
9. Underdeveloped money and capital market markets in LDCs limit the implementation of the strategy. This also accounts for high cost of borrowing and lack of collateral security
10. Unfavorable government policy of high taxation and low subsidization discourages the would be potential investors in the industrial sector
11. Low levels of technology in developing countries are also a constraint to implementation of this strategy. Because it requires advanced technology for example use of modern machines in most of the industries this is lacking

EXPORT PROMOTION STRATEGY

It refers to a development strategy of promoting the domestic manufacturing sector with a view of increasing the export base of the manufactured goods or an industrial development strategy aimed at construction of industries to produce goods for foreign markets. It involves attraction of foreign resources to foster the development of an economy

Out ward looking development strategy encourages the flow of free trade, free movement of capital, labour extensive foreign investment in form of multinational corporations

OBJECTIVES OF THIS STRATEGY

- To increase exports
- To increase government revenue
- To increase employment opportunities
- To improve the BOP position etc

POLICIES INVOLVED

- Reduction in protective tendencies
- Liberalization of the market
- Liberalization of foreign exchange market
- Improve on the quality of production
- Improve on transport and communication network

CONDITIONS NECESSARY TO A SUCCESSFUL EXPORT PROMOTION STRATEGY

Explain the necessary conditions for a country to attain a successful export promotion strategy.
The following are the conditions necessary for export promotion to be successful:

1. Sufficient productive raw materials and intermediate goods in form of natural resources' semi processed goods etc
2. Adequate capital to make it possible to lay down the necessary infrastructures, promote research and technology development
3. Skilled man power should be available with necessary management and entrepreneur skills
4. Well developed and distributed energy facilities to foster the development of industries
5. Well developed transport and communication facilities to facilitate easy movement of goods and raw materials from one place to another
6. There must be developed technology to facilitate production of high quality goods which can compete on the world market
7. Massive advertisement most especially in the world market
8. Fiscal incentives to exporters in form of tax holidays, subsidies in order to encourage the development of the export sector
9. There must be a sufficient market in foreign countries and market research can be carried on to identify the products needed and also discover other market potentials

ADVANTAGES OF EXPORT PROMOTION OR ARGUMENTS FOR EXPORT PROMOTION STRATEGY

1. It increases foreign exchange earnings of the country through increased foreign exchange. This improves on the BOP position of the country
2. It creates more employment opportunities in the country especially if they are labour intensive and produce on large scale. This increases the earnings of people thus improved standards of living
3. It increases the volume of out put which promotes economic growth in the country
4. It encourages full utilization of resources in LDCs by widening external market. This reduces excess capacity and encourages the use of idle resources
5. It encourages the production of high quality goods which can compete favorably on the international market leading to improved standards of living of people
6. It promotes international relations and co-operations among countries through exporting of various commodities
7. It leads to increased government revenue through the widened tax base. This enables the government to extent social services to the people
8. It facilitates industrial development as more industries are established there by creating both forward and back ward linkages
9. It facilitates foreign capital inflow especially brought in by the foreign investors engaged in the manufacturing industries
10. It promotes the diversification of exports this reduces dependence on few export products thus minimizing un desirable effect of commodity concentration of trade
11. It widens consumers' choice due to production of variety of goods and services in an economy
12. It facilitates the development of infrastructure like power supply, rehabilitation and expansion of main roads which are pre-liquisities for the establishment of this strategy
13. Export promotion encourages technology transfer and development in LDCs this results in production of high quality goods and services

DISADVANTAGES OF IMPORT SUBSITUTION DEVELOPMENT STRATEGY

1. It results in over utilization of resources leading to their quick depletion especially those which are non renewable. This hinders a country from a achieving **sustainable development** i.e. development which caters for the **present and future generation**
2. Shortage may occur in the domestic market thus bringing about the problem of scarcity and demand pull inflation
3. Foreign dominancy is encouraged as many industries may be owned by foreigners leading to profit repatriation and leaving developing countries under developed
4. It may lead to unemployment due to use of machines and foreign expatriates with skills
5. Export promotion increases government thus neglecting some social services leading to low standards of living of the citizens
6. The strategy requires huge amounts of capital which lack in most LDCs

Revision questions

I. "***LDCs should adopt an inward looking development strategy if they are to achieve rapid development" Discuss***
II. ***Explain the implications of adopting an export promoting strategy in LDCs to attain economic development***
III. ***What are the limitations to export promotion strategy in LDCs?***

LIMITATIONS TO EXPORT PROMOTION STRATEGY IN LDCS

1. Insuffient skilled man power to implement the strategy
2. Small entrepreneurship class in LDCs is also a set back to the implementation of this strategy
3. Inadequate capital to set up industries and to carry out market research
4. Poor transport facilities making it difficult to access inputs and distribute final out put to external markets
5. Inadequate credit facilities as most of the investors in LDCs are poor
6. Lack of well established export promotion institutions to sensitize and monitor the program and also assist in financing weak exports
7. Inadequate foreign exchange to advertise in the export market
8. Highly priced commodities. The products manufactured in LDCs tend to be of high prices because most of the equipments used are imported so they tend to be neglected in most foreign market
9. MDCs impose heavy restrictions on imported manufactured goods from LDCs thus reducing the market
10. MDCs tend to discriminate manufactured goods from LDCs they instead prefer primary products and as a result LDCs have continued to export primary products
11. Most LDCs have almost similar products for export thus exporting to other countries is faced with stiff completion and import restrictions
12. The prevailing political instabilities in LDCs is a major hindrance towards the establishment and maintenance of export promotion industries
13. Low levels of technology in LDCs lead to production of poor quality goods and services

MEASURES TO ENSURE GREATER EXPORT EARNINGS

1. Tariff reforms (protectionism) i.e. by reducing taxes on exports. This in the long run may stimulate exports for example making exports tax free
2. International negotiations and formation of economic co operations to expand the markets. Expansion of export markets may require negotiations with a number of international organizations and formation of bi-lateral agreements that may strengthen LDCs bargaining power

3. Selective trade control policies. Through these policies, the government may argue commercial banks to give higher priority to the requirements of exporters
4. Establishment of a compensation scheme which aims at partial compensation of eligible exports for example for high costs of production, fluctuating prices etc
5. Modernization of agriculture through NAADs, PMA, and NARO to increase the volume of exports since it is the dominant sector in most LDCs
6. Infrastructural improvement i.e. rehabilitating main roads and improving impassable feeder roads in rural areas, adequate power supply etc
7. Political stability in all parts of the country should be maintained to create a conducive investment climate
8. Technology transfer and development should be encouraged in order to produce good quality export products that can compete favorably on the world market

Revision questions

- ✓ Distinguish between inward and out looking growth strategies
- ✓ What have been the limitations of export promotion industrial development strategies?
- ✓ Explain the steps have been taken by the government to ensure greater export earnings
- ✓ How is the government of Uganda ensuring greater export earnings?
- ✓ Examine the advantages and disadvantages of export promotion development strategies over import substitution development strategy
- ✓ Explain the objects of import substitution strategy in your country

CHOICE OFTECHNOLOGY AND DEVELOPMENT

Technology refers to the skills, knowledge and procedures of making, using and doing productive activities. It also refers to the methods of production that involve the use of applied science in form of production in order to increase the productivity of a country's resources

TYPES OF TECHNOLOGY

a) Capital intensive technology (labour saving technology)
b) Intermediate technology
c) Appropriate technology
d) Technology transfer and development

The choice of techniques of production in LODCs depends on: relative price ie price of labour Vs price of capital, availability of technology, employment creation, level of development of the country, benefits and problems of the technology

CAPITAL INTENSIVE TECHNOLOGY (LABOUR SAVING TECHNOLOGY)

Is a method of production that uses proportionately more capital than other factors of production particularly labour in the production process

ARGUMENTS FOR CAPITAL INTENSIVE (ADVANTAGES/MERITS/POSITIVE IMPLICATIONS)

1. It increases the productivity of other factors of production like labour thus increasing the volume of goods and services in the economy it minimizes chances of labour strikes thus reducing the possibility of destruction of property

2. It increases the level of capital accumulation due to greater savings. This is because amount spent on wages is low leading to more profits for re-investment thus accumulating more capital
3. It minimizes the costs of employing and maintaining very many workers thus reducing the costs of production and selling goods at relatively cheaper price
4. It leads to development of skills among the workers as it requires training of labour to use the complicated machinery
5. It facilitates technology transfer and development which help LDCs to improve on the quality of out put and quantity
6. It produces high quality products which can compete favorably on the international market thus fetching more foreign exchange
7. It facilitates the development of infrastructure for example roads, power supply, storage facilities since its implementation necessitates so
8. It is time saving thus insuring adequate supply of commodities whenever they are needed
9. It helps in transformation of an economy from dominantly agriculture economy to industrial oriented one since it promotes the manufacturing
10. In the long run it increases the level of employment opportunities since it increases the level of savings and investments in the economy. Thus expanding the scale of operation
11. Economies of scale are enjoyed in form of reduced average cost due to large scale production

DISADVANTAGES OF CAPITAL INTENSIVE TECHNOLOGY

1. It causes technological unemployment as many workers lose their jobs when they are replaced by machines
2. It requires high skilled man power which is scarce gin LDCs due to low levels of education and poor education system
3. It increases the problem of external dependence in the economy since it requires the importation of expensive capital goods like spare parts, computers etc. this may worsen the BOP problem in LDCs
4. The small market in LDCs can hardly sustain the high levels of out put. This implies wastage of resources by producing a lot of commodities which are not consumed
5. It increases the problem of income inequality in the economy between those who can afford the strategy and the majority poor who still use rudimentary production method
6. It is expensive since it involves high initial costs to install the machines and high maintenance costs.
7. It may lead to depletion of resources due to over exploitation hence making the future generation vulnerable to scarcity of resources
8. It involves high social costs such as pollution of air and water, noise etc. this results in diseases like cancer leading to low standards of living
9. It encourages profit repatriation since it is mainly employed by foreigners who have capital to buy machines
10. It is inappropriate in activities where human judgment is important for example harvesting since employing it in such activities may reduce the quality of out put produced
11. It leads to rural urban migration since it is mainly applied in urban centers leaving rural areas un developed. This results in congestion, open urban un employment etc

LABOUR INTENSIVE TECHNOLOGY (CAPITAL SAVING)

This is a production method which uses proportionately more labour than capital in production. It is suitable in countries that have more labour than capital

ARGUMENTS/ADVANTAGES OF LABOUR INTENSIVE TECHNOLOGY (CAPITAL SAVING)

1. It provides employment to the majority of the population particularly the unskilled and semi skilled labour. Thus improving peoples' standards of living
2. It provides a fair income distribution amongst the majority since many people are actively involved in income generating activity. This reduces social unrest in the country
3. It is relatively cheap and easily adopted. It requires simple tools which can even be locally produced and abundant supply of unskilled and semiskilled labour in LDCs
4. It reduces rural urban migration sine it is more suitable in rural areas where agriculture is mainly carried out thus making rural people employed
5. It saves a country's foreign exchange as it requires simple tools which are less costly and can be produced at home
6. Labour intensive technology encourages development of craft man ship in workers which is a basis for industrialization
7. It increases aggregate demand in an economy since every boy has access to income thus widening the market for local produce
8. It reduces external dependence sine it does not require high skilled man power implying that LDCs can easily utilize their local human resource thus stabilizing the BOP position
9. It widens the tax base due to many people being employed using labour intensive technology. This enables the government to extend social services to its people
10. It is the most suitable technique in the dominant agricultural sector, since its applicable at almost all levels

DISADVANTAGES/ ARGUMENTS AGAINSTLABOUR INTENSIVE (CAPITAL SAVING TECHNOLOGY)

1. It may be very expensive in the long run in terms of high wages and other benefits which lead to high costs of production. Thus discouraging investment
2. It produces low quality products due to less standardization. This leads to difficulty in getting market for the commodity
3. It leads to low levels of out put as a result of inefficiency created in the production process. This retards the process of economic growth and development
4. The risks of strikes and labour unrest are very high since more labour is employed. The many workers can easily organize themselves and strike incase of any misunderstanding
5. It requires close supervision of the workers which may be costly
6. It hardly provide jobs to the educated since it does not employ so many skilled personnel in the production process
7. It worsens the BOP problem in LDCs due to increased importation of capital goods and spare parts from MDCs.
8. Labour intensive wastes a lot of time and this result into failure to respond to rapid structural changes
9. It may discourage foreign investors familiar with operating heavy industries

INTERMEDIATE TECHNOLOGY

Refers to a production method which is neither capital nor labour intensive. It is nether too advanced nor too primitive

FEATURES OF INTERMEDIATE TECHNOLOGY

- It uses both labour and capital in fair proportions
- It should optimally utilize the available local resources
- It should lead to a balanced regional development and greater dispersion of industries
- It must be capable of being easily adopted into existing plan targets

WAYS OF OBTAINING INTERMEDIATE TECHNOLOGY

Upgrading the existing traditional technology
Degrading the advantaged technology
Entirely develop intermediate technology without basing on existing ones

MERITS OF INTERMEDIATE TECHNOLOGY

1. It creates more employment opportunities in LDCs since it strikes the balance between labour and capital intensive technology. This improves on people's standards of living
2. It reduces the cost of urbanization by creating rural based industries like congestion, development of slums, high crime rates etc
3. It reduces inequality in development and income between the rural and urban areas since it is relatively cheap and affordable by many people. It also strikes the balance between labour intensive and capital intensive
4. It is relatively cheap and therefore affordable by LDCs since it does not require sophiscated skills
5. It reduces rural-urban migration with it's associated like high crime rates, congestion, development of slums etc problems since it is rural based technology
6. It leads to development of skills, inventions and innovations which creates a technological base for LDCs
7. It leads to better resource utilization since it is based on local resources
8. It promotes and facilitates the development of local small scale industries distributed all over the country
9. It saves the scarce foreign exchange since it uses locally available resources thus reducing external dependence

DISADVANTAGES OF INTERMEDIATE TECHNOLOGY

1. It is difficult to obtain it because it is hard to up grade sine people may be reluctant to learn new methods of production
2. It requires research and investment especially where it involves the development of new machinery
3. The technology is only applicable on a limited range of industries such as grain milling, bakery
4. Production of inferior goods or poor quality goods
5. It requires some capital which is lacking in LDCs

APPROPRIATE TECHNOLOGY

Refers to the method of production which is socially, economically and technologically suitable for a given country in terms of available resources and development requirements

TECHNOLOGICAL TRANSFER AND TECHNOLOGICAL DEVELOPMENT

TECHNOLOGY TRANSFER

It refers to the shifting or movement of knowledge, skills, and new and efficient production techniques from one economy to another. Mainly from developed economy to less developed economies

TECHNOLOGY DEVELOPMENT

Is the process of introducing, initiating, and improving the indigenous means of production

WAYS OF TECHNOLOGY TRANSFER

1. Direct foreign investment i.e. the sale of technology in form of machinery, equipments, raw material, processed, training management etc specialized services like financial, managerial, engineering, construction etc
2. Training of skills i.e. training of personnel, conducting seminars/short courses, research etc
3. Product transfer i.e. sale of technology which include complete product process, product mix, drafts, design etc
4. Transfer of knowledge that is when knowledge about modern technologies is passed on through scientific exchange in form of research etc

ADVANTAGES OF TECHNOLOGY TRANSFER

1. It creates more employment opportunities and this helps to reduce unemployment problem in the long run due to massive investments and skills development
2. It helps LDCs to over come backwardness. The transfer of technology from MDCs brings in advanced production techniques and machines, innovations in products, skilled personnel, marketing techniques etc
3. It increases productivity of factors of production in order to lower the per unit cost of production. This can be done by transferring capital intensive technologies from the DCs to LDCs
4. It accelerates economic growth since it encourages production on a large scale thus increasing employment of the local people
5. It fills the technological gap. This can be bridged by technology transfer from MDCs. Modern technology supplements the available indigenous technology and helps in modifying and adopting advanced technology in LDCs
6. It promotes the development of basic and key industries. Technology transfer is required by the LDCs to built their infrastructures, to tap natural resources and to establish new industries
7. It helps to improve efficiency in production thus reducing the average costs of production and prices of commodities
8. It solves the problem of BOP. With establishment of export promotion industries and import substitution industrial strategies the transfer of technology tends to increase exports and reduce imports there by improving the country's BOP position
9. It helps to improve the quality of commodities produced thus ensuring local producers' ability to compete with goods from other countries
10. It facilitates exploitation of idle resources in the economy thus increasing the country's National income
11. It leads to social and cultural transformation of the population it the ties of traditionalism are broken thus leading to economic development
12. Technology transfer improves on international relationship between countries thus facilitating international trade

ARGUMENTS AGAINST TECHNOLOGICAL TRANSFER

1. It encourages use of capital intensive technology of production thus causing the problem of technological unemployment
2. It discourages local initiatives and discourages since the local people can have access to the imported technology
3. It increases the problem of dependency since research is carried out in the country where it is imported from

4. It deprives LDCs of their scarce foreign exchange since they have to import expensive capital goods and spare parts plus other inputs from abroad
5. It increases the need for foreign aid since LDCs can not sustain it without borrowing thus expanding the size of national debt
6. It encourages dependency on foreign experts who are needed to operate the machines such expatriates are expensive to maintain
7. It encourages uneven regional development and income inequality since it is basically adopted in urban areas

ECONOMIC DIVERSIFICATION

This refers to the deliberate government effort to reduce dependence on one sector by creating many sectors and activities within the economy. It involves reliance on wide variety of products from several sectors

TYPES/FORMS OF ECONOMIC DIVERSIFICATION

SECTORAL DIVERSIFICATION: This refers to creation and development of several sectors within the economy g agriculture, industry, tourism, transport etc

INTRA-SECTORAL DIVERSIFICATION: This refers to the creation of a variety of economic activities within a sector e.g. in agriculture sector it may involve the growing of variety of crops

INTER-SECTORAL DIVERSIFICATION: this refers to the creation of variety of interdependent sector which have mutual interrelationships i.e. forward and back ward linkages

REGIONAL DIVERSIFICATION: This refers to the setting up several economic activities within a region and within different regions in the country e.g. ensuring that every region within the country has agriculture, industry and several sectors

HOW TO DIVERSIFY THE ECONOMY

A) Diversification within the agricultural sector

This is the creation of a number of economic activities or productive activities in the agricultural sector. It involves the introduction of various crops, so that if one crop is affected others may help in raising farmers' incomes. It also includes livestock rearing to supplement low production and possibly the setting up of processing industries

REASONS FOR DIVERSIFICATION OF AGRICULTURE (REFER TO AGRICULTURE NOTES)

B) Promotion of manufacturing sector

This involves setting up different plants or industries producing different consumer and capital goods in order to reduce reliance on agriculture. Its advantages and problems are similar to those of export and import promotion strategy

ARGUMENTS FOR EONOMIC DIVERSIFICATION

1. It increases foreign exchange earnings since a variety of products produced can increases the country's export potential
2. It increases government revenue through taxation of many economic activities which enables the government to extent social services to the people
3. It increases supply of raw materials to manufacturing industries which promotes the development of agro-based industries
4. It increases out put thus promoting economic growth. Economic diversification is a step towards self sufficiency in the production of goods
5. It reduces income inequality and promotes stability of incomes of the people due to many economic activities in the economy a loss in one can be compensated by profits made from other activities
6. It increases employment opportunities within the economy, seasonal unemployment can be reduced since there several activities undertaken through out the year
7. It minimizes the effect of price fluctuation in the economy: introduction of a variety of products within the sector can lead to price stability since the supply of commodities can be sustained
8. It reduces rural urban migration since as most people will be engaged in several activities in the agricultural sector. Hence increased rural incomes
9. It reduces external dependence due to reduced commodity concentration of trade as a result of many economic activities in the country
10. It widens consumers' choice since diversification involves production of a wide variety of goods thus improving their standards of living
11. It takes advantages of all possible linkages that will exist in an economy and thus minimizes wastage of resources
12. It leads to attainment of regional balance in development since LDCs join their efforts to eradicate social and sectoral dualism through diversifying their economies

ARGUMENTS AGAINST ECONOMIC DIVERSIFICATION

1. Inadequate capital available to producers which limits the use of modern technology in the production of goods
2. Limited domestic and foreign markets for goods discourages output within an economy
3. Poor infrastructure development especially roads in rural areas hinders access to markets of raw materials
4. Political instability and unrest discourages production in some parts of the country
5. Conservatism of people especially being rigid to change from traditional methods of production
6. Poor land tenure system limits agricultural diversification
7. Inadequate entrepreneurship ability and skills to apply modern production methods
8. Inadequate skilled manpower
9. Low levels of technology in LDCs

REVISION QUESTIONS
Distinguish between intermediate technology and appropriate technology
Explain the arguments for and against technology transfer and development
Explain the advantages and disadvantages of labour intensive technology over capital intensive technology
Distinguish between technology transfer and technology development
Justify the case for and against intermediate technology
Distinguish between intersectoral and intra-sectoral diversification
Discuss the merits of economic diversification

THE CHOICE OF PARTEN AND RATE OF CAPITAL ACCUMULATION
FOREIGN AID AND ECONOMIC DEVELOPMENT

There are two major sources of funds for capital accumulation

i. Domestic sources which include savings
ii. Individuals, companies and the government

The government can turn public savings in form taxation into capital e.g. roads, railways, dams, schools etc. however public savings fall far short of government requirements in LDCs and therefore the second though much undesirable option is foreign sources which include borrowing from foreign countries and companies and foreign investors bringing in their capital plus foreign aid in form of soft loans and grants

FOREIGN AID
Is the net transfer of resources from one country (donor) to another country (recipient) which can be inform of money, goods or services, technology etc
Foreign aid can either be bi-lateral or multilateral
BI-LATERAL AID: is the assistance rendered by one country to another. It's a form of aid between two countries e.g. USA and Uganda
MULTI-LATERAL AID: Is the inflow of resources from sources (countries) or international bodies to another country e.g. from IMF, world bank, USAID (United States Assistance for international development)
QUALITIES (X-STICS) OF AGOOD AID

i. A good aid should increase the productive capacity of the economy
ii. It should increase forex earnings of the recipient country
iii. It should make provision for training to the indigenous people
iv. It should be in the field where domestic investment is inadequate
v. It should increase employment opportunities in the country
vi. It should make use of local capital in almost all projects

FORMS OF AID
1) GRANTS: These are resource transfers without any requirement for payment
2) LOANS: These are resource transfers which must be repaid back with interests or not in a given period of time.
TYPES OF LOANS

a) **Concession loans**: these are loans given with an interest lower than the market rate of interest. These are also called **soft loans**
b) **Non- concession loans**. These are loans given at the market rates of interest. They are also called **hard loans**

3) Technical assistance: This is resources transfer inform of high level of man power such as engineers from developed to developing countries

4) Forex: This is usually resource given to a country to overcome BOP crisis e.g. IMF offers forex assistance to countries suffering from temporary forex shortages
5) Military hardware assistance: This aid involves provision of military training and military hardware for a country's defense

6) Consumer goods like food and drugs, books and others
7**) Direct Foreign aid assistance**: this is the transfer of resources by foreign individuals, companies and multinational cooperation in form of business operation
8) Machinery and equipment: instead of donor country giving actual cash to the recipient country it donates machinery and equipment of equivalent value. It is normally given to a specific project or program

SOURCES OF AID

i. Governments
ii. International aid agencies e.g. IMF, WFP, UN, Red Cross
iii. Individuals
iv. Private foundations e.g. Vision Africa, Kulika Uganda

TERMS OF LENDING

SOFT LOANS: These are characterized by long periods of grace i.e. payment is normally after a long period of time especially 10-99years. They usually carry low interest rates and an interest holiday Incase of failure to pay back the loan, it can be extended to more years without increasing the interest rate
Soft loans are less tied is the recipient is free or has a grater say to allocate the loan where it wants it
HARD LOANS: These are short term loans and carry interest rates (grace period is short and rate of interest is high there fore the donor country benefits much at the expense of the recipient country The donor country dictates on how the loan is to be used hence becoming tied aid

TIED AID V^{S} UNTIED AID
TIED AID: is the aid which requires the recipient to abid by conditions set by the donor on how to it for example the recipient country is required to purchase goods from the donor country using the grants given or aid given to finance a specific project named by the donor
OR
Is the aid which requires the recipient to implement socio-economic and political conditions dictated by the donor before the aid can be given. Aid can be tied either **by source** i.e. loans or grants or by **project**
Source tied aid is the aid which requires the recipient country to spend the loan or grant on buying the donor country's goods. I.e. the technology to be used, man power to use etc
Project tied aid: is the aid given for the implementation of a specific project named by the donor.for example road construction, water projects etc. The resources can not be diverted to another project
Merits of tied aid

- *Avoids diversion of funds to un intended projects*
- *It checks corruption*
- *It ensures proper planning*

UNTIED AID: This is the aid given to a recipient country to use it according to its development requirements. It the aid with no strings attached and the recipient country is free to use it to its priority areas

REASONS WHY COUNTRIES GIVE OUT AID

1. Developed countries give aid as a means of securing market for the manufactured goods for the rich countries. This is possible through source tied aid
2. For humanitarian reasons or ground for example in times of war, floods, drought etc
3. For strategic reasons for example for war purposes in order to achieve military goals by developed countries for instance building their military bases in other countries
4. For development purpose for example to liberty other developing countries from poverty through giving them grants, loans etc
5. Aid is sometimes given as a means of securing spheres of political influence among developing countries
6. Developed country give aid because they want to acquire raw materials for their industries
7. Developed countries give aid to strengthen their relationship with developing countries

THE INCREASING NEED FOR AID BY LDCS

Account for the increasing need for foreign aid

The need for aid of developing countries has increased more than ever. Therefore, LDCs are finding it hard to survive without foreign aid and this is due to the following factors:

1. High population growth rates that have outcompeted economic growth rates hence the available resources cannot cater for the available population leading to increasing need for foreign aid
2. The increased natural and man made disasters like famine, the AIDs problem, drought, desertification etc have made life very hard in LDCs hence making the need for aid inevitable
3. The increasing levels of corruption and embezzlement have led to the falling levels of production hence the excessive reliance on foreign aid to supplement domestic production in form of goods and services
4. LDCs are undergoing structural economic changes and their economies are being transformed into market economies in order to start these needs foreign aid is need
5. The rate of brain drain has increased of recent due to political and economic uncertainties that face LDCs. This has created skilled manpower gap in these countries thereby necessitating the need for foreign aid to cover the manpower
6. The increasing conflicts and civil wars in LDCs have led productive areas to waste and resources have been diverted from production to war efforts. The declining productivity leaves no option but the dependence on aid
7. The falling prices of commodities from LDCs in international markets has led to declining terms of trade and BOP problems hence the need for aid
8. The emergence of new nation states from the colonial York e.g. the New Southern Sudan, Eretria etc and from wars and dictatorships call for massive donor support if these states are to achieve self reliance
9. The present international economic order. Developing countries have been marginalized in world trade, world politics, world technology etc. there have been subjected to un precedented exploitation and manipulation all of which have led to external dependence leading to increasing need for foreign aid

ADVANTAGES/MERITS/POSTIVE IMPLICATIONS/ARGUMENTS FOR/POSTIVE EFFECTS

1. Foreign aid helps to cover saving investment gap. In a situation where required investment funds exceed domestic saving from taxation and other sources foreign aid is vital to achieve development
2. It helps to fill the foreign exchange gap. Foreign aid helps in financing imports since in LDCs the required import always exceed the available foreign exchange earnings from exports

3. It helps to close the man power. The skilled manpower requirements in LDCs exceed the locally available supply of trained manpower therefore foreign aid in form of technical assistance helps to cover this gap
4. It helps to cover the technological gap i.e. aid inform of technology, machines and equipments enables LDCs to have access to better technology which leads to production of good quality products and also to overcome technological shortages
5. It helps to close the government revenue expenditure gap (Budgetary gap) by widening the tax base for example aid in form of direct foreign investment which is a source of revenue to governments of most LDCs
6. Foreign aid helps in alleviating effects of catastrophes e.g. famine, floods, earthquake, land slides, epidemics etc. this is aid in form of goods and services from Red Cross, WFP, UN, WHO etc
7. It facilitates the development of infrastructure of the recipient country for example aid in form of medical assistance, project tied aid inform of road construction, water supply, power supply etc
8. Aid helps in provision of employment especially if it invested in productive projects like workshops of entrepreneurship development skills, direct foreign investment like in telecommunication industry etc
9. It strengthens international relationship between the aid giving and recipient country. This stimulates trade and fosters political stability
10. Foreign aid in form of skilled manpower, machines and equipments improves on local labour skills and productivity thus stimulating economic growth and development
11. Foreign aid provides public goods in developing countries because many of them do not have enough funds to provide utilities to their nations although they are essential for development yet private investors cannot participate into their provision
12. It helps to reduce BOP deficits in developing countries since aid in form of grants increases foreign exchange, aid in form of goods and services supplements domestic production
13. Foreign aid inform of military assistance enhances the security of the recipient country since such a country is able to stand against foreign aggression and to protect the life of the people and their property
14. Foreign aid in form of capital investment accelerates industrial growth. This leads to increase in national income and economic growth

DISADVANTAGES/DEMERITS/NEGATIVE EFFECTS/ARGUMENTS AGAINST

Good as it is foreign aid has serious shortcomings that affect the development of a recipient country

1. It may worsen the BOP problems due to repayment obligations especially when aid is tied with high interest rate
2. Due to debt servicing nationals may be denied essential goods and services because most of the money will be spent on payment of debts leading to poor standards of living of people
3. Some times foreign aid inform of skilled labour, machines and equipments can lead to unemployment of local labour force which accelerates poverty in developing countries
4. Foreign aid may lead to economic dominance of donors over recipient countries leading to continued external dependence and its adverse effects
5. Project tied aid may be tied to unproductive projects which may not be vital to the society and this leads to wastage of resources
6. It may have political strings which undermines the country's political sovereignty for example constructing donor's military base in the recipient country and other undesirable policies like liberalizing homosexuality

7. Incase of procurement tied aid, a country will be forced to buy expensively from the donor country yet the same goods can be purchased else where at low prices leading to unfavorable BOP position
8. Foreign aid encourages dumping in developing countries. Most LDCs are being turned into dumping grounds for outdated technologies and capital equipment in the name of aid
9. Aid in form of goods reduces market for similar locally produced goods. This discourages local production and investment thus retarding the process of economic growth and development
10. Foreign aid sometimes is inconsistent it may not come at the required time and this makes planning difficult
11. Technical aid inform of skilled expatriates may lead to erosion of cultural and social values of recipient countries as the citizens may try to adopt the culture of expatriates
12. It may lead to imported inflation especially aid tied by source. Developing countries may be forced to buy goods from donor countries experiencing inflation
13. Foreign aid also promotes political instabilities in most developing countries. This is true with aid in form of military assistance given to rebel groups. This leads to persistent underdevelopment in these countries
14. It leads to brain drain. This is possible with aid inform of scholarships given to students from developing countries and this renders such countries to shortage of skilled manpower
15. It may lead to over exploitation of resources in developing countries leading to their quick depletion thus failing to achieve sustainable development. This is possible with aid in form of technical assistance in exploiting resources

NB. Absorptive capacity is the ability of a country to effectively utilize the foreign aid it gets

WHY DONORS ARE RELUCTANT TO GIVE AID

Capital inflows in LDCs in form of grants, technology transfer and soft loans has reduced instead the hard loan element have increased. This trend can be explained by the following factors

1. Donors have been discouraged by the failures of LDCs to turn massive aid injected in their economies into meaningful sustainable developments
2. Donors have been discouraged because of corruption and embezzlement which are booming industries in many LDCs. Aid have been mis appropriated and misallocated by policy makers in LDCs on luxurious consumption and non priority areas
3. The failure of many LDCs to honor their debt obligations. LDCs are pushing forward for debt cancellation rather than repaying the debts which has further discouraged the inflow of aid
4. The undemocratic and poor human rights records of some governments in LDCs also discourages donors from giving aid to such countries
5. The failure of LDCs to adhere to the set conditions of IMF and World Bank has reduced the flow of aid. The IMF and world bank set conditions for LDCs as a pre-condition for aid for example structural changes like privatization, reduction of public sector spending through cost sharing etc which many LDCs have failed to implement
6. The un predictable political climate in LDCs e.g. rebel activities through military coups, riots and constant demonstrations etc have discouraged aid from more developed countries
7. Threats of nationalization of assets owned by foreigners in LDCs has limited multi-lateral assistance and foreign investors in LDCs
8. The questionable sincererity and integrity of some leaders in LDCs does not give confidence to donors to give aid to LDCs e.g. president Bashiri of Sudan

FOREIGN DIRECT INVESTMENT/FOREIGN CAPITAL/FOREIGN PRIVATE CAPITAL INVESTMENT
This is an economic situation where foreign firms either locate production plants within the domestic economy or acquire substantial ownership position in the domestic firms e.g. Multinational co-operations like Coca-Cola, Pepsi, financial institutions like Barclays, Cairo bank, flue stations like shell, total, kobil, telecommunication services like Airtel, MTN, Orange

MULTINATIONAL CORPORATIONS/ENTERPRISES (MNCs)
These are organizations whose activities extend across the boarder of more than one country with headquarters in their home countries for example financial institutions like Stanbic, Barclays, Crane bank etc soft drinks companies like Coca-Cola, Pepsi etc fuel stations like Shell, Total Kobil etc telecommunication companies like MTN, Airtel, Warid etc

ADVANTAGES/MERITS/ARGUMENTS FOR FOREIGN DIRECT INVESTMENT (FDI)

1. It promotes economic growth. Foreign direct investment aid to productive capacity of the host country thus more goods and services are produced thus accelerating economic growth and development
2. It promotes technology transfer and development in developing countries which improves on the quality of goods and services produced. This is particularly in form of capital inputs like machines and equipments etc, managerial and marketing skills
3. It increases government revenue in form of taxes like Pay As You Earn (PAYE), corporate tax, license fee etc which enables government to extend social services to people in form of roads, hospitals, water and power supply. This improves on their standards of living
4. Improvement of labour skills of horst countries where by international co-operations under take the initiative to train local human resource leading to increased labour productivity
5. It promotes productivity of factors of production particularly in entrepreneurship, land and capital hence utilizing idle resources and reducing chances of operating at excess capacity
6. Creation of more employment opportunities in developing countries (Uganda) leading to increased levels of income and thus improved standards of living
7. It encourages infrastructural development for example improved transport system through constructing roads, water supply in remote areas, good banking system that can mobilize savings from people needed to take off and other social over head capital. This fosters development in LDCs
8. Provision of a variety of goods and services which widens consumer's choice leading to improved standards of living thus development for example in the telecommunication industry there is a variety of net works like Warid, Orange, Airtel etc incase of Uganda
9. They promote forward and backward linkages in various sectors of the economy for example they buy raw materials locally available and sell their products to the local consumers. This stimulates local investments as the local entrepreneurs try to supply the required raw materials
10. It strengthens international relationships which increase capital inflow through investments and a stable political climate
11. Direct foreign investment reduces BOP problems in developing countries due to increased foreign exchange from increased exports
12. Direct foreign capital investment encourages economic diversification especially in the industrial sector and agriculture. This is due to intensive research carried by foreign companies; they come up with various activities in these sectors. This reduces risks of depending on one economic activity

DISADVANTAGES/NEGATIVE IMPLICATION/ARGUMENTS AGAINST FOREIGN DIRECT INVESTMENT

1. High capital flight because most international corporations are foreign owned, the owners tend to repatriate all the profits leaving many developi8ng countries undeveloped
2. It worsens economic dependence problem and its associated disadvantages. Like violation of political sovereignty, unemployment of local labour force etc
3. It promotes technological unemployment in developing countries due to use of capital intensive technology which involves the use of machines to replace human labour thus leading to persistent poverty
4. It leads to excessive concessions given in form of tax rebates (compensations, reductions, holidays and exemptions), heavy protection from outside competition, subsidies and land accommodation leading to low foreign exchange earning and limited contribution to government
5. It result in over exploitation of leading to their quick depletion hence hindering sustainable development
6. It promotes sector and regional imbalances in development because most of the foreign direct enterprises are located in urban and sub-urban areas neglecting rural areas. This promotes dualism in an economy
7. It discourages domestic investment as local firms are out competed due to the managerial ability, technology and advertisements of multinational corporations hence in the long run local entrepreneurship is killed
8. There adoption of cultural and moral values which are undesirable e.g. luxurious consumption, habits, drinking and smoking, sexual immoralities which are not appropriate to developing countries
9. It worsens income inequalities because most of the foreign enterprises concentrate in urban areas and workers in such firms are highly paid compared to those working in local enterprises

OBSTACLES TO FOREIGN CAPITAL INVESTMENT IN LDCS

1. Small size of domestic market that can hardly sustain foreign firms
2. Inadequate basic infrastructure e.g. inadequate and unstable power supply, improved transport network and developed banking system
3. Inadequate skilled labour
4. Strict foreign exchange controls that discourage foreign investors from carrying out investments in developing countries
5. Political and economic instabilities that exist in developing countries
6. Heavy taxes charged on multinational corporations
7. Limited basic natural resources

STEPS TAKEN IN UGANDA TO ATTRACT FOREIGN INVESTMENT

1. The formation of Uganda Investment Authority as a centre for all information and investment related activities like investible areas, procedures involved in getting trading licenses
2. Government high powered delegations have been sent to European countries, USA and Asia to convince foreign investors to come and invest in the economy
3. Many concessions including tax holidays, exemptions, reductions, land allocation have been put in place to attract foreign investors. For example exports are tax free

4. Economic liberalization policies such as privatization, foreign exchange liberalization and other market oriented reforms that are conducive to foreign investment have been undertaken
5. Restoration of peace and stability in most parts of the country is being done to instill confidence to the foreign investors
6. Development of infrastructures is being taken most especially improving the transport system through rehabilitating and expanding main roads to attract foreign investors
7. Educational reforms are being taken to solve the problem of inadequate skilled manpower in Uganda and to produce labour force needed by foreigners
8. Expansion of the market is being taken through regional integrations and international publicity so as to attract foreign investors. Uganda is a member of East African Common Market, COMESA etc
9. Import substitution industries are being encouraged to attract foreign investors to come and produce goods locally which where formerly imported

REVISION QUESTIONS

Distinguish between multinational corporations and direct foreign investment

Assess the role of multinational corporations in the development of your country

HOW CAN FOREIGN AID BE MADE MORE BENEFICIAL TO DEVELOPING COUNTRIES

1. Developing countries should first study the absorptive of their economies before seeking for aid. This will ensure effective utilization of aid in the most productive way i.e. analyzing the locally available resources e.g. labour force its quality and quantity
2. Developing countries should only accept aid that has a positive and maximum impact on the economy because a good aid should enhance development of skills, technology and employment opportunities in the recipient country
3. Poor countries should always channel aid to development ventures because it is always from such projects that the money to pay back the loans and interest ca be generated.
4. Aid should be for self reliance and economic independence. Developing countries should reject aid that makes them perpetual dependants on the developed countries
5. Poor countries should look for the cheapest sources of aid, short term loans with high interest rates should be rejected because they lead to excessive debts and BOP problems
6. Aid and trade should go hand in hand. It should not isolate poor countries from world markets. Therefore developing countries should get aid from countries that allow them to participate in international trade
7. To ease the burden of repaying foreign debts donor countries should accept the debtor countries to pay them in their local currencies. This would imply that the donor country buys the products of the debtor country
8. Debt rescheduling. This is the postponement of debt repayments. It gives relief to the debtor countries and time to make the necessary arrangements of repaying debts and interest
9. Developing countries should also press for the cancellation of debts by the donor countries. Such debts should be converted into grants
10. Foreign aid should not only be targeted at export oriented projects but should also go to import substitution projects as well. It should also go to sectors like education health, nutrition, agriculture, administration. This will raise the efficiency of labour and other co-operant factors

REVISION QUESTIONS

- Distinguish between soft loans and hard loans
- State any three features of hard loans
- Discuss the various forms of foreign aid in your country
- Give four ways in which foreign aid is given
- Distinguish between concession loans and non-concession loans
- Mention any three sources of foreign aid in your country
- Distinguish between tied aid by project and tied aid by source
- Account for the existence of tied aid in developing countries
- Explain the arguments for and against foreign aid in an economy
- Account for increasing foreign capital investment in developing countries
- Examine the implications of direct foreign investment in your country
- What have been the attempts to attract foreign investors in your country?

EDUCATION AND ECONOMIC DEVELOPMENT

Education refers to the process of acquiring skills, knowledge and ability which can enable an individual to involve in developmental activities or

Education is a stock of knowledge and skills embedded in a person (worker). It is basically done to improve the productive capacity of a worker. Education is of two types

FORMAL EDUCATION: Is the training and instruction to impart knowledge and skills, abilities etc to labour following a drawn-up curriculum and use of trained teachers in a class room atmosphere with a time table

FEATURES

i. It follows a well-planned curriculum
ii. It has a time table to follow
iii. It is conducted in a classroom environment
iv. There use of well trained instructors
v. There is use of an official language

INFORMAL EDUCATION: Is the training and instruction to impart knowledge, skills, abilities and experiences to labour but in an unceremonious and un conventional way which does not involve a class room, timetable etc

CHARACTERISTICS OF EDUCATION

1. It is an intangible commodity
2. **It is an investment**. Education is an investment because of the following:

a) It involves costs like any other investment i.e. people spend on it with expectation of benefiting in future
b) Education has future returns inform of improved standards of living like all investments
c) It involves risks and uncertainties common with all investments i.e. School drop outs as a result of indiscipline
d) It has an opportunity cost i.e. what one forgoes by being at school especially the labour force
e) It has inputs like any other investments e.g. teachers, books, students etc
f) It has positive social returns which are rendered by the educated peoples

1. **It is a consumer good**. Education is a consumer good because of the following

a) The recipient derives utility because of the benefits that an individual and the public get as a result of education
b) It raises life expectancy of the recipient through improved standards of living
2. **Education is an economic good** because of the following
a) It has an opportunity cost
b) It has a market price/cost
c) It generates utility to the trainee
d) It is scarce

BENEFITS/ADVANTAGES/ MERITS/POSITIVE ROLES OF EDUCATION

1. It increases labour productivity. Employment of skilled labour in the production process enables producers to increase the quality and the quantity of out put since this labour is more efficient than the unskilled labour
2. It provides employment to people. People acquire jobs either directly or indirectly for example as teachers, bursars, lectures, inspectors in schools and other institutions are employed directly while others sell books, food, firewood to education institutions
3. Education helps to control population growth rate by delaying marriage due to many years at school. In addition educated people tend to produce few children thus enabling a country to plan effectively
4. It increases labour mobility. This is because education equips workers with skills that can enable them transfer from one job to a another with greener pastures
5. It saves scarce foreign exchange which would have been used to employ expatriates thus reducing the BOP problem
6. It encourages innovations and inventions which help to promote technological development that help to increase productivity of resources thus accelerating economic growth and development
7. Education reduces income inequalities in the long run when almost all citizens are educated and employment such that they can earn reasonable incomes
8. It improves health standards not only by increasing people's incomes and spending on food but also helping them to make better health choices
9. Education may lead to social change. It can be used to eradicate backward attitudes, practices, superstitions, beliefs and values that may hinder economic change
10. Good education can be used to forge national unity and develop a spirit of nationalism leading to economic growth and development
11. Education if attained by the majority makes growth development policies easily understood and implemented
12. Education widens the tax base by employing many people leading to increased government revenue in for of pay as you earn and other forms
13. It encourages rural development by adapting modern techniques of farming this increase income level of rural people thus encouraging rural development

DISADVANTAGES/MERITS/NEGATIVE ROLES

1. It may cause rural-urban migration because the people who acquire education prefer to stay in urban areas leading to poor performance of agriculture due to short of man power
2. When few people are able to acquire education income inequality results which create social unrest
3. It leads to brain drain. This involves the flow of skills from developing countries to developed countries with high paying jobs thus rendering such countries to shortage of skilled man power

4. The skilled and educated have a demonstration effect on consumption. They tend to consume goods from developed countries. This results into low savings and consequently capital accumulation is affected
5. It may erode the rich cultural values of a country due to influence of western culture from western education

PROBLEMS CREATED BY THE CURRENT EDUCATION SYSTEM IN UGANDA

1. Education has become too expensive and can only be afforded by a few while the majority remains illiterate leading to social dualism
2. It has resulted into high crime rates in the country due to increasing number of educated jobless people. These have been got involved in criminal activities like prostitution. Robbery etc
3. It has worsened the problem of income inequality between those who are educated and have better paying jobs those who are not educated
4. It has encouraged rural urban migration which results into problems like slum development, increased crime rate etc. this is because the educated people prefer to work in urban areas
5. Education system is more theoretical than practical as a result it produces job seekers thus causing high levels of unemployment
6. It has promoted brain drain where the educated people have left their countries and go for greener pastures in developed countries leading to shortage of skilled man power in LDCs
7. It has resulted into erosion of important cultural values because the educated people prefer adapting western cultures than indigenous values. This has resulted into immoralities
8. It is responsible for high level of social discrimination in the country

REVISION QUESTIONS

Explain the problems associated by the current education system in Uganda

How can these problems are reduced

Distinguish between formal education and informal education

Assess the role of education the development of your country

Account for high government expenditure on education

DEVELOPING PROCESS AND DEVELOPMENT STRATEGY

REVISION TOPICAL QUESTIONS

"Uganda should adopt an agricultural rather than an industrial development strategy if it to attain a faster rate of economic growth" Discuss (UNEB, 2004, p2)

Distinguish between balanced growth and un balanced growth strategies of economic development

Examine the advantages and disadvantages of the balanced growth strategy in Developing countries (UNEB, 2002, p2

What is the role of foreign Aid in the economic developing of your country? 10mks

Explain the problems associated with over relying on foreign 10mks (UNEB, 2002, p2)

Distinguish between Import substitution and Export promotion strategies of industrial development

Asses the implications of adopting the import substitution strategy of industrial development in Developing countries (UNEB, 2001, p1)

What are Multinational Corporations 4mks

Asses the contribution of MNCs to the development of your country (UNEB, 2001, p2)

Differentiate between Import substitution and Export promotion strategies of Industrialization

Examine the merits and demerits of the Export promotion strategy of industrialization (UNEB, 2000, p1)

Asses the contribution of foreign capital investment to the development of your country

Examine the steps being taken to attract foreign investors in Uganda (UNEB, 2000, p2)

What is the difference between economic growth and economic development 4mks
Explain the features of economic under development (UNEB, 1999, p1)
Distinguish between import substitution and Export promotion strategies of industrialization
Examine the advantages and disadvantages of Import substitution strategy of industrialization (UNEB, 1998, p1)
Examine the merits and demerits of using capital intensive techniques of production in your country (UNEB, 1998, p2)
Asses the role foreign capital investment in the development of your country UNEB, 1998, p2)
Distinguish between economic growth and economic development
Examine the factors necessary for enhancing the growth of an economy (UNEB, 1997, p1)
To what extent is an Inward looking industrial development strategy ideal for your country? 20mks (UNEB, 1997, p2)
State and explain the ways in which agriculture is dominant in Uganda's economy (UNEB, 1996, p1)
Since agriculture is the dominant sector in less developed countries; it should receive the main emphasis in development. Discuss 12mks (UNEB, 1996, p2)
Explain the major obstacles to technology transfer from the developed to developing countries. (UNEB, 1996, p2)
Distinguish between balanced growth and un balanced growth strategies
What growth strategy would you recommend for your country? Give reasons to support your answer (UNEB, 1995, p2)
What is meant by under development 5mks
To what extent is under development in the third world a result of external factors (UNEB, 1995, p2)
Distinguish between balanced growth and un balanced growth strategy
Account for the low level of economic development in your country (UNEB, 2010, p2)
Define economic under development 02mks
Explain the causes of under development in country

UNEB QUESTIONS ON DEVELOPMENT AND UNDER DEVELOPMENT AND THE CHOICE OF DEVELOPMENT STRATEGY

UNEB 2004 p1
Distinguish between big push theory and a balanced growth theory
State ant two limitations of the big push theory in an economy
Distinguish between project tied aid and soft loans
Give ant two advantages of project tied aid
SECTION B
Differentiate between balanced growth and unbalanced growth strategies
Examine the implications of balanced growth theory in an economy
2004 P2
SECTION A
What is meant by appropriate technology?
State any three factors that have affected the development of appropriate technology in Uganda
Define critical minimum effort
Mention any three factors which limit the operation of a balanced growth strategy in your country
SECTION B
What is meant by economic underdevelopment 6mks?
Account for the low rate of economic development in your country 14mks
Uganda should adopt agriculture rather than industrialization to attain a faster rate of economic growth. Discuss 20mks

2006 P2
Define a development goal
Give any three economic development goals in your country
SECTION B
What is meant by underdevelopment?
Explain the causes of underdevelopment in your country

2007 P2
Assess the impact of Multinational Corporation in your country

2008 P1

State the big push theory
Mention ant three factors that limit the application of Big push theory in an economy
SECTION B
Distinguish between economic growth and economic development
Examine the implications of economic growth in an economy
2009 P1
State any two characteristics of Rostow's take off stage of economic growth
Mention two limitations of the theory
SECTION B
Explain the factors that determine economic growth in an economy
Explain the benefits of economic growth in an economy
2009 P2
Define economic underdevelopment
Explain the causes of underdevelopment in your country

2010 P1
Define economic development strategy
Explain the merits of diversification of production
2010 P2
Define tied aid
State three problems of relying on foreign aid in your country
SECTION B
Distinguish between balanced growth and unbalanced growth strategy
Account for the low level of economic development in my country

1a) Describe the factors limiting saving levels in an economy

b) Explain the low saving levels in your country

2a) Why may supply of a commodity increase as the price increases

b) Distinguish between extension in supply and an expansion in supply

c) Account for supply rigidities in your country

3a) Explain different income elasticity of demand

b) Under what circumstances the concept of elasticity may be applied

4a) Distinguish between standards of living and retail price index

b) Explain the indicators of good standards of living in your country

5a) Income inequality is a necessary evil. Discuss

b) What have been the attempts to over the problem of income disparities?

6aWith illustration describe the Keynes full employment

b) Explain the solutions to demand deficiency according to Keynesian

7a) Account for increased subsistence agriculture in developing countries

b) How is agriculture promoting linkages in your country?

8a) Distinguish between cottage industries and weight gaining industries

b) Account for predominance of small scale industries in your country

9a) Explain the effects of social dualism in your country

b) Suggest workable measures to reduce such effects

10a) Distinguish between monopsony and duopoly

b) Explain how monopoly power is regulated using: price legislation and taxation

11a) State and explain forms of dependence in your country

b) Explain the dependence problem in Uganda

EAGLE DISCOVERIES LTD

POPULATION AND LABOUR

POPULATION, LABOUR AND TRADE UNIONS

BY MR. PIPELINE CCM

30/05/2011

POPULATION AND LABOUR

INTRODUCTION

POPULATION

This is the total number of people who live in a specific area such as a town, cities, region or country in a given period of time. Population in a given area includes both temporary and permanent residents.
The size of a country's population is established through a population census which is normally carried out every after ten years for the case of Uganda.

POPULATION CENSUS

This is the counting of people in order to discover various suspects of population policy for planning purposes. Referring to Uganda population census has been carried out as follows; 1911, 1921, 1931, 1948, 1959, 1965, 1980, 1991 and 2002. Note that the most significant population exercises were those carried out from 1948 onwards.

REASONS FOR A POPULATION CENSUS

1. The need to know the number of people living in a given country/economy hence relate it to to the available resources.
2. To discover the distribution according to age so as to plan for social and economic infrastructure which may be of importance to peoples' standards of living.
3. To establish the birth rate, death rate and therefore the natural growth rate since knowing the rates helps to formulate appropriate population policies.
4. To establish the number of dependants and the working population since this helps the government to design a sounding wage and tax policy.
5. To establish the quality of population and occupation distribution so as to design a proper education and man power planning proramme for economic development.
6. To establish population structure by sex (females and males and their social status for proper planning exercise.
7. To know the rate of migration so as to make necessary adjustments in the budget to cater for emigrants and immigrants.
8. Helps to determine the market size and hence planning production.
9. Helps in calculating per capita income figures of an economy and hence the determination of the economic welfare.

DEFINITIONS OF SOME TERMS

1. **Population density**; this is the number of people per km²
2. **Crude birth rate**; this refers to the number of children born alive in a year per 1000 number of people. It should be noted that it's the birth rate determines the growth rate
3. **Crude death rate**; is the yearly death per 1000 of the people in an area
4. **Infant mortality rate;** this is the number of deaths among the children of 1-4years per 1000 live births in a given situation
5. **Fertility rate**; this refers to the average number of births per 1000 which a woman can bare in her productive period. It is assumed that under normal circumstances the productive age of a woman ranges from 15-45 years. It is the rate at which a woman can conceive.
6. **Mortality rate;** It refers to the number of people who die before their life expectancy is over. for example life expectancy in Africa is estimated to be between35-45years and those who die before reaching that age contribute to the mortality rate.
7. **An aging population;** these are people with in the age of 85years and above. In developed countries improvement in standards of living has raised life expectancy and lowered death rates leading to aging population.

The concepts of over, under and optimum population

Under population

This refers to a situation whereby a country's resources exceed its population i.e. with under population average product or out put per head rises with an increase in population. This is due to full use of natural resources, provision of labour and specialization.

Over population

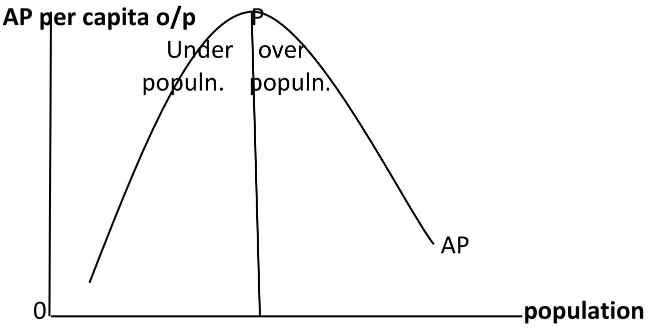
This is where the population of a country exceeds the resources available in that country or is the situation where population is beyond optimum in that there are too many people for the available resources. This implies that resources will be shared among many people each having less and finally leading to less per capita out put. Thus per capita out put can only be increased by reducing the population.

Optimum population

This is the population which is between over population and under population. It is that situation where a country's resources match in equal proportion with the population. With optimum population the per capita output/average product is maximum and resources are fully employed.

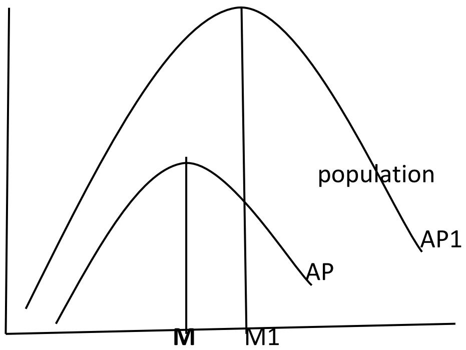
It is the population size that can produce the highest output possible given the country's resources.

Below is the illustration of under, over and optimum population



P is the optimum population

It should also be noted that the optimum point is not fixed. Changes in technology and increased use of resources and other structural reforms in the economy may change the optimum point as shown below;



M is a lower optimum size corresponding to the lower AP and M1 is a higher optimum population size that corresponds to a higher AP1

CHARACTERISTICE OF UNDER POPULATION

i. Low population growth rate possibly due to low birth rates
ii. Low supply of labour force
iii. Excess capacity in most production units
iv. Limited market for most products

CHARACTERISTICS OF OVER POPULATION

i. Operation of positive checks like wars, diseases etc
ii. Falling per capita out put as a number of productive resources may be used up
iii. Decline in living conditions in form of medical facilities, over crowding, poor sanitation etc
iv. High birth rates and low death rates
v. Persistence unemployment
vi. Persistence unfavorable BOP position

SOCIO-ECONOMIC EFFECTS/IMPLICATIONS OF UNDER POPULATION/ A DECLINING POPULATION

1. Shortage of labour force to effectively combine with co-operant factors to produce desired out put. This results into reduction in the size of the country's entrepreneurship if it is declining.
2. Too few people are a disincentive to large scale production which leads to low economic growth rates.
3. High transport or distribution costs due to thinly and sparsely distributed population

4. Under utilization of economic resources hence slowing the economic growth process
5. High social capital per head reflected for example the doctor –patient ratio, teacher-pupil ratio etc
6. Limited domestic market since the population is too thin to have a significant effect on commercial production leading to low economic growth rates thus underdevelopment.
7. Subsistence production may become persistent leading to low standards of living in the country
8. Under population continuously calls for external dependence mainly in form of foreign manpower
9. Low per capita income and thus low welfare
10. The pattern of demand changes in favor of the dominant old ones. This can easily lead to structural unemployment (Declining population)

MEASURES TO AVOID THE SITUATION OF UNDER POPULATION

1. Encouraging large families say by giving them incentives like free education, tax exemptions etc
2. Encouraging immigration and restricting emigration
3. Encouraging polygamy in society
4. Relax marriage laws to encourage population growth
5. Improvement in medical services in order to check infant mortality rate.

SOCIO-ECONOMIC EFFECTS/IMPLICATIONS OF OVER POPULATION/RAPID/INCREASING POPULATION

1. Unemployment and under employment because of excess labour capled with few existing employment opportunities. This explains the existence of disguised UN employment in Uganda (LDCs). High UN employment may result in insecurity and idleness.
2. Food shortage is likely as a result of over using land and due to operation of the law of diminishing returns on agricultural land and the inelasticity in the supply of land
3. High death rates arising from the difficult to provide adequate medical facilities
4. Over straining the basic infrastructures for example medical services, transport and education. This results in overcrowding and declining quality of services and therefore mitigating against an improvement in the quality of the population as agents of production which require massive investment in social services.
5. High dependence burden on the working age group leading to low standards of living due to high expenditure and other adverse effects. This is due to the population being dominated by the young who do not contribute to production
6. Unfavorable BOP position arising from increased importation of goods to meet the rising demand as population continues to grow and reduces the surplus exports. Thus leading to underdevelopment in the country.
7. Reduced agricultural productivity as a result of land fragmentation and degradation arising from rural population pressure leading famine.
8. Low capital accumulation due to low levels of saving caused by high dependence ration leading to low investment levels hence limited contribution to the country’s GDP
9. Demand pull inflation is likely to arise due to over population capling scarce goods and services in the domestic market.
10. Over population makes planning difficult hence a decline in economic performance and growth
11. Limited domestic market/low effective demand due to high dependence ratio.
12. Results in brain drain due to high UN employment leading to shortage of skilled manpower in the country.
13. Causes/perpetuates income inequality thus leading to social unrest in the country.
14. Quick depletion of resources hence failing to achieve sustainable development
15. Faster growing economy leads to congestion and pollution which if not checked results into declining welfare of people. This prompts the opening up of new farmlands, most of which are ecologically sensitive (e.g. forests, swamps and hillsides).
16. Due to lack of savings and K-accumulation there is adoption of low technology which leads to poor out put in both quality and quantity

Positive implications

1. It stimulates the development of an economy by providing ready domestic market for the goods and services produced
2. It is a potential for labour force thus curbing the man power gap in LDCs
3. Promotes optimum utilization of idle resources thus reducing incidences of excess capacity and accelerating economic growth

4. Encourages labour mobility and its advantages like greater productivity, reduced regional imbalances in development etc
5. Increased government revenue due to large taxable capacity thus enabling the government to provide social services to its people
6. It is an incentive/potential for massive future investment due to the existing large market
7. Initiates effort to work harder to sustain the predominant dependant population
8. Government is awakened to its responsibility of providing necessary infrastructure and this leads to increase in out put the young are usually innovative- room for inventions
9. Reduces per capita social overhead cost

MEASURES TO AVOID SITUATION OF OVER POPULATION

1. Use of extensive family planning methods for example use contraceptives such as condoms
2. Provision of social and economic disincentives for large families for example high taxes and giving incentives to small families like free education
3. Mass sensitization of people on dangers of high population and possible measures that can be employed to control high population growth rate.
4. Encouraging emigrations and discouraging immigrations in the country
5. Designing and putting in place strict marriage laws and penalties
6. Undertaking manpower exchange programs to reduce population pressure in the economy
7. Re-distribution of population in areas with high population density to those which are sparsely populated

REVISION QUESTION

What is meant by the term Optimum population? 4mks

Examine the implications of a high population growth rate in your country. 16mks UNEB 2007p2)

THEORIES OF POPULATION STRUCTURE

Population can be studied under two broad theories i.e. Malthusian theory of population and the theory of demographic transition.

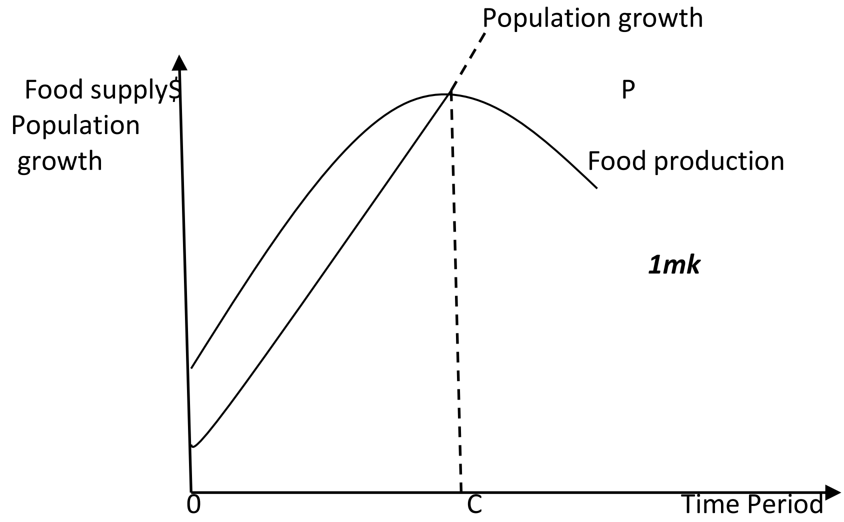
THE MALTHUSIAN POPULATION THEORY

It states that **population growth is directly dependant on availability of means of subsistence (food)** ***1mk*****.** As long as food is available, population will always grow until it is **checked by preventive checks** like moral restraint, celibacy ***1mk***etc and he warned that if not checked, **positive checks** will operate in form of famine, wars, and diseases to reduce the population ***1mk***

This is because man's ability to reproduce him self is faster than the rate at which he can produce food and because of that population will always grow at **a geometric rate** i.e. would double after every 30-40years ***1mk*** for example 2, 4, 8,16,32,64,128, etc while food production grows at an **arithmetic rate** i.e. by a constant figure for example 4, 8, 12, 16, 20, 24 ***1mk***etc

For that reason, population growth will reach a point (**Malthusian population trap)** where it is equal to food production ***1mk*** beyond which means of subsistence would not be enough to sustain the population because food production depends on land whose **supply is fixed and subjected to the law of diminishing returns** ***1mk***

ILLUSTRATION OF MALTHUSIAN POPULATION TRAP



Point CP is the Malthusian population trap

MALTHUSIAN POPULATION TRAP

This is an inevitable population level or size that can just be supported by the available resources. It is a level of food production beyond which there will be a reduction in population as the existing means of subsistence (food) will not be enough to sustain it.

Preventive checks; Are those which bring down the birth rate for example family planning, late marriage, self restraint and other forms of birth control.

Positive checks; Are those population control measures which increase death rate for example famine, wars and epidemics. They tend to occur naturally.

VALIDITY OR RELEVANCE OF MALTHUSIAN POPULATION THEORY

1. The Malthusian population theory is to a lesser extent applicable to Developing countries (LDCs) in that;
2. Land being fixed and subject to law of diminishing returns is being experienced in developing countries as Malthus postulated. This is because the best land is cultivated first it goes on reducing until it becomes barren.
3. Preventive checks or natural family planning methods are used to day to control population in a number of countries. For instance birth control measures, celibacy and late marriages are used which were an initiation of Malthus. Hence the theory is applicable.
4. The positive checks on population exist in LDCs to day for example wars, epidemics, famine etc thus making the theory applicable.
5. Land problems/ disputes are common issues in LDCs and this is assign of over population according to Malthusian population theory. For example land disputes in Kibaale and Buliisa districts, the newly established controversial land bill that has created conflict between the kingdom of Buganda and the central government
6. Some area in Uganda face food shortage and this is evidenced in relief aid in terms of food that the country gets from friendly countries and humanities or organizations like World Food Program. The recent famine in Teso region.

IRRELEVANCE OF MALTHUSIAN POPULATION THEORY/CRITICISM/LIMITATIONS

To a greater extent, the theory is not applicable to LDCS in that;

1. It assumes constant technology which is un realistic sine technology is ever changing as time passes by. For example in terms of food storage and increasing land fertility.
2. It assumes a closed economy yet Uganda is an open economy thus there are possibilities of food importation to supplement domestic production thus meeting the demand of her increasing population.
3. The law of diminishing returns can be postponed through agricultural modernization by use of fertilizers, crop rotation, and bush following etc which is not foreseen by the theory. Hence making theory inapplicable.

4. The theory fails to visualize labour mobility or migration to ease pressure on land in crowded areas ye labour in Uganda moves from one area to another. Hence making theory inapplicable.
5. The theory did not foresee the possibility of LDCs getting aid and resources from other countries to relieve them of food shortages. Yet Uganda gets aid in form of food from World Food Program and other organizations.
6. Population growth does not depend on food (income) alone as the theory assumes. Because in Uganda it is due to some cultural beliefs of attaching high value on children in some tribes, political stability etc. Hence making theory irrelevant to Uganda
7. The theory is based on a subsistence economy yet LDCs' economies are not predominantly subsistence any longer. Uganda's economy has elements of commercial production i.e. production for external markets like existence of plantations. Thus making the theory inapplicable.
8. Agriculture modernization is not foreseen by the theory, yet this is taking place in most LDCs. Use of modern faming methods is being practiced in Uganda, application of fertilizers and improve seed and breed varieties are being used by farmers. Hence making the theory irrelevant.
9. There is not mathematical relationship as regards food growth and population growth i.e. it does not the time when the population would be equal to food supply. If that time was known, than probably the government would do something either to increase food supply or reduction in population. This makes the theory irrelevant to developing countries
10. Malthus said that population growth is due to an increase in birthrates alone but it can also be due to a decrease in the death rates. Thus making theory inapplicable
11. The theory ignored the opening up of new lands like swamps and water reclamation (putting idle land in use) yet swamps are being reclaimed in LDCs for agricultural purposes and settlement. This makes the theory irrelevant in LDCs.
12. Malthus never put into consideration international migrations or even migrations from one region to another in the same country. This reduces the danger of starvation as prophesized by Malthus. This is being done in Uganda, people move from areas affected by famine to areas with food.
13. Malthus did not realize that rising living standards can cause a fall in birthrates and population. Hence making the theory irrelevant.
14. According to him, population growth can only be prevented by moral restraint but he should have put into account the modern methods of family planning for example use of contraceptives. Yet such measures are being used in Uganda. Hence theory is invalid.
15. The theory did not for see great improvement in transport that can enable labour (people) to migrate from one area to another

ASSUMPTIONS OF THE THEORY

i. It assumes a closed economy
ii. It assumes that technology is constant
iii. It assumes a subsistence economy
iv. It assumes that increase in food production leads to increase in population
v. It assumes that population can only be prevented by moral restraint
vi. It assumes that the supply of land is fixed
vii. It assume the law of diminishing returns
viii. It assumes immobility of labour etc

REVISION QUESTION

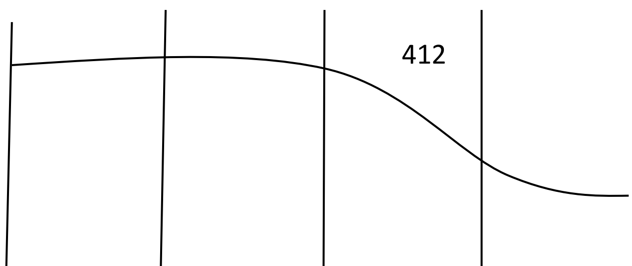
Explain the Malthusian population theory 6mks
To what extent is Malthusian population theory is applicable to Developing countries? 14mks (UNEB 2009 p1)

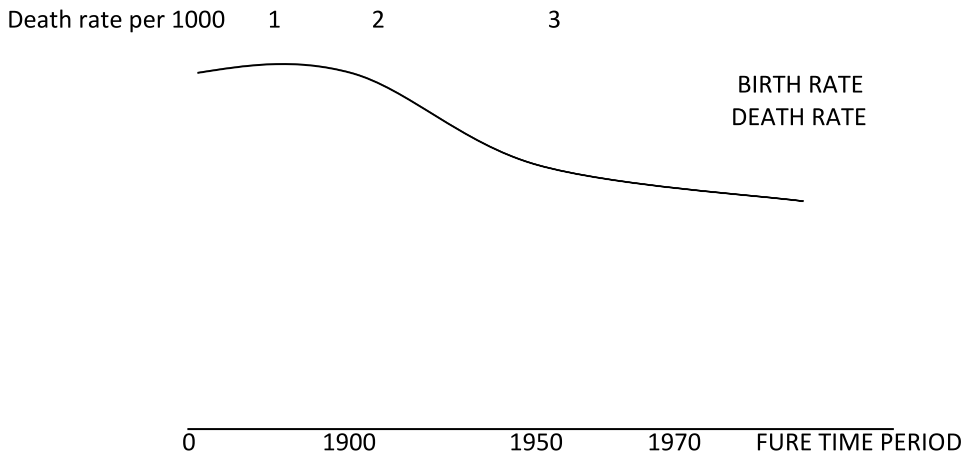
THE THEORY OF DEMOGRAPHIC TRANSITION

Demographic transition tries to explain the historical perspective in population growth from high death rates to low and stable birth rates and death rates as an economy develops. This is when the standards of living begin to rise and education increases house holds then start to limit the size of the family.
It emphasizes that every country passes through the three main stages of population development.

AN ILLUSTRATION OF DEMOGRAPHIC TRANSITON IN THIRD WORLD COUNTRIES.

Annual Birth &





STAGE 1

This is a characteristic of a pre-industrial society where both the birth rate and death rate are high. Society is rule based, children are believed to be God-given and parents produce many children with the hope that some will survive. Mortality rates are high because of prevalence disease and absence of proper medical care. Thus the increase in birth and death rates remains approximately the same resulting in static population growth.

STAGE2

Here the death rates begin to fall due to increased economic progress which brings better standards of living, increased production and elimination of preventable diseases. Birth rates however remain high because of improved medication this results into a high population growth. This marks the beginning of the demographic transition, from a stable or a slow growing population to rapidly increasing numbers.

STAGE3

Declining population growth rate due to falling birth rate and death rate. This is as a result of modernization and development caused by wide spread education and the introduction of artificial methods of birth control which cause a decline in fertility.

POPULATION CHANGES

These are either increases or decreases in population. It could be measured by the difference between the number of people born and those who die ie the difference between birth rate and death rate.

POPULATION INCREASE

This means the rise in number of people in a given area or country overtime. It could be a result of net migration or natural growth.

A situation in an economy where there are a number of young people such that there is a high possibility for population explosion to occur is referred to as **High momentum for population growth**

Population explosion. This refers to the sudden or abrupt sharp and rapid increase in the population thus making the available resources too inadequate to sustain the population.

CAUSES OF POPULATION INCREASE IN LDCs

This is basically a combination of increased birth rate and declining death rates

1. Increases birth rates are due to;
2. High illiteracy levels
3. High fertility rates in women i.e. the fertility rate in developing countries is about 7 children per woman of bearing age.
4. Cultural factors and religious inclination for example Islamic religion
5. Early marriages
6. Inadequate population laws
7. Improved medical fertilities
8. Limited use of birth control measures and family planning methods.
9. Increased immigration rates
10. Death rate id declining because of;
11. Reduced mortality rates arising from improved immunization and vaccination against killer diseases

12. Improved living conditions in general

LIFE EXPECTANCY
This is the number of years an individual can survive or the time period an individual under goes from birth to death. Life expectancy in LDCs is low (approximately 35-45 years) as compared to an average of 65-70 years in most developed countries
Statistics shows that an average life span of an African male is 45 years while an African female has an average life expectancy of approximately 54years.

POPULATION DECREASE
This is due to reduced birth rates and this arises out of;

i. Increased use of family planning methods and other birth control measures
ii. Increased civilization which does not respect polygamy
iii. Late marriages
iv. Tied marriage laws
v. Intensive sensitization about dangers of large population

FACTORS AFFECTING POPULATION SIZE AND GROWTH

1. **Population migration**. This includes emigration and immigrations where the rate of immigration exceeds the rate of emigration, population tends to growth much faster unlike in situations where by there are few immigrants than emigrants.
2. **Mortality rates**. High mortality rates reduce the population growth and size while a low mortality rate results into high population growth thus big population size.
3. **Fertility rate in women**. A high fertility rate in women normally results into high population and thus a large population size and a low fertility rate results into a low population growth rate and thus a small population
4. **Level of development of society**. The higher level of development results into a low population rate than a society which is economically and socially underdeveloped. This is due to wide spread education, civilization and modernization which encourages use of modern family planning methods in a developed society.
5. **Social factors such as culture, religion and traditions**. Some cultures and traditions encourage polygamy others attach a great value to children all of which result into high population growth and thus large population size. While religions discourage polygamy like Christianity which leads to low population growth rates thus a small population size.
6. **Availability of means of survival** (according to Malthus). Where means of subsistence are readily available population tends to grow faster than in areas where these means are of subsistence are insufficient that have low population growth rate thus low population size.
7. **Literacy level of the population**. Society with high level of literacy has low population growth rates thus a small size of the population due to late marriages and use of family planning methods. A society with high illiteracy rate has a high population growth rate due to limited use of family planning and attaching a high value on children leading to a small population size.
8. **Level of women involvement in economic activities**. In a society where women are highly involved in economic activities, they space their children to suit their work schedule thus a low population growth rate than in a society where women are fulltime house wives. Such a society will have a high population growth rate because of having excess time to produce.
9. **Level and knowledge of about birth control of family planning methods**.
10. **Political climate of a given country**.

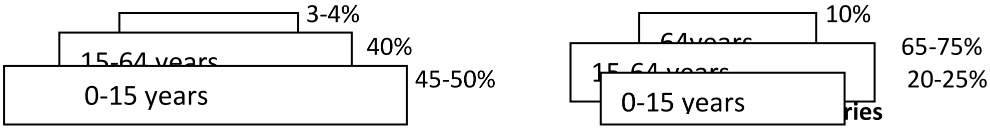
POPULATION PROBLEMS
These are either problems of increasing population or declining population
Problems of increasing population are the same as Socio-Economic/negative implications of rapid/increasing/over population and problems of decreasing population refer to negative implications/Socio-Economic effects of under population/Declining population

POPULATION STRUCTURE IN UGANDA (LDCs)

By population structure is mean' the composition/classification or distribution of population according to sex, age, occupation, employment level, education attainment, growth rates and other attributes. The population structure of Uganda is such that;

1. It is dominated by the young who constitute over 40% of the population that is between the ages of 0-15 years compared to 21 % for developed countries. LDCs have a very small percentage of people with 64 years and above i.e. 3-4%
2. Female tends to be more than males in LDCs
3. The population is mainly rural based i.e. approximately 80% of the population live in rural areas.
4. The majority of the population is semi skilled or UN skilled. This is due to high illiteracy rate to the extent that about 32% can not read and write.
5. There is a high population growth of about 3.4% per annum which is one of the worlds' largest
6. Productive force of the population is engaged in primary production (subsistence) and a minimum number in manufacturing and civil service activities.
7. A big proportion of the population live below the poverty line (about 37%)
8. High rate of rural –urban migration

POPULATION PYRAMIDS TO ILLUSTRATE AGE STRUCTURE



POSTIVE ECONOMIC IMPLICATIONS OF THE ABOVE STRUCTURE

1. High market potential
2. High potential labour force
3. An incentive or potential for massive future investment
4. High tax potential
5. Initiates effort to work harder to sustain the predominantly dependent population
6. Government is awaken of its responsibility of providing necessary infrastructure and this leads to increase in out put
7. The young are usually innovative i.e. there is room for potential inventions
8. High potential for increased resource utilization
9. Reduced per capita social over head costs

NEGATIVE ECONOMIC IMPLICATIONS

1. Low labour productivity due to reduced average product per head as a result of inadequate resources
2. High dependence burden/low savings
3. UN employment and under employment
4. Limited domestic market/low effective demand
5. External resource dependence for example on foreign man power due to existence of abundant unskilled and semi skilled labour over skilled labour
6. BOP problems due to high import requirements to supplement the domestic supply
7. Over straining available infrastructure. This results into overcrowding and declining quality of services and there fore mitigating against an improvement in the quality of the population as agents of production
8. Effective planning for the population becomes difficult leading to low economic performance thus low economic growth and development
9. High government expenditure on provision of social services
10. High social costs inform of pollution, congestion
11. High chances of brain drain
12. High rates of rural urban migration and associated disadvantages
13. Accelerates income inequalities
14. Quick depletion of resources due to over exploitation

REVISION QUESTION

Describe the structure of Uganda's' population 6mks

Examine the implications of the structure of your country's population 14mks

LABOUR AND WAGES

LABOUR

Is the human effort or resource both physical and mental that contributes to the production of goods and services. Labour can be skilled, semi skilled or UN skilled. It can as well be mobile or immobile both occupationally and geographically

Unskilled labour tends to be occupationally mobile while the skilled labour tend is highly immobile occupationally. The youth are more geographically mobile yet the aged are geographically immobile.

Notes about labour productivity and efficiency, Labour demand and supply and labour mobility refer to notes of production

LABOURFORCE

This is the number of people or proportion of the population that is made up of the working age group or is available for employment in an economy at a given time.

FACTORS DETERMINING LABOUR FORCE OF A GIVEN COUNTRY

13. **Population size.** The larger the population, the bigger the labour force and the smaller the population, the smaller the size of the labour force.
14. **Population structure in terms of age and sex**. The population comprising mainly of the 25-60 age group has larger work force than a population structure dominated by the young and the aged who are economically less productive. Similarly more males imply a larger labour force.
15. **Education/training period.** Where the training period is low, the size of labour force may be low while a sufficient training period avails more productive labour force to an economy.
16. **Government policy in relation to retirement age**. Early retirement reduces the size of labour force while late retirement gives an economy a wider labour force base.
17. **Migration rate**. High immigration rates result into increased population and hence increased labour force while high emigration rates plus cases of brain drain reduce a country's' labour force.
18. **Natural conditions/abilities**. An economy with many physically and mentally able people has more potential for labour force than one with a few naturally able individuals which has less potential labour force.
19. **Traditions and culture**. Certain traditions and culture do not allow women to work and if women constitute a big percentage of the population then the economy will have limited workforce other wise societies with limited cultural restrictions have a larger labour force base.
20. Working conditions
21. Peoples' attitude towards work
22. Wage offered
23. Social and political conditions in the country
24. Efficiency of other co-operant factors

CHARACTERISTICS OF LABOUR FORCE IN LDCs

1. It is dominated by the young. Labour force in LDCs is basically young thus child labour is highly prevailing i.e. there is a big number of children of below 18 years who are employed mainly in the formal sector.
2. It grows at a faster rate, in other wards as fast as the population growth rate its self. This is evident by the high un employment rate, incidence of under employment and disguised un employment.
3. It is highly illiterate or dominated by the un skilled manual labourers. This causes chances of low average productivity.
4. It also characterized by low productivity i.e. out put per unit of labour employed is low partly because of low skills and may be due to low wages.
5. In terms of mobility it is evident that occupationally, the work force tends to be mobile and geographically less mobile because most of them are un skilled.
6. Mostly rural based. The majority of the productive population is found in the rural sector since over 80% of the population in developing countries live in rural areas.
7. Abundant and cheap. Labour force in developing countries is in abundant supply and because of their limited acquired skills, they are relatively cheap.

8. Occupationally, the majority of the labour in LDCs is employed in the primary and informal sectors. This is because in most of the agro-based economies over 80% of the labour force are engaged in agriculture and a limited percentage is left for the service and industrial sectors

MAN POWER PLANNING

This refers to the long time projection of demand and supply of labour aimed at attaining a balance between labour demand and labour supply. In other wards man power planning refers to the efforts by the government to balance the supply and demand for labour

MAN POWER PROBLEMS

There are a number of manpower problems faced by LDCs' economies mainly arising from ineffective man power planning and they include the following:

1. Un employment and under employment. A number of people in the working age group are jobless in LDCs partly because of lack of a proper employment policy that allows and promotes job creation ability.
2. Scarcity of indigenous high level man power like specialized surgeons, high quality surveyors and technicians which has constantly called for reliance on expatriate man power in these areas.
3. Brain drain. This is the exodus of highly skilled man power to other countries like USA, Canada which has deprived LDCs of the few trained man power.
4. Low wages and poor remuneration. Majority of the work in the developing world are under paid and worse still irregularly paid such that they are un able to plan for their earnings.
5. Inappropriate education system whose out put is theoretical and lacks practical skills required in agriculture, technical fields and vocational oriented jobs.
6. Shortage of training facilities such as lack of training equipment, limited scholaristic materials, insufficient classrooms etc has affected the training process in most developing countries.
7. Discrimination in the labour market based on sex, age, religion, race etc has denied capable manpower opportunities to exploit their potentials.
8. Poor working conditions. Many employers do not give their employees sufficient terms of service and as a result workers end up being exploited, changed and even mistreated.
9. Misallocation of the few skilled personnel. This is a common in government institutions and organizations where jobs are given on political consideration.
10. Lack of a appropriate manpower planning resulting into cases of surpluses in some fields and shortages in other fields
11. Reliance on expatriates e.g. in the construction sector which leads to profit repatriation and it is even expensive
12. Increase in the use of child labour usually before 15years because it is cheap
13. There is high cost of training man power hence some people become tired or give up and become unskilled
14. Inadequacy of managerial and entrepreneurial skills

SOLUTIONS TO THESE PROBLEMS

A number of measures may be taken to solve manpower problems in developing countries and they include:

1. Education reform. There is need to change the education system from one that emphasizes theoretical knowledge to one that puts emphasis on developing vocational and practical skills
2. Increased investment in provision of education facilities. Training institutions should be well equipped with relevant facilities that would aid the process of providing a holistic practical education.
3. Intensive man power planning so that there is a balance between man power training and their absorption in employment.
4. Man power exchange program between countries to ease shortages and surpluses.
5. Creation of more employment opportunities i.e. directing resources into productive investment that would generate employment opportunities directly or indirectly.
6. Pursuing a service training program to improve on the labour skills and productivity and encourage diversity of skills
7. Strict immigration laws especially on the locally trained manpower to minimize the rate of brain drain
8. Putting in place minimum requirements for employers for example a minimum wage legislation to guard against labour exploitation

9. Improvement in working conditions and welfare of employees.
10. Encourage Uganda professionals to return home so as to discourage the use of expertiates who are very expensive

WAGES

A wage (as a reward for labour service) is the payment made to labour for its participation in production. It is the price of labour which takes the form of real or nominal wage.

NORMINAL WAGE

This is the payment for labour in monetary units; it's the wage accruing to all units of labour in terms of some monetary units for example shs 10, 000 per week etc.

REAL WAGE

This is the payment for labour in terms of goods and services i.e. It is that reward that a labour factor receives in terms of goods and services that a money wage can purchase. Taking the example above, if out of the weekly 10,000/= the employee can buy a bunch of matooke and one kg of sugar. Then the bunch of matooke and one kg are the employee's weekly income.

Real wage= Nominal wage/price level

DETERMINANTS OF REAL WAGE

i. Price level. If the general price level is low and the purchasing power is high, the real wage will be high to and if the price level is high, the purchasing power will be low and the real wage to.
ii. Size of the nominal. A high monetary reward would imply a higher real wage and where the nominal wages are low; the real wage tends to be low to.
iii. Availability of subsidiary earnings where a worker is able to get side incomes his real wage is higher than that of his counter part who is un able to get side income.
iv. Level of non monetary benefits (fringe benefits)
v. In an occupation where an employee is given for example accommodation, medical services, insurance cover etc his real wage will be high un like a worker who relies on the basic nominal pay.

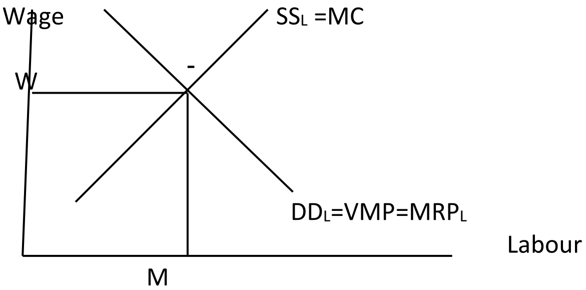
RELATIVE WAGE

This is the wage of one worker or profession in terms of another i.e. it measures the payment given to a worker or profession in regard to what another worker or profession gets.

WAGE DETERMINATION IN UGANDA

1.Market forces of demand and supply of labour. Under a perfectly competitive labour market wages are determined by the intersection of demand and supply of labour just like the price of any other factors of production. Where demand for labour is grater than supply, wages increase and if the supply exceeds demand wages will fall

ILLUSTRATION



At the point where Marginal Cost (SS_L) equals Marginal Revenue products (DD_L) will be the wage given to the worker. No entrepreneur will pay a worker beyond its value of Marginal Product because it will make his production process very expensive.

2. Government policy of wage legislation. In this case the government establishes a minimum wage which should be followed by employers.

3. Individual bargaining power. In this case the worker is paid depending on his ability to negotiate for a better wage

4. Collective bargaining. Trade unions negotiate with the employers associations until the wage is agreed upon Wages are also determined through employers who set their own wages for workers

5. Piece rate system is used where a worker is paid according to the amount of work done.

6. Time rate system is used where a worker is paid according to number of hours worked or after a specified period of time.
7. Payment in kind. This is where a worker is being given goods they produce instead of nominal wage
8. Sliding scale system of wage payment. This is where workers are paid according to the cost of living

FACTORS THAT INFLUENCE WAGE LEVEL IN AN ECONOMY

1. Market forces of demand and supply of labour as already explained above
2. Government policy of wage legislation. The government in its policy of minimum wage legislation sets the minimum pay to a given category of workers by doing so the government would have decided on the workers wage rate. I9f the minimum wage set is high, workers' wage will also be high if it is low workers' wage will be low
3. Trade unions through collective bargaining determine the amount of wages payable to their members. Strong trade unions secure higher wages than weaker ones which can afford just the bear minimum wage.
4. Individual worker's bargaining strength. Individuals with strong bargaining power get better wages than their counter parts with low bargaining power which receive low wages
5. Employers' willingness and ability to pay. Employers who are willing and able to pay better wages to their workers enable such workers to get higher wages compared to their counter parts with employers who are not willing and able to pay better wages
6. Number of hours worked in case of time rate system of wage payment. The more the number of hours worked the higher the wage and the less the number of hours worked the lower the wage.
7. Amount of out put produced in case of piece rate system of wage payment. More productive workers in terms of out put or work done are paid higher wages than those whose productivity is low. They are paid low wages.
8. Level of education or training or skills attained, the higher the skills the higher the wage and those with limited skills get lower wages.
9. Cost of living levels. Wage rates are at times fixed in relation to the cost of living such that workers in areas of high cost of living are paid higher wages unlike those who work in places where the cost of living is relatively low
10. Social factors as attributed to age, sex , religion etc some employers base their payment of wages on such social factors and its on this basis that wage differentials exist between age groups, sex etc.
11. Level of expertise or experience. The higher the level of experience and expertise the higher the wage while people with limited experience usually get lower wages.
12. Degree of risk of the job. Occupations that have high risks to life are highly paid compared to less risky jobs that are paid low wages

WAGE DIFFERENTIALS

Workers are given different wages even when they are in the same industry or doing a similar job because of the following:

1. Differences in the nature of jobs
2. Variation in the level of skills (education and training)
3. Differences in bargaining strength of individual workers
4. Government policy on income/wages which tends to be non matching
5. Differences in the cost of living
6. Differences in employers' ability and willingness to pay
7. Differences in the number of hours worked – for the case of time rate system
8. Differences in talents and natural gifts
9. Discrimination in the labour market
10. Differences in elasticity of supply of labour
11. Differences in peoples' ability to do work- for the case of piece rate system
12. Differences in the strength of trade unions
13. Differences in experience, expertise, responsibility or seniority
14. Differences in non-monetary benefits/ payments
15. Differences in elasticity of demand for the product labour produces

REVISION QUESTION

Explain the causes of wage differential in an economy 10mks (UNEB, 2008 p1)

WAGE THEORIES

SUBSISTENCE THEORY OF WAGE

This is also referred to as the Iron's law of wages and was developed by French economist who had greatly been influenced by the writings of Malthus.

It states that workers should be paid the bare minimum (subsistence wage) for their survival so that they can work harder after experiencing hardships like hunger and starvation. It emphasizes that the wage level should correspond with the subsistence level of living at which people could just maintain the existence

Above this wage it assumed that population would increase and below it standards of living will too law that people may die. This theory was used to justify payment of low wages to workers during the French revolution.

CRITICISM OF THE THEORY

- There is no direct correlation between wages and birth rates i.e. arise in real wages and birth rates i.e. arise in real wages May not necessary lead to arise in birth rate. However the opposite of the theory may be true
- The subsistence theory of wages approaches the concept of wage determination from the supply side ignoring the demand side
- The term subsistence is not very clear because what is considered to be the bear minimum for human existence varies over time and things
- It ignores wage differentials

THE WAGE FUND THEORY

This theory states that wages are paid from wage fund created by the employers and the size of the fund depends on past accumulation of capital. The amount per worker will depend on the fund and the number of workers available. For example 10,000/= as wage fund to be given to 10 labourers, then each worker will receive 1000/= as his wage.

At the time when this theory was developed it was thought that a fund must be accumulated in advance before wages would be paid. It there fore fallows that the fund at any given moment limited the amount of wages that could be paid.

IMPLICATIONS OF THE THEORY

- An increase in production would mean lower wages unless such an increase is accompanied by a corresponding increase in capital accumulation.
- According to the theory wages can be improved by either restricting population growth (jobseekers) or by expanding the wage fund
- Taxation of employers by reducing their ability to accumulate capital would result into lower wages

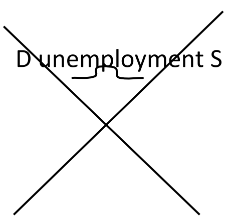
CRITICISM OF THE THEORY

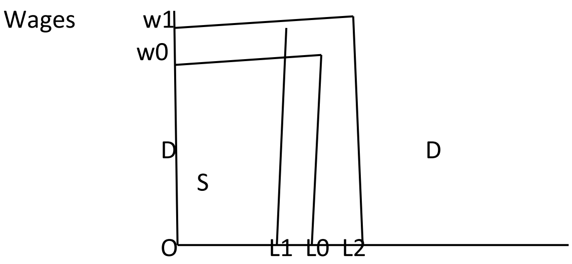
- The order of wage determination according to the theory is un realistic. Under normal circumstances, the wage rate is pre-determined and not delivered by dividing an accumulated funds with the number of workers
- It does not provide an explanation to how wages may rise. If there competition for labour that may force the individual employers to rise the wage rates to attract more labour
- The theory assumes that labour is homogeneous and earns the same wage but gin reality labour is not homogeneous and there are wage differentials due to diversity in nature of workers

MINIMUM WAGE LEGISLATION THEORY

This is a registered amount of money above the equilibrium below which the employer is not allowed to pay the employees. It usually put there in LDCs to provide basic subsistence of life

ILLUSTRATION





W1 is the minimum wage received L1

REASONS WHY THE GOVERNMENT WAY FIX AMINIMUM WAGE

1. It fixes a minimum wage in order to satisfy the market need or to encourage employees to be able to acquire the basic necessities which in turn encourages investments arising from aggregate demand
2. To protect workers from employers' exploitation.
3. To increase the general purchasing power of workers leading to their increased standards of living.
4. To promote efficiency of workers
5. To motivate mobility of idle labour
6. To satisfy trade union demands and control strikes
7. To fight mal-practices like corruption among workers
8. To minimize income inequalities
9. To check on brain drain
10. To attract expatriates
11. For political support

EFFECTS OF MINIMUM WAGE LEGISLATION

Positive effects

1. Favorable or minimum wage legislation tries to bridge a gap between the poor and the rich and its associated effects. This is because it is subjected to all employees
2. Minimum wage legislation can also benefit the employees as it creates the psychological contented labour force and this increase efficiency and productivity of labour and this gives the incentives to further production
3. It crates industrial peace and reduces the dangers of strikes by the workers
4. It tries to reduce geographical wage differentials
5. It increases the purchasing power of workers and thus provides an incentive to producers for further investments
6. It protects the workers against exploitation by employers who would other wise pay workers a lower wage
7. A high minimum wage attracts more labour force and thus it encourages labour mobility and its associated benefits
8. In some instances a minimum wage helps to reduce corruption tendencies especially in government departments. Some times the government adjusts wages upwards in an attempt to fight corruption. This is because workers tend to be satisfied with the set minimum wage
9. It helps the government in power to gain political support and hence promoting political peace/political stability in the country
10. It helps to reduce brain drain and its associated negative effects in the country. In other wards, when the government sets a high minimum wage, many workers find it unnecessary to leave the home country to look for jobs in foreign countries
11. It reduces RUM and its associated problems. This is because the minimum wage set by the government for particular labour operates country wide i.e. both in rural and urban areas

Negative effects

1. High minimum wage legislation may increase costs of production leading to higher prices which negatively affects consumers' welfare. This can further discourage investments due to high wage bill
2. Minimum wage legislation leads to un employment i.e. it reduces demand for labour hence of the labour force becomes unemployed

3. Minimum wage legislation may lead to rural urban migration and its negative effects i.e. open urban unemployment, congestion etc if it is urban based
4. A high minimum wage is likely to lead to inflation (demand pull inflation) and its associated problems in an economy. This is due to increased aggregate demand for goods and services by consumers resulting from a higher minimum wage
5. Higher minimum wage reduces the profit margin of the employer (producer) hence limiting the expansion o the firm
6. It increases government expenditure in form of increased wage bill and costs incurred in implementing the minimum wage thus retarding other development projects

REVISION QUESTION

Explain the merits and demerits of high minimum wages (UNEB, 2008, p1)
Assess the consequences of a minimum wage in an economy

MERITS

1. Increased efficiency of the workers
2. Reduced voluntary un employment/ increased supply of labour
3. Labour unrest is minimized
4. Brain drain is reduced
5. Increased savings and investments
6. Increased revenue to government through taxation
7. Equity in income distribution if rationally implemented
8. Helps in fighting mal-practices e.g. corruption, embezzlement
9. Helps to motivate mobility of idle labour
10. Government gains popularity
11. Increases demand for goods and services due to increased incomes
12. It protects workers from employers' exploitation

DEMERITS

1. Excess supply of labour in relation to its demand
2. Increases the costs of production due to high labour costs
3. Technological unemployment results
4. Worsens income gap if not evenly implemented
5. Discourages investments
6. Rural-urban migration may result if the high wages are urban based
7. Inflationary tendencies set in
8. Low profit levels discourage entrepreneurship

THE MARGINAL PRODUCTIVITY THEORY OF WAGES

The theory was developed by an economist called Jacob Clarke and it states that

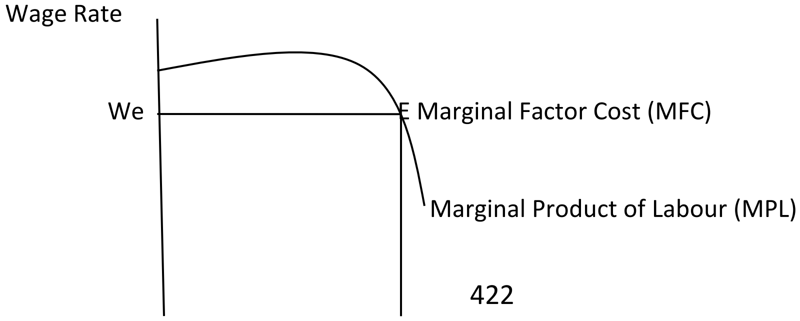
It states that "labour/ a worker is paid an amount equal to the value of its marginal out put/product i.e. Wage=VMP_L=MRP_L

Where, VMPL is the value of marginal out put a worker produces and MRPL is the marginal revenue got products a worker produces.

OR

"Under perfect conditions, a factor of production (labour) should be paid a wage which is equal to his/her marginal revenue product"

ILLUSTRATION OF THE THEORY



0 Le Labour

From the above diagram, 0Le is the equilibrium number of workers while 0We is the equilibrium wage rate thus a rational employer stops recruiting labour when the marginal factor cost (MFC) is equal to the marginal Product of Labour (MPL) at point E. profit maximization requires that an employer does not pay the worker a wage higher than the Marginal Revenue Product (MRP). Thus the Marginal Physical product (MPP) is equal to the Marginal Revenue Product (MRP) and is equal to the Marginal Factor Cost (MFC) and is equal the wage paid to the worker. In other wards MPP= MRP= MFC= Wage paid to labour

According to the theory the entrepreneur will pay no more for any factor of production that he employs than the value of its marginal product since to do so will increase the costs of production

NB:

Marginal physical product refers to the additional out put to total out put resulting from the employment of an extra unit of a variable factor (labour)

Marginal Revenue Product refers to the additional revenue to total revenue obtained from the sale of the marginal physical product

For the successful working of this theory the following assumptions are under taken:

1. The theory assumes conditions of perfect competition in the labour market i.e. no government intervention in wage determination, perfect labour mobility, labour is homogeneous etc
2. There is free and complete completion among the employers for labour force and among workers for jobs
3. It assumes that employers and workers are able to calculate the marginal productivity of labour in advance i.e. out put can be quantified into measurable units
4. The supply of labour is assumed to be perfectly elastic i.e. basing on homogeneity in skills and nature
5. The law of diminishing returns is assumed to be operational to justify lower wages for successive units of labour
6. It assumes that labour can be substituted for other factors of production to maximize gains
7. The theory assumes full employment of labour and other factors i.e. there is no unemployment in the long run whatsoever
8. It assumes that the amount of labour can continuously be varied i.e. the amount of labour can be increased or decreased whenever desired
9. It assumes that the bargaining power of both workers and employers is the same

ILLUSTRATION OF THE THEORY

Assuming one unit of out put is sold at 1000/= and the employer employs 6 workers, the marginal productivity of each worker can known as shown in the table

Unit of labour	**Total product**	**Mp**	**MRP**	**wage**
1	20	20	20,000	20,000
2	30	10	10,000	10,000
3	35	5	5000	5000
4	38	3	3000	3000
5	39	1	1000	1000
6	39	0	0	0

From the table above, if wages are 20,000/= during a particular period the employer must employ only one worker because employing the second labourer would mean paying him an extra of 10.000/= thus a loss to the firm. Similarly if wages are 1000/=, the employer must hire only 5 workers because employing the 6th would mean paying him yet he does not even earn anything to the total product of the firm

In conclusion all labours hired receive a wage equal to or less than the MRP of the last hired employee.

LIMITATIONS/CRITICISM OF THE MARGINAL PRODUCTIVITY THEORY

1. The theory is too theoretical as it assumes conditions of perfect completion in the markets. Perfect competition is an ideal situation that does not exist in real world. There is no free competition among

the employers since the scale of operation is different among different firms and there fore economies of scale are different.

2. In practice it difficult to asses the marginal productivity of workers for example services offered by teachers, doctors, lawyers etc. Entrepreneurs normally base their wage rate on the demand for the product of labour
3. Workers are interdependent in the present age of specialization which was ignored by the theory (producing joint out put) so it is difficult to measure the marginal product of it.
4. The theory ignores technological progress that may raise the MRP with no increase in wages. If there is use of more efficient methods, out put will increase and the revenue of the firm without increase in the marginal productivity of labour.
5. The theory ignores other factors used to reward factors of production other than marginal product for example entrepreneurs some times base their wages they pay on skills and experience, prevailing conditions for example high profits would mean higher wages and low profits would mean low wages or use of subsistence level as a measure which can be above or below the marginal product of labour
6. It ignores the fact that access to co-operant factors may cause wage differentials and not necessarily difference in productivity of workers
7. The assumption of perfect mobility of labour is not realistic as there are a number of barriers to labour mobility both occupationally and geographically
8. Operations of labour organizations (trade unions) and occasional interference by the government in the labour market leave no room for the theory to operate. Some times labour organizations and governments determine wage which was ignored by the theory
9. The law of diminishing returns does not always apply since there are situations when affirm realize increasing or constant returns to scale.
10. Labour is not homogeneous as the theory assumes. In practice labourers have different abilities, talents and productivity.ie some are skilled while others are un skilled
11. The theory ignores the supply of factors of production in determining factor rewards. In the short run labour supply especially skilled labour force may have inelastic supply and this would mean that the employers have to pay a higher wage for such labour
12. It ignores effects of historical factors in determining factor rewards e.g. inherited wage structures especially in developing countries thus making it irrelevant since it considers only marginal product as the only determinant of wage
13. Factors of production are not fully employed as the theory assumes. In other wards, there is a possibility of producing at excess capacity which makes it unrealistic
14. The theory ignores the subsistence theory of wages to fix factor rewards which may either be low or high the marginal product of the factor of production
15. If the marginal product is paid to the factor of production as the theory assumes, then producers/firms would not make profits thereby making it self contradicting yet it assumes profit maximization
16. Factors of production are fully substitutable as the theory assumes. In other wards the theory ignores specificity of factors of production where a factor can perform only one particular activity for which it was made

THE BARGAINING THEORY OF WAGE

It states that the relative bargaining power of labour and employers determines wages, terms and conditions of employment, hours of work and other agreeable conditions of employment

The theory emphasizes that the level of wages is to a large extent determined by the strength of trade unions and employers associations through the process known as collective bargaining

COLLECTIVE BARGAINING

It is a peaceful round table negotiation between representatives of trade unions (workers) and the employers on issues pertaining to wages, conditions of work and general welfare of workers

THE MARKET THEORY OF WAGES

This says that a wage is determined by the forces of demand and supply for labour. If the forces of demand and interact the wage will be determined at their interaction as already explained

SYSTEMS OF WAGE PAYMENT/ MODES OF PAYMENT TO WORKERS

THE PIECE RATE SYSTEM OF WAGE PAYMENT

This is a method of wage payment where wages are paid according to the measurable amount of work done. Or a worker is paid according to the amount of work done

ADVANTAGES OF PIECE RATE SYSTEM

1. Faster workers can earn more than those who are slow or inclined to waste time thus laziness is discouraged
2. More out put is produced as every worker tries hard to produce more so as to earn more
3. The cost of supervising employees while working is reduced because any reduction in out put affects the employees by reducing their earnings
4. Effort and initiative are stimulated as individual workers attempt to put in their best so as to earn more income
5. Where workers operate in small groups, team spirit is developed and as a result higher productivity is achieved
6. Innovation and creativity are encouraged as workers come with unique methods and ways of doing work faster and being productive
7. The possibility of exploiting workers is minimal as each worker is paid the exact reward for the work done
8. Interest is added to dull and routine workers. Some occupations are so boring that workers are only encouraged to continue with them if they are paid according to how much a worker produces
9. Work is completed faster under the piece rate system as workers try to out compete each other in getting a bigger portion or pay
10. Workers are encouraged to reach their places of work easily hence fostering time management at work place

DISADVANTAGES OF PIECE RATE SYSTEM

1. It is inapplicable in service sector where the where out put produced can not be measured
2. The attempt to increase earnings may result into work being rushed. This may in some cases necessitate employment of supervisors to check the quality of work thus increasing the costs of production
3. Workers may be induced by higher earnings to speed up work to such an extent that they may over strain themselves at the expense of their health
4. Variations in the piece rate from one industry to another or from one place to another undermines solidarity of trade unions
5. Slow but careful workers are not favored by the system and as a result firms in the long run lose quality employees with better out put in terms of quality
6. The system makes workers to pay too much attention on quantity in order to increase their earnings and as a result the quality of final out put declines
7. Piece rate system encourages income inequality among workers which can lead to social unrest in the society
8. It makes workers too speedy leading to accidents
9. Under this method trade unions may lose control over the supply of labour and this makes it hard to strike or to assist workers in periods of unemployment

TIME RATE SYSTEM OF WAGE PAYMENT

It is a system of wage payment where the employee is paid according to the number of hours or time spent at work. It may be per day, week or a month. Where this system is in operation all employees doing similar work are paid an agreed some of money per given period of time.

Time rate system is more satisfactory used under the following:

i. Where quality work is essential
ii. Where the work cannot be hurriedly done e.g. driving, passing judgment by lawyers
iii. Where no standard type of work could be done after day e.g. repair work, surgeons
iv. A situation where care has to be taken of delicate machinery e.g. in hospital, medical tastes where out put can not be easily quantified or measured e.g. teaching, nursing and other direct services
v. Where working for long hours may undermine or affect workers health e.g. working in a chemical brand
vi. It is also better to use a time rate where labour by is nature affixed factor which has to be engaged what so ever the out put e.g. clerical officers, shop attendants

ADVANTAGES OF TIME RATE SYSTEM OF WAGE PAYMENT

1. Better quality work is done hence the quality of final output is high.

2. Workers are not over strained as the time of work under this system is standard
3. It minimizes the risks of accidents and damages at work as workers take their time performing tasks assigned to them
4. Efficiency in production is encouraged as workers tend to be responsible and careful in the course of production
5. Employers can plan in advance to secure payment for their workers as payment tends to be on regular intervals
6. It enables employees to plan for their earning as payment is regular and standardized
7. It improves on the employees and employers relationship as they are ever in close contact
8. It is suitable to professionals like doctors, teachers, policemen etc whose services cannot be easily valued

DISADVANTAGES OF PIECE RATE SYSTEM

1. There is lack of incentives for better workers as workers with the same qualifications get the same wage irrespective of what contribution each of them made to the firms' out put
2. Super vision of workers is usually necessary and this increases administration costs of the firm
3. It encourages laziness, absenteeism and thus out put is likely to reduce since workers are paid according to time worked and not out put
4. Fast and serious workers are discouraged since they earn the same amount like their slow colleagues
5. Agreements, terms and conditions of employment can be undermined by workers adopting go slow tactics e.g. factory workers may be encouraged to do work slowly so that they can earn over time pay after normal working hours
6. Out put likely to be low because it's not the basic for payment

BONUS PAYMENT SYSTEM

This is the method of wage payment where extra or additional payment is given to a worker for his exceptional and more than normal contribution in the production process of a firm. It's a payment over and above the fixed wage

It is a merit pay granted for outstanding performance and that is why at time it is called individual performance related pay

ADVANTAGES

- It gives salaried employees incentives to work harder
- Promotes efficiency
- Encourages innovation and inventions
- Rewards extemporary effort accordingly

PROFIT SHARING SYSTEM

It is where the management distributes a specified percentage of profits to the employees, under this system employers put aside a percentage of their total annual profits to be shared among employees or workers may be allowed to buy shares in the company so that they share the dividends as co-owners of the business.

SLIDING SCALE SYSTEM OF WAGE PAYMENT

It is a system of wage payment where workers are paid according to cost of living i.e. where cost of living is high workers' wages are increased accordingly

NON PECUNIARY PAYMENTS

These are non monetary rewards or benefits that are attached to a job for example medical care, security, transport etc. these benefits help to decrease workers' demand for high nominal wages.

PAYMENT IN KIND

This is where workers are given goods they produce instead of cash for example boxes of soap, cloths etc

COMMON TERMS USED IN RELATION TO WAGES

Allowances

These are elements of pay that are provided as a separate sum of money for such aspects of employment as over time, shift working, living in places of high cost of living etc

Service related pay

It is a payment mainly to salaried workers portioned on scale basis and increase by fixing increments depending on the services in the job

Wage freeze

Is the legally backed holding of wages at their existing levels for a specified period of time so as to control or check inflation

Wage restraint

Is a voluntary restriction of wage increases. Government encourages trade unions and employers to moderate their demand for wage increase to check inflation

TRADE UNIONS

A trade union is an organization or association of workers of a particular craft or industry who have come together to collectively negotiate for higher wages, conditions and terms of employment and to safe guard the welfare of their members.

It is a corrective representative of workers that act as middlemen between workers and employers and it is a continuing and permanent democratic organization voluntarily created by the workers to improve on their working conditions as regards payments, hours of work fringe benefits etc

OBJECTIVES OF TRADE UNIONS

1. To attain better remuneration and appropriate benefit for the workers particularly those who are members of unions. This is the prime objective of any labour organization since individual workers cannot be able to do that
2. To ensure conducive working conditions such as attractive fringe benefits, good welfare facilities, shorter working hours for each member
3. To protect members against un fair treatment by some employers for example un fair dismissal
4. To improve the skills of the members through training as this would improve the productivity and efficiency of workers thus strengthening their bargaining power
5. To maintain/provide/improve social benefits to the members of the labour movement. They provide assistance to their needy workers in form of unemployment benefits, sick pay
6. To advise the government in areas of planning. Trade unions in a number of countries have advised government to lay down wages and employment policies, manpower planning and in other development programs to ensure maximum benefit to their members
7. To forge unity among trade unions members and ensure consistence in membership since unions act as fronts for better negotiations and attainment of stability in employment
8. To fight for human rights for example political independence, democracy and good governance
9. To provide an efficient means of expressing the problems and concerns of workers collectively. This is because it would be very difficult for a single worker to press for changes in the conditions of work for the workers
10. To protect the rights of members of union as set out by labour laws based on international Labour Organization (ILO) standards. E.g. workers are entitled to annual leaves, working hours a day or over time allowances in case of working beyond overtime a day, working allowances in case of working on public holidays etc

EXAMPLES OF TRADE UNIONS

Uganda National Teachers' Union (NATU)
Uganda Textiles, Garments, Leather and Allied Workers' Union (UTGLAWU)
Uganda Printers, Paper and Allied Workers' union (UPPAWU)
Uganda Nurses and Midwives Union (UNMU)
Uganda Railways Workers' Union) (URWU)

TYPES OF TRADE UNIONS

1. INDUSTRIAL UNION

This is an association of all workers in a particular industry regardless of the type of job done by a worker for example the medical workers unions to whose membership is open to all those employed in a medical institution as doctors, nurses, administrators, accountants. The Uganda Railway workers

2. CRATE UNIONS (CRAFT)

Is an organization of workers with similar skills across the industrial structure. Membership is based on skills as long as a worker has that skill, he can join the union irrespective of industry or company in which he is employed. For example national teachers union, national medical union, union of engineers

3. WHITE COLLAR UNIONS

It is an organization of administration and clerical staff (salary employees) and other non manual workers for example they are very popular in teaching, local governments etc

4. GENERAL TRADE UNIONS

These are trade unions that cover workers in different establishments, occupations and industries. Here membership is open regardless of workers, place of work nature worker's industrial qualification etc.

5. COMPANY UNION

This is the simplest form of trade union that is composed of employees of one firm or two different establishments. They are the most common type of trade unions in Uganda

6. **OPEN SHOP UNIONS**

These are unions where employment in a given industry/ line of occupation does not require prior registration by an individual with the trade union

7. **CLOSED SHOP UNIONS**. These are unions where employment in a given industry/line of occupation requires an individual to first register with the trade union before being considered for employment in that industry

CONDITIONS NECESSARY FOR THE FORMATION OF TRADE UNIONS

For a trade union to be formed, there are some enabling factors which include the following:

1. Unity among members. In this case members intending to form the union must disregard tribal, religious and political differences
2. Dissatisfaction. Members should be dissatisfied with either wage/salaries or conditions of work or with the general behavior of the employer which necessitate forming a trade union
3. Consistence of workers. It is normally those workers that are likely to work for a long period of time that would want to improve their conditions of worker/service and hence the need to form a trade union
4. Great dependence on wages/ salaries. A worker who has no any other source of income requires that his/her wage be secure and good enough for his/her subsistence. In other wards, workers with other sources of income of income hardly bather a bout trade unions

WEAPONS USED BY TRADE UNIONS TO ACHIEVE THEIR GOALS/OBJECTIVES

1. Collective bargaining

It is a formal way involving peaceful and round table negotiations between representatives of trade union workers and employers on issues pertaining to wages, hours of work, welfare of workers. After successful negotiations a contract (agreement) containing the terms agreed upon is signed by all parties concerned

2. Go slow tactic

When peaceful negotiation fails, trade unions instruct their members to work slowly and less efficiently to reduce the out put such that the employer finds less to sale to gain profits. Since this subjects the firm to losses the employer will find it necessary to meet the demands of workers

3. Sabotage/Boycotts

It involves trade union members persuading the public not to purchase products the industry and this cause loss for the firm. Unions may also engage in press wars by publishing propaganda and malicious articles against their employees

4. Picketing

It is a deliberate act of trade union members to prevent the workers' loyalty to the management who want to work from doing so

5. Threatening to strike

Workers may give an ultimatum to employers to look into their earlier presented grievances and failure to do so they threaten to strike

6. Sit down strike

It is meant by workers reporting to their work place but they all lay down their tools and refuse to work in order to force management to look into their demand

7. Demonstrations

Workers may go out on streets to seek public sympathy as far as their problems are concerned

8. Violence/Strikes

This is the strongest weapon of trade unions used as a last resort after all avenues for negotiations have failed. It's a destructive violent method that results in massive losses if not checked in time. However, they are successful if well organized

CONDITIONS FOR STRIKES TO SUCCEED

i. There must be absolute solidarity with no incidences of traitors
ii. it must be supported by all members
iii. The demand for workers striking should be inelastic or the kind of labour on strike should not be easily replaceable in short run
iv. Trade unions should be financially sound to maintain workers while on strike
v. There should be no good law prohibiting demonstration and strikes
vi. Restricting or limiting the supply of labour. It is similar to go slow only that it involves restrains

BASES FOR WAGE CLAIMS BY TRADE UNIONS/WHY TRADE UNIONS DEMAND HIGH WAGES

1. **Productivity argument.** Trade unions believe that labour contributes significantly to the rise in productivity of the firm. Therefore increase in the firms' out put is usually used as a basis by labour associations and unions to demand for higher wages
2. **Profitability argument.** Trade unions argue that increase in profits arise from increase in out put to which the labourers contributed so their participation should be rewarded in form of increased wages
3. **Comparative wage argument.** Trade unions in particular firm usually demand for pay rise when workers in the same industry for those doing similar jobs have received a wage increase
4. **Increased cost of living.** Arise in cost of living reduces the real income of fixed income earners and it is on this basis that trade unions demand for increased wages so that workers maintain a given standard of living
5. **Where the minimum wage legislated by government is not paid to workers by management**. Trade unions usually come out to bargain for pay rise when employers fail to pay their employees the minimum wage legislated by government
6. **A situation where the employers are not paying wages agreed upon earlier alone**. Under this circumstance trade unions come out and remind employers to fulfill their earlier promises.
7. **When members of the trade unions have acquired more skills through training**. Effective training improves labour productivity so when trade union members have acquired more skills they find it justifiable for wage increment
8. **When the work load has increased without corresponding increase in pay**. This may arise out of the employers who may take advantage of weak bargaining powers of workers by increasing their task without proportionate increase in their rewards. It is under such circumstance that trade unions demand for proportionate wage increment in accordance with the additional tasks
9. **When the job has become more risky or dangerous or too demanding**. Trade unions will demand for higher wages as a kind of insurance compensation to the ever present danger and risks to workers' lives
10. **Where the supply is inelastic** or where there is full employment labourers argue that they are doing more work since they can not be easily replaced. They claim for higher wages on the basis of their supply that has limited substitution
11. **When workers discover that their wages make up a small proportion of the total production costs** of the firm they would fight for pay rise since the wage increment would not significantly effect the profitability of the enterprise
12. **Where the industry's products have demand which is price inelastic**, trade unions may demand for wage increment because they knew that the producers can easily pass on the wage rise to consumers in form of increased prices

REVISION QUESTION

Under what circumstances may the trade unions claim for wage increment?

FACTORS THAT DETERMINE THE SUCCESS OF TRADE UNIONS IN GETTING WAGE INCREASES

1. **Level of profitability of the enterprises.** Trade unions will be more successful in getting pay rise when the firm is making supernormal profits. However, in situations when the firm is not making enough profits, it may be difficult for trade unions to succeed in their struggle

2. **Elasticity of supply of labour.** Where labour supply is inelastic trade unions are likely to succeed but where labour supply is elastic trade unions may fail since workers with elastic supply are abundant and are easily substituted for
3. **Financial position of the trade union .**A trade union with a sound financial position is able to sustain its members during strikes and thus has a strong bargaining power than a financially weak one which can not keep its members together in times of long strikes
4. **The degree of organization of trade unions.** A well organized unions is able to rise wages for its members but unions which are not organized find it hard to get wages increased as they may fail to put their position clear to the employers
5. **Nature of the labour market.** Trade unions are more successful in a competitive labour where many employers demand for their services but where the labour in the market is less competitive it is not easy for trade unions to get better terms of employment

6. **Elasticity of demand for the firm's out put.** If the demand for the product is inelastic workers may succeed in rising wages unlike in circumstances when the demand for products is elastic
7. **Prevailing economic conditions.** Trade unions easily get pay rise in times of economic prosperity than in times of economic recessions/depressions. This is because such periods are characterized by low effective demand due to low levels of income leading to low profits earned by employers thus low wages paid to workers
8. **Level of employment.** The higher the level of unemployment, the more difficult it for the unions to get wage increment as workers fear to lose their jobs by striking or demanding for higher wages. Unlike when there is low level of unemployment trade unions are mostly like to be successful due to limited competition from the un employed non members
9. **Degree of government interference in trade union activities.** Where the government unreasonably interferes with the activities of trade unions e.g. bribing trade union members, threatening and intimidating to punish trade union member. This frustrates the activities of trade union members. On the other hand where trade unions press for their activities freely without government interference, they become strong hence achieving their objectives
10. **Level of leadership skills and management.** Efficient leadership and management strength of the trade union enables it to mobilize and co-ordinate its members thus achieving its objectives but poor leadership creates loopholes in trade union activities hence failing to achieve its objectives
11. **Size of the membership/unionization degree.** The higher the number of members involved in trade union activities, the stronger the trade union becomes. This is because many members are able to press for their concern and accordingly achieve their objectives. On contrary few members are always compromised and thus weaken trade unions hence failure to achieve their objectives
12. **Political climate in the country/ degree of political influence in the trade union activities;** Political stability eases mobilizations and coordination of trade union members country wide to agitate for their aims ie political stability enables trade union activities hence making trade unions strong. On the other hand, political instabilities such as wars frustrate the activities of trade unions hence making them weak.
13. **Degree of awareness of the members about the existence and activities of trade unions;** A high degree of awareness about the activities and existence of trade unions implies more members joining the trade union hence strengthening the trade union. On the other hand, limited awareness about the activities and existence of trade union implies small membership of trade union there by making the trade union weak.
14. **The proportion of the wage bill to the total costs of production;** If the proportion of the wage bill to the total cost of production is high, then the activities of trade unions hardly succeed since by increasing the wages the employer would make less or no profits. This weakens the trade union. On the other hand, if the proportion of the wage bill to the cost of production is very low, then the employer finds it easy to increase the wages of workers hence making the trade union strong.
15. **Availability of infrastructures/ communication net work;** The more viable the communication network/ good infrastructure is, the stronger the trade unions. This is because, such communication network makes mobilization and coordination of members easy which enables them to agitate for their needs very easily. On the other hand, a poor communication network frustrates mobilization and coordination of trade union members hence making the trade union weak.

A question: What factors limit the success of trade unions in demand for higher wages in your country?

CHARACTERISTICS OF TRADE UNIONS IN DEVELOPING COUNTRIES

Trade unions in developing countries usually lack define qualities of firmly established labour organizations and represent a small proportion of the population

1. Unions are fragmented and are less united as members are divided along ideological, personal, tribal, racial differences, political differences. These have caused disunity all through and rendered trade unions in a weak bargaining position
2. They lack structure and have inconsistent membership because most of them are made up of migrant workers and target workers who hope to retire after a short period of time
3. Majority of the members are unskilled and this makes it hard for the unions to bargain with their employers as most of the members do not know their rights as workers
4. They are financially weak as majority of the workers are poor and in some cases members are reluctant to pay their subscription and membership fees. Because of limited finance, they are weak in action and can not sustain long strikes
5. Most trade unions in LDCs lack proper leadership as they are characterized by a lot of rivals and corruption among the leaders. Most leaders use trade unions as stepping stone for promotion into organizational ranks or in political spheres
6. Most union members have low productivity as majority is not highly skilled. This is due to abundance of unskilled labour force. This does not generally matter as it leads to weak bargaining position and disorganization of the unions.
7. In LDCs there is much government interference in trade unions' activities. In this case strikes of any nature are there fore made illegal and workers are always suppressed by the government

PROBLEMS FACED BY TRADE UNIONS IN DEVELOPMENT COUNTRIES

1. Poor leadership as most of the trade unions are made up of unskilled workers, this makes it extremely hard for the unions to negotiate favorably with their employers
2. Interference by the government in the operations of the trade unions. Government put stringent restrictions on activities of trade unions since they look at such labour movements as challenges too their powers. They for example denounce strikes and any forms of aggressions in demanding for rights yet these are some of the most effective weapons of trade unions
3. Small and inconsistent members. The majority of the members are migrant workers and target workers and worse still trade unions form a small percentage of the working population. This makes it hard for unions to organize union activities
4. Financial difficulties. Most trade unions are financially weak and this has made them dependant on the outside sources of funds thus frustrating their effort in times of negotiations or when demanding for improvement in times and conditions of employment
5. Disunity among the trade union members caused by tribal, religious, political and social differences. This has made unions to be compromised always
6. Corruption and mismanagement by trade union top leaders
7. High rate of un emp0loyment and the general fear by the predominantly un skilled members of trade unions losing their jobs should they attempt to go on strike. This has kept most trade unions weak and disunited
8. Problem of illiteracy where by a good number of union members do not know the role of trade unions. Employers at times misinform and manipulate the illiterate union members thus frustrating their attempts for wage increment
9. Weak industrial sector and predominance of subsistence production. Most LDCs are predominantly agricultural and only have few small scale industries yet trade unions are more effective and dynamic in industrial sector
10. The few elite members of the trade unions use such organizations as stepping stones for attaining political positions in government. This tendency has undermined trade unions' efforts and development
11. Ignorance of many workers about their rights. Most workers do not take interest in unions activities because they do not know what trade unions are and more so they do not know their rights

IMPACT OF TRADE UNION ACTIVITIES ON DEVELOPMENT

POSITIVE EFFECTS OF TRADE UNIONS

1. ***Promotion of human dignity and rights*** by minimizing possibilities of exploitation of the workers by their employers

2. ***Promotion of political independence***. A number of trade unions have developed into political fronts and become vehicles for achieving political objectives and social organizations
3. ***Promotion of social welfare***. Trade unions fight for improvement in accommodation, medical facilities, social amenities and other social welfare facilities and when these are provided the living conditions are improved
4. ***Income re-distribution and promotion of equity in the society***. Where trade unions are organized and are under good leadership such organizations assist the government in making appropriate income and wage policies
5. ***Development of skills through training***. Many trade unions arrange for the training of their staff and members to increase their productivity. They do so by arranging regular in service training and organizing seminars to update skills of their members

NEGATIVE EFFECTS

1. They tend to bring about wage push inflation as they may force producers to increase prices of products to try to meet increase in costs of production due to wage increment. This leads to low standards of living of the consumers
2. Rising wages reduce the profit margin for the entrepreneurs and this act as a disincentive to investment
3. Reduction in out put during times of strikes has direct effect on growth in that when workers are on strike there would be no production and if such situation is not addressed immediately it may result into a cute shortage of goods, growth rate is reduced and un employment may increase
4. They may bring about political unrest since some of the trade unions are transformed into political fronts
5. Their activities may force employers to use alternative methods of production resulting into un employment i.e. where trade union demands have become too high for the employer to meet, employers tend to replace labour with capital where possible resulting into unemployment
6. In the long run they may lead to unfair income distribution. This is because when wages increase, demand for labour force fall, few labours can be employed and there fore few of them will earn higher incomes. Since the un employed will not earn anything this will lead to a wider income disparity

REVISION QUESTIONS

SECTION A (LABOUR)

Define the term occupation mobility of labour
Give any three factors that limit occupational mobility of labour in your country (UNEB, 2007, p2)
Define the tern labour force
Mention any three factors which determine the size of the labour force (UNEB, 2006, p1)
Distinguish between labour mobility and efficiency of labour
State any factors which influence the efficiency of labour in an economy (UNEB, 2005, p1)
Differentiate between marginal product of labour and average product of labour
Mention any three factors that may increase the average product of labour (UNEB, 2004, p1)
What is meant by the term collective bargaining?
Give any three features of trade unions in developing countries (UNEB, 2003, p1)
What is meant by factor mobility?
Give any three barriers to factor mobility in your country
Give any three factors which determine the productivity of labour in your country (UNEB, 2003, p2)
Mention any four factors which limit occupational mobility of labour in your country (UNEB, 2001, p2)
Mention any four factors that determine the strength of trade unions in your country (UNEB, 1999, p2)
What is meant by efficiency of labour?
State any three factors which affect the efficiency of labour in your country (UNEB, 1997, p2)
Mention any four methods that may be used by a trade union to settle industrial disputes (UNEB, 1994, p2)
Differentiate between nominal wage and real wage
Give two modes of paying workers in your country (UNEB, 1993, p3)
Distinguish between mobility of labour and division of labour
How are the two related (UNEB, 1992. P2)

SECTION B (LABOUR)

What is meant by collective bargaining?
To what extent have trade unions in your country achieved their objectives? (UNEB, 2004, p2)

What are trade unions?
Under what circumstances are trade unions justified to demand for wage increases? (UNEB, 2002, p1)
Under what circumstances may workers demand for higher wages? (UNEB, 1998, p2)
Examine the problems facing trade unions in your country (UNEB, 1998, p2)
Normally what arguments do trade unions put forward when demanding for higher wages? Discuss them
How can trade unions in less developed countries are an able to raise wages for their members? (UNEB, 1996, p1)
Examine the factors that determine labour supply in your country
Account for the differences in wage rates in your country? (UNEB, 1994, p2)
What are the functions of a trade union?
What problems do trade unions in your country face? (UNEB, 1993, p2)

POPULATION SECTION A

Given that the working population in a country is 12000000 the young population is 14000000 and the elderly population is 4000000. Calculate the country's dependency ration (UNEB, 2002, p2)
Give any two disadvantages of such a population structure
Explain the Malthusian theory of population
State any two limitations of the Malthusian theory of population (UNEB, 2001, p1)

SECTION B

What is meant by the term optimum population?
Examine the implications of a high population growth rate in your country (UNEB, 2006, p2)
Describe the population of your country
Examine the economic implications of such a population structure (UNEB, 2005, p2)
Explain the Malthusian theory of population
To what extent is the theory relevant to your country (UNEB, 2004, p1)
Define the term optimum population
Examine the economic implications of an increasing population in an economy (UNEB, 2003, p1)
Explain the Malthusian theory of population
What are the limitations of Malthusian theory of population? (UNEB, 1999, p1)
Differentiate between under population and over population
Examine the effects of a high population growth rate in an economy UNEB, 1997, p1)
Explain the Malthusian population theory
Examine the relevance of the theory to developing countries (UNEB, 1994, p1)
Explain the methods used by trade unions to obtain wage increases
Explain the factors that limit the ability of trade unions to raise wages in your country (UNEB, 2009, p2

MONEY AND BANKING

MONEY

Money refers to anything which is generally acceptable as a medium of exchange for the discharge of debts or obligations. It is there fore a legal tender. To day money is received in form of coins, bank notes and cheques

FUNCTIONS OF MONEY

1. It is a medium of exchange. Money acts as a means of payment for goods and services and makes it possible to approximate the quality or quantity of a good or a service to be exchanged
2. Money is a measure of value. The value of a commodity is reflected in its price i.e. a commodity with a high price is expected to give more satisfaction than that with a lower price
3. Money is a store of wealth (value). It can be used to store wealth in form of liquid cash, instead of bulky assets. One may sell goods to day whether perishable or durable and turn them into money till ten years or any time to come before turning this money back into commodities
4. Money is a unit of account. Money is used to carry out accounting and business calculation. This concerns estimating the progress of the business
5. Money is a means of differed payments. Money is used to make future payment for any credit transaction or any amount borrowed
6. Money makes it possible for the price mechanism to operate since it is used in determining prices of commodities
7. Money transfers physical assets to liquidity
8. Money serves as a tool used by the government to regulate economic activities within an economy

QUALITIES OR PROPERTIES OF GOOD MONEY

1. The most essential property of money is that it must be accepted or acceptable throughout the community. A bank note for example is not required for its own sake but for what it can purchase and this is only possible if it is accepted in society
2. Portability. It must be easily moveable from one place to another
3. Durability. It should be long lasting so as not to ware out easily to necessitate expenses of printing to replace worn-out currency
4. Divisibility. What is used as money should be capable of being broken down into small units without any loss in value. It should facilitate small transactions
5. Homogeneity. Whatever is used as money in the country should look the same i.e. uniform currency of the small value and units should actually look a like in terms of size and sharp
6. Stability. Good money should be stable in value to maintain the purchasing power and make it easily available

Difficult to forge. Good money should be easily recognized and should be different from counterfeit money. In other wards it should be identifiable

7. Scarcity. Money should be scarce, though not too scarce, it should be difficult to earn otherwise its excess availability will affect its value and acceptability

8. Good money should be easy to put in any shape i.e. it should enable coins to be printed (merited) into any shape of acceptable values in respect to weight, size etc without deterioration in value
9. Good money should be convenient, cheap and easy for the government to print

EVOLUTION OF MONEY

a) Barter system was the earliest form of exchange where Commodities were directly exchanged for commodities. Because of its problems like perishability of commodities, double coincidence of wants etc use of commodities of high value replaced barter system
b) Items like salt, hoes, tobacco etc any of them could be accepted by an individual because of the ease in using them for exchange with other commodities
c) Because the above commodities were perishable, durable commodities were adopted as a step towards solution. These commodities included copper, iron, and cowries' shells, beads, silver and gold. This was called **metallic regime**
d) However, they were not all that scarce crippling the transaction system. To create scarcity rare metals became an alternative. Gold and silver were used for their intrinsic value. This was called the **Bi-metallic regime**. However, they had a problem of people melting them for money in periods of money scarcity to cause inflation and deflation by melting them back to metals. This time minerals were being kept by the gold smiths. These are people entrusted to keep gold on behalf of others and smelt it.
e) Use of paper money. In the beginning, people were keeping their gold with gold smiths who gave them receipts after signing on the back (endorsing). Gold owners started settling their debts and other obligations plus transactions by use of these receipts because they were portable and as good as gold. This marked the beginning of the use of paper money
f) The work of gold smiths was later taken over by the formation of the central bank which was responsible for issuing these receipts. These gold documents were later standardized to make paper money hence marking the origin of paper money (fiduciary issue)
g) The existence of banks led to the formation of deposit money. This is the money created by commercial banks in the process of accepting deposits and lending using a cheque form. This process is known as credit creation

TYPES OF MONEY

a) **Token money**: this refers to money whose intrinsic (inner) value is less than its face value. It is also referred to as representative money
b) **Crude commodity money**: Are articles which carry out the functions of money for example salt, beads, grains, cattle, rice, tobacco etc
c) **Standard or full embodied money**: Refers to the money made from coins with intrinsic or metallic value is equivalent to its face value
d) **Quasi/Near money**: These are assets which can easily be converted into cash g bank drafts, cheques, bills of order, trade credit bills
e) **Representative money**: This is money which is completely backed by the gold bullions and gold coins hence held by the treasury (its money in circulation which is equivalent to the gold kept in the central bank)
f) **Convertible money**: Refer to money which can be exchanged without restrictions. This money should be backed by profit bullions in the central bank
g) **Paper money/inconvertible money**: This is money which is not backed by standard coins of bullions. Therefore all currency notes issued by the central bank of a country but not gold constitutes inconvertible or paper money

h) **Legal tender**: It is that money which must be accepted by law in the settlement of debts in the country i.e. currency issued by the country's central banks e.g. coins and paper notes
i) **Foreign reserves/foreign currency**: This is money in form of foreign exchange usually kept by the country to facilitate international transaction e.g. Us dollars, pound starling, Japanese yen, Documarks, Canadians etc
j) **Currency** is any form of money used in a given country or region e.g. coins, banknotes etc
k) **Fiat money**: refers to money printed by the central bank on government orders not backed by gold or government securities

FORMS OF CURRENCY

a) **Hard currency (convertible currency**): This is a currency or form of money which can easily be exchanged into other currencies or for gold like dollars, pound starling etc
b) **Securities**: These are income yielding documents which can be bought and sold like treasury bills, bonds etc
c) **Bonds**: Are long term securities issued by the government or public companies used to borrow from the public
d) **Bills of exchange**: is an conditional order in writing by the seller or creditor
e) **Treasury bills**: These are short term securities issued by the government or public companies to lend money in the public
f) **Instruments of credit**: These are written promises that are made to make payments on a specific date or in the future like cheques
g) **Fidiciary issue:** This is the money issued by the central bank at its own judgment and not backed by foreign reserves but it is backed by government securities
h) **Money in circulation**: Refers to liquid cash in hands of the public and financial institutions plus facilities that can perform the function of money
i) Distinguish between revaluation and overvaluation of currency
j) **Revaluation** refers to upward change in the exchange rate of a currency under a fixed exchange rate system
k) While
l) **Over valuation of a currency** refers to upward change in the exchange rate in a currency above the market price
m) Distinguish between currency devaluation and depreciation
n) **Devaluation** is the legal or official lowering of the value of a country's currency in terms of the foreign currency
o) While
p) **Currency depreciation** is the fall in the value of local currency against foreign currencies as a result of interplay of forces of demand and supply

Effects of currency depreciation

i. Projected planning is made difficult due to change in the value of the local currency
ii. It worsens external debt burden
iii. It leads to rise in prices of goods and services locally
iv. It encourages foreign investment
v. It leads to speculation
vi. Makes exporters receive high currency value since earnings in foreign currencies are of high value than the local currency

ADVANTAGES AND DISADVANTAGES OF BARTER TRADE

i. It preserves scarce foreign exchange
ii. It enables exchange to take place without looking for foreign exchange
iii. It widens the market for commodities
iv. It encourages trade among the LDCs which lack foreign exchange
v. The effect of price fluctuation is avoided since bargaining is in terms of physical quantity

vi. It improves on the relationship between two societies hence it creates a harmonious situation

DISADVANTAGES

i. Indivisibility of items e.g. a commodity like a car could not be easily divided into small units for exchange
ii. Difficult in determining the relative value of goods and services e.g. it is difficult for bags of beans to be exchange for what he wants
iii. Double coincidence of wants. One finds it difficult to get another person who would want to exchange for what he wants
iv. Portability of goods. Goods such as animals were bulky and were not easily potable over long distances
v. Perish ability of goods. Goods such as fresh foods like milk could not be stored for along period of time
vi. Lack of deferred payment. It was difficult to determine the quantity of a commodity to be used which is relatively stable in value i.e. commodity value tends to change over a short period of time depending on their relative scarcity

MONETARY ECONOMY: This is an economic system in which in which exchange is facilitated by the use of money as opposed to barter trade where goods are exchanged for goods

MERITS OF A MONETARY ECONOMY

i. There is a high output and economies of scale
ii. High standards of livings because people can sell their goods and acquire their basic necessities
iii. Encourages specialization which leads to higher output and high quality products
iv. Foreign exchange is reserved since surplus output is exported. This can be used for the development of other activities like infrastructure
v. Employment opportunities expand very easily as different economic activities are carried out to supply local and foreign markets
vi. Industrialization is possible and this brings about rapid development of an economy
vii. Savings are mobilized which can be used for investment
viii. It facilitates trade and exchange since money is possible
ix. It is used in rewarding factors of production in terms of rent, profits, wages, interest etc

DISADVANTAGES

i. It promotes illegal ways of obtaining money like through corruption, prostitution hence destroying the morals and righteousness of the society
ii. It may lead to uneven distribution of income /income inequality because different economic activities do not use the same income to the respective people included in their activities
iii. The production of cash crops may decrease the production of food crops which leads to dependence
iv. It brings about rapid exploitation of resources which may lead to depression of resources
v. The means of production are costly since the technology has to be imported
vi. It is too dependant on market which may lead to huge losses incase of market decline

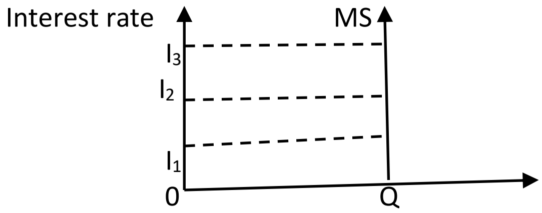
MONEY SUPPLY

Refers to the quantity of money in circulation in a particular country at a specific period of time. It consists of money in circulation and the money held by banks at a given time

FORMS OF MONEY SUPPLY

i. **NARROW MONEY SUPPLY**: It's the total sum of money in hands of the public plus the amount on current account of commercial banks
ii. **Broad money supply**: It is the total sum of money in the hands of the public plus all deposits within the commercial bank

iii. **Exo-geneous money supply**: It is the supply of money which is fixed and determined by the monetary authority or by the central bank .It is also called discretion money supply



iv. **Endo-geneous money supply**: is the one which is determined by the level of economic activities in the country or depend on other factors which influence money supply like interest rate. It is called automatic money supply

DETERMINANTS OF MONEY SUPPLY

1. Fiscal policy used in a given country: If the government increases the tax rates without printing more money, money supply tends to fall but if the government reduces the tax rates while increasing its expenditure on public goods/services, money supply tends to increase
2. Level of economic activities/level of production of goods and services/level of national income: High level of production implies a big size of national income and an increase in money supply to enable exchange of goods and services while a low level of production means low level of money supply due to low level of economic activities
3. The level of credit creation: If commercial banks can easily carry out credit creation, money supply tends to increase since many people will open bank accounts and also get loans but hindrances to the process of credit creation limit money supply
4. The level of monetization of the economy/the size of the subsistence sector: High level of monetization increases money supply due to high level of commercial activities but a large subsistence sector means low money supply due to low level of commercial activities
5. The level of liquidity preference: when people prefer to hold or keep money in cash form, money supply tends to increase but when they decide to keep it in assets or banks, then money supply will reduce
6. Monetary policy carried out by the central bank: If an expansionary monetary policy is applied like using low bank rate, money supply tends to be high since borrowing is encouraged while a restrictive monetary policy like selling of securities to the public reduces money supply
7. The size of foreign exchange reserves: If the volume of foreign exchange reserves at the central bank is big, the supply of the local currency will be high to facilitate conversion of foreign currencies to the local currency while low size of foreign exchange reserves leads to low money supply
8. Rate of capital inflow and outflow. A high rate of capital inflow increases the level of money supply in the economy while a high capital outflow reduces the level of money supply in the economy
9. Rate of interest: A high rate of interest on bank deposits encourages people to deposit their money into banks which reduces the volume of money in circulation leading to low money supply while low interest rate on deposits limits bank deposits which increases the volume of money in circulation leading to high money supply

EFFECTS OF INCREASE IN MONEY SUPPLY

POSITIVE EFFECTS

1. It increases the rate of economic growth. An increase in money supply encourages investment in the country which increases the volume of goods produced leading to increase in economic growth
2. It increases job opportunities. An increase in money supply encourages people to set up investment projects which create more job opportunities for people
3. It increases government revenue. An increase in money supply promotes investment which widens the country's tax base hence increasing government revenue
4. It increases aggregate demand. An increase in money supply enables people to buy more goods and services in the country
5. It leads to an improvement in S.O.L. an increase in money supply enables people to access basic needs of life which leads to an improvement in people's s.o.l
6. More employment opportunities may be generated resulting from increased levels of investment
7. It offsets economic depression due to increased economic activities
8. It reduces the subsistence sector. When money supply in an economy increases, the subsistence sector tends to reduce as activities become commercialized

NEGATIVE EFFECTS

1. It leads to inflation. An increase in money supply increases the level of aggregate demand which results into demand pull inflation
2. It reduces the value of money or depreciation of money which may discourage investments
3. It worsens the BOP problem because exports become more expensive hence discouraging foreign buyers yet imports become cheaper
4. Illegal activities like smuggling, corruption, prostitution, black market etc are encouraged as people try to earn more so as to cope with the increase in the cost of living
5. Unemployment may result when some investors are forced to close down their businesses and transfer them to other countries
6. It may cause industrial unrest due to worker's demand for high wages to enable them cope with increased cost of living

CIRC UMSTANCES UNDER WHICH AN INCREASE IN MONEY SUPPLY MAY NOT RESULT INFLATION

1. Incase of existence of price control. An increase in money supply may not result into inflation incase the government controls prices inform of maximum price legislation which is below the maximum price
2. Incase an increase in money supply is followed by an increase in the level of taxation. An increase in direct tax rate reduces the disposable income of people hence lowering aggregate demand which prevents inflation
3. Incase it is accompanied by increase in marginal propensity to save. An increase in money supply does not lead to inflation if it is followed by an increase in the level of saving since savings reduce aggregate demand for goods and services
4. When increase in money supply is followed by an increase in interest rate. An increase in interest rate on savings encourages people to save money in banks which limits inflation caused by increase in money supply
5. Incase the increase in money supply is followed by an increase in volume of out put. An increase in the volume of output leads to a fall in price levels even when money supply increases
6. Incase the increase in money supply is followed by an increase in imports. An increase in imports increases the availability of goods and services in the domestic market which leads to a fall in prices even when money supply increases

7. When the increase in money supply is followed by a decrease in the volume of exports. A decrease in the volume of exports increases the availability of commodities on domestic market which leads to a fall in prices although money supply may be increasing
8. If the increase in money supply is used to purchase capital goods which are used to increase the scale of production inflation may not result from increased money supply
9. If the increase in money supply is followed by reduction in the velocity of circulation of money may not lead to inflation. This is because when the rate at which money changes hands reduces this also reduces prices caused by increase in money supply

QN: ***Explain the factors that limit money supply in an economy***
Under what circumstances may money supply increase in an economy?

DEMAND FOR MONEY

This is the people's desire to hold their wealth in cash form or near cash form instead of investing it in other assets

Liquidity. This is the ease with which an assets or a commodity can be converted into cash without any significant loss in value

THEORIES OF DEMAND FOR MONEY

There are two theories explaining the demand for money and these include the following:

i. The Keynesian theory of demand for money
ii. The quantity theory of money

THE KEYNESIAN THEORY OF MONEY OF DEMAND FOR MONEY

According to the Keynesian theory people demand for money due to the following motives:

i. Transaction motive
ii. Precautionary motive
iii. Speculative motive
iv. Finance motive

TRANSACTION DEMAND FOR MONEY

This is where people demand for money so as to make their day to day transactions e.g. purchase of food, clothes etc

FACTORS THAT DETERMINE THE TRANSACTION MOTIVE FOR MONEY

i. The level of income of an individual. A person with high levels of income will hold a larger amount of money for transaction motive compared to a person with low level of income
ii. The price levels and their changes. High level of prices makes people to hold more money to pay for high prices of commodities of commodities and if prices are low, people will hold less amount of money for transaction motive
iii. People's consumption habits. People who consume expensive products tend to hold large amounts of money for transaction motive
iv. The duration between wage payments. If the time interval between one payment and the next is short, the desire to hold cash for transaction motive will be low but if the time interval between payments is long large amount of money will be held for transaction motive
v. The need to fulfill other motives. If the desire to hold money for other motives is low, a person may hold large amounts of money for transaction motive the reverse is true

PRECAUTIONARY MOTIVE

This is the desire to hold money so as meet some unexpected expenditures that may arise eg spending on immediate treatment of a child who falls sick

FACTORS THAT INFLUENCE PRECAUTIONARY MOTIVE

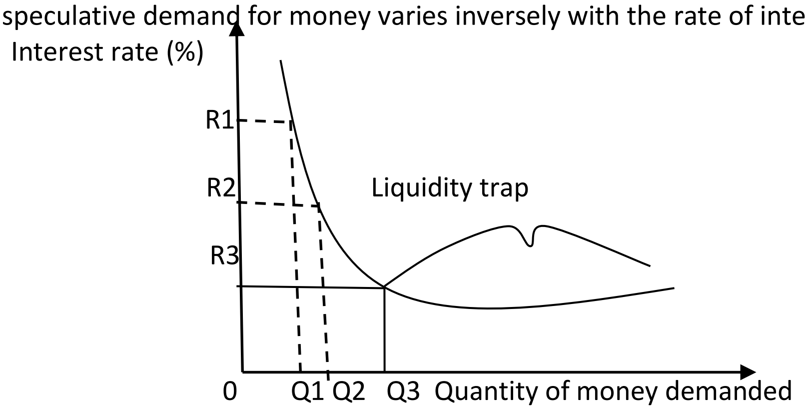
The person's level of income. A person with high level of income usually holds larger amounts of money for precautionary motive compared to a person with low level of income

The cost of keeping liquid assets in the bank reserves. If the cost is high like due to delays in obtaining the money, people will hold large amounts of money for precautionary motive yet if the cost is low, less money will be held for precautionary

SPECULATIVE MOTIVE.

This refers to the desire to hold money to earn high interest in the future both in the capital and money markets after assessing the future prospects. Money is held for making profits on securities, bonds, treasury bills etc

The speculative demand for money varies inversely with the rate of interest as shown below



LIQUIDITY TRAP. Is the lowest interest rate below which the demand for money/speculative motive is zero. Graphically the liquidity trap is showed by the horizontal section of the demand for money when the interest rate is at its lowest R3 below which speculative demand for money is zero

An increase in the interest from R2 to R1 encourages people and business firm to use their money to buy securities such as bonds and treasury bills which reduces the demand for money from Q2 to Q1

The factor that determines the speculative demand for money is the interest rate. If the interest rates are expected to fall, speculators will decide to sell now and hold more cash so as to avoid capital losses but if future interest rates are expected to rise, speculators will hold less cash of selling at higher prices later

FINANTIAL MOTIVE/INVESTMENT MOTIVE

According to Keynes this is the peoples' desire to hold cash to finance their ongoing investments in which large sums of capital have been invested. Here cash is invested to meet the variable costs incurred by the business

FACTORS THAT INFLUENCE FINANCE DEMAND FOR MONEY

1. The level of demand for the goods and services. If the demand for the products is high, people will increase cash held for finance motive so as to expand production and earn more profits but if the demand for the products is low, producers will hold less cash for financial motive
2. The marginal efficiency of capital. The higher the marginal efficiency of capital, the higher the demand for money for finance motive and lower the marginal efficiency of capital, the lower the demand for money for finance motive
3. The level of income

INTEREST RATE

An interest rate is a monetary payment made for use of capital s a factor of production

REASONS FOR PAYING INTEREST RATE

It is a reward for savings. Interest rate is paid by financial institutions to encourage savers to post pone present consumption to the future

It is the price paid for the use of credit. According to classical it is paid for the use of loanable

It is a reward for risk taking. Is a risk for money lenders to part with their money/cash because it can be lost if the borrowers default their forms

It is paid as a reward for inconveniences experienced by money lenders since they part their money which they otherwise would have used in their personal businesses

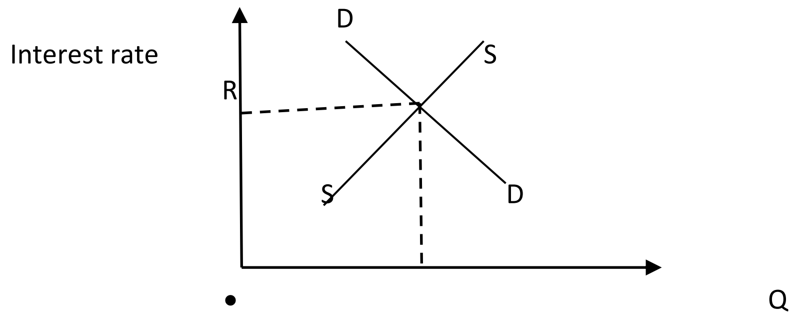
THEORIES OF INTEREST RATE DETERMINATION

There are two main theories that attempts to explain how the rate of interest is determined interms of demand and supply

a. The loanable fund theory
b. The liquidity preference theory

THE LOANABLE FUNDS THEORY

It states that the rate of interest is determined by the interaction of the demand for loanable funds and supply of loanable funds such as shown below



SS= supply of loanable funds
DD= demand for loanable funds
R=Equilibrium rate of interest
Q=Equilibrium quantity of loanable funds

THE LIQUIDITY PREFERENCE THEORY

This theory was put forward by John Maynard Keynes and it states that the rate of interest is determined by the demand and supply of money and not by the demand and supply of loanable funds

TYPES OF INTEREST RATE

a. **Bank rate**. This is the interest rate charged by the central bank on commercial banks which borrow money from it
b. **Deposit rate**. This is the interest paid by commercial banks/financial institutions to depositors. It varies from bank to bank and also depending on the type of bank account and amount of deposit
c. **Lending interest rate**. This is the rate at which commercial banks give out loans, bank drafts and bank over drafts to borrowers. Lending rates are usually higher than deposit rates
d. **Ways and loans.** This is the rate charged by the central bank on government for borrowing money from it
e. **Government stock interest rate**. This is the reward earned by the government on its shares sold in government undertakings

f. **Treasury bills discount rate**. This is the rate at which the central bank sells treasury bills to the public or discounts markets

Treasury bills are documents or instruments of short term borrowing issued by the government through the central bank at fixed interest rate depending on their maturity periods like 91 days, 182 days etc

FACTORS THAT DETERMINE RATE OF INTEREST IN AN ECONOMY

1. Level of risks involved in lending. Risky ventures where the lender has high doubts always attract high interest rate while low interest rate are charged on borrowed money where lending is less risky
2. Length of loan repayment period. The interest rate for capital tends to be high for loans whose repayment period is long while loans whose repayment period is short, the interest rate tends to be low
3. Level of demand for loanable funds. High demand for loanable funds leads to a high interest rate while low demand for loanable funds leads to a low interest rate
4. Level of deposits for commercial banks. A high level of deposits increases the availability of loanable funds which leads to low interest rate while a low level of deposits limits the amount of loanable funds leading to high interest rate
5. Level of money supply. A high level of money supply in an economy leads to high interest rates while low level of money supply leads to low rate of interest
6. Level of development of the banking sector. The interest rate tends to be low incase of a well developed banking sector with many banks due to competition while for under developed banking sector, the interest rate tends to be high since borrowers have limited number of banks to borrow from
7. Prevailing economic situation. The rate of interest tends to be low in situation of economic recessions and depression so as to encourage investment while in periods of economic boom the rate of interest tends to be high due to high demand for loans
8. The marginal efficiency of capital. When the marginal efficiency of capital is high the demand for capital is high and this forces the interest rate to go up but when the marginal efficiency of capital is low, the demand for capital will be low leading to low interest rate
9. The degree of liquidity preference. High liquidity preference in an economy necessitates the central bank to charge high interest rate to break it but a low liquidity preference leads to a low rate of interest
10. Policy of an individual lender. If the lender wants to make high profits on money lent, he/she will charge high interest rate but if the aim is not high profit, low interest rate will be charged
11. Government expansionary/contractionary monetary policy. If the government adopts an expansionary monetary policy, the interest rate will be low so as to attract borrowers, but if a contractionary monetary policy is adopted interest rate will be high so as to discourage borrowing or lending

DETERMINANTA OF DEMAND FOR MONEY (LIQUIDITY PREFERENCE)

1. General Price level. High price levels force people to hold large sums of money to enable them live the standards of living they are used to which leads to high level of money demand while low prices lead to low cost of living hence leading to a low level of money demand
2. Rate of interest. High rates of interest on savings encourage people to deposit their money into banks which lead to low level of money demand while low interest discourage people from making deposits in banks which leads to high level of money demand
3. Degree of uncertainty. High risks involved in commercial banks force people to hold large sums of money which leads to high demand for money while minimal risks in banking institutions encourage people to make deposits in commercial banks which lead to low demand for money

4. Level of transactions. Many transactions to be carried out require people to hold large sums of money leading to a high level of money demand while limited transactions to be carried out reduces cash requirement leading to low level of money demand
5. Level of development of banking infrastructure. Well developed banking institutions promote bank deposits which lead to a low level of money demand while under developed banking institutions limit people from depositing money in banks leading to high demand for money
6. Income level. High incomes encourage people to hold large sums of money which leads to high level of money demand while low income levels limit people from holding a lot of money which leads to a low demand for money
7. Knowledge about banking facilities. Possession of adequate knowledge about banking facilities encourages people to make bank deposits which leads to a low demand for money while inadequate knowledge about the banking facilities limits bank deposits leading to high demand for money

QUANTITY THEORY OF MONEY

The theory was advanced by Professor Irving Fisher. It states that the general price level in an economy varies directly with the amount of money in circulation assuming the velocity of circulation of money and level of transaction are held constant

According to Irving Fisher, the quantity theory of money is expressed by the equation of exchange

PT=MV

Where,

P=General Price level

M= Amount of money in circulation

V=Velocity of money i.e. number of times money changes hands

T= Number of transactions

or

- It states that the general price level is determined by the quantity of money in circulation assuming that the velocity of circulation of money (V) and the level of transaction (T) are constant. **2mks** This implies that the price level and the amount of money in circulation vary in direct proportion to each other that is to say a proportionate increase in the amount of money in circulation leads to a proportionate increase in the general price level.
- Irving Fisher based this theory on the equation of exchange which is **PT=MV** where,
- **P** standards for general price level
- **T** standards for volume of transactions **2mks**
- **V** standards for velocity of circulation of money
- **M** standards for quantity of money in circulation

The theory assumes the following:

- It assumes that the velocity of circulation of money (V) is constant
- It assumes that the general price level is determined by the amount of money in circulation
- It assumes a highly monetized economy
- It assumes that the supply of money is determined by the central bank **2mks**
- It assumes that the economy is at full employment
- The theory assumes that money is only held for transaction motive
- It assumes that all money is used/ pent
- It assumes that the level or number of transaction (V) is constant

Given that m=50, v=3 and t=6 calculate the general price level

P=<u>MV</u>

P

$P = \frac{50 \times 3}{6}$

p= **shs25**

Given that p=45/=, m=30/= and T=6, calculate the velocity of circulation of money

$P = \frac{mv}{T}$

$P = \frac{30v}{6}$

$V = \frac{45 \times 6}{30}$

V= **9**

Given that m=180, p=60, and v=4, calculate the level of transaction T

$P = \frac{mv}{T}$

$60 = \frac{18 \times 4}{T}$

$T = \frac{180 \times 4}{60}$

T= **12**

Assuming V and T are constant and money is given as (M) = shs300millions, V= 10times and T= shs 100millions. What will be the general price level?

$P = \frac{MV}{T}$

$= \frac{300.000.000 \times 10}{100.000.000}$

= shs30.000.000

When m is doubled find P

300.000.000x2= 600.000.000

$P = \frac{MV}{T}$

$= \frac{600.000.000 X 10}{100.000.000}$

P= Shs 60.000.000

RELEVANCE OF THE THEORY

To a smaller extent the theory is relevant to my country/in an economy because of the following:

- People hold some money for transaction motives as the theory assumes for example for purchasing goods and services to satisfy their wants
- The amount of money in circulation has tended to influence prices in Uganda as the theory assumes for example the recent increase in the amount of money in circulation during presidential campaigns increased prices of goods and services up to 30% in November 2011
- Some people in the country especially the poor tend to consume all their income as the theory assumes thus making it relevant
- Most transactions in the country involve the use of money as the medium of exchange. This makes the theory relevant because it assumes a highly monetized economy yet money is being used in most transactions

- The supply of money in Uganda is largely determined by the central bank which is the bank of Uganda of Uganda as the theory assumes. This makes it relevant to my country

IRRELEVANCE OF THE THEORY/LIMITATIONS/INAPPLICABILITY/CRITICISMS OF THE THEORY

- **to a bigger extent the theory is irrelevant to my country in the following ways:**
- It ignores the existence of barter trade by assuming a highly monetized economy which involves the use of money as the only medium of exchange **yet** some transactions are made through barter exchange. This makes the theory irrelevant because people especially in rural areas exchange goods for goods
- The theory ignores the demand for money and only emphasizes the supply of money in an economy yet there are both. This makes the theory irrelevant because people demand for money for different motives like precautionary and financial motive
- The theory ignores other motives of holding money **yet** they exist and only considers transaction motive. This makes the theory irrelevant because people demand for money to meet their financial needs, unexpected contingencies etc
- There is no general price level as the theory assumes but rather a series of price levels due to existence of different goods and services with different quality and quantity. This makes the theory irrelevant because in Uganda 1kg of sugar is not the same price as that of salt
- It does not show how the value of money is determined and only attempts to explain changes in the value of money **yet** the value of money is determined using price index. This makes the theory irrelevant to my country
- The existence of government control of prices in the country makes the theory irrelevant since it assumes money supply as the only determinant of price **yet** the government influences price control through policies like taxation which normally increase or decrease prices of goods and services
- It ignores the influence of interest rate in determining the demand and supply of money and only considers the central bank as the only determinant. This makes the theory irrelevant because low interest rate increases the demand for money and high interest rate increases money supply in the country
- It ignores others methods of determining prices in the country like haggling between buyers and sellers and only assumes money supply as the only determinant yet such methods exist. In Uganda at times prices are determined by sellers and buyers after reaching an agreeable price
- The theory does not take into account other causes of price increase and only assumes money supply yet increase in costs of production can lead to increase in prices of goods and services, supply rigidities can also cause structural inflation thus making the theory irrelevant
- Increase in money supply some times results in higher savings due to high marginal propensity to save and this reduces the velocity of circulation of money and prices fall which is contrary to the theory. This makes the theory irrelevant since it assumes that increase in money supply will lead to increase in the general price level
- The existence of unemployment and under utilization of resources makes the theory irrelevant because it assumes conditions of full employment yet they do not exist in the country. Increase in money supply at times increases the volume of goods and services which makes the prices to fall or not to change at all which is contrary to the theory
- The quantity theory of money is not a theory at all but it is a truism because increase in money supply leads to increase in prices

THE VALUE OF MONEY

Value of money refers to the amount of goods and services that a nit of money can buy

Relationship between value of money and price levels

Value of money is negatively or inversely related to price levels since when price levels rise, the value of money falls and when price levels fall. Value of money rises

TYPES OF VALUE OF MONEY

Internal value of money. This refers to the purchasing power of money over domestic goods and services i.e. the volume of locally produced goods and services that can be purchased with a given amount of money

External value of money. This refers to the purchasing power of money (local currency) over foreign goods and services

Nominal value of money. This refers to the value of money at current prices

Real value of money. This refers to what nominal money can buy e.g. if shs. 5000 can buy 2 books then the real value of money is 2 books

SEIGNOIRAGE. Refers to the profits earned by minting authority. It is the difference between the real value of the material used in making money and face value indicated on money

FACTORS THAT DETERMINE/INFLUENCE THE VALUE OF MONEY

1. Price level. A high price level results into low value of money while a low price level implies high value of money
2. Available stock of goods and services. The higher the amount of goods and services in an economy, the higher the money value since prices tend to be low and the lower the volume of goods and services, the lower the value of money due to high prices
3. Government monetary policy. If an expansionary monetary policy is adopted, money supply tends to be high and price levels will also be high resulting I low value of money while a restrictive monetary policy reduces money supply and lowers prices hence high value of money
4. Capital inflows and outflows. If the capital inflow exceeds the capital outflows, the value of money may be high since investments are promoted but if capital outflows exceed inflows the value of money may be low due to low investment, low volume of goods and services and high price levels
5. Velocity of circulation of money. The higher the velocity of circulation, the lower the value of money due to high prices and the lower the circulation of money, the higher the value of money due to low prices
6. Prices of imports. The higher the price of imports, the lower the external value of money and the lower the price of imports, the higher the external value of money
7. Level of demand for money. A high demand for money leads to a high price level hence low value of money while a low demand for money results into low price level hence a high value of money

FINANCIAL MARKETS

These are markets where savings are mobilized and out of these savings loans are given to borrowers to carry out investments. Also financial securities such as treasury bills, government bonds and bills of exchange are bought and sold

FORMS OF FINANCIAL MARKETS

Money market. This is a market where short term financial securities are bought and sold

Capital market. This is a market where long term financial securities are bought and sold

Stock exchange market. This is a market where already issued shares and bonds are bought and sold

FEATURES OF MONEY MARKETS, CAPITAL MARKETS AND STOCK EXCHANGE MARKETS IN DEVELOPING COUNTRIES

i. They are mainly urban based
ii. They mainly operate on a small scale
iii. They charge high interest rate
iv. They deal in a limited variety of financial assets
v. They are few participants in the market

FUNCTIONS OF STOCK EXCHANGE MARKETS

i. They encourage saving for long term investment
ii. They regulate price rates of the traded securities
iii. They publish useful information about the various companies in order to guide investors

REVISION QUESTIONS

Distinguish between money demand and money supply
Examine the factors that determine money supply
Distinguish between nominal and real value of money
Explain the determinants of money value
Under what circumstances may money supply increase?
Explain the conditions that may lead to increase in money demand
What conditions may force interest rate to decrease in an economy
Explain the determinants of interest rate in developing countries
State and explain the quantity theory of money
To what extent is the theory relevant to your country?
Why is the quantity theory of money inadequate yard stick to determine the general price level in your country?
Explain the advantages and disadvantages of monetary economy over barter trade economy
Trace the evolution of money
Present the qualities of good money

BANKING

A bank is a financial institution that accepts people's deposits, safeguards them and makes them available to owners on demand and gives advanced loans to trust worthy borrowers

TYPES OF BANKS

Central bank. Refers to a monetary institution that is responsible for managing the monetary systems of a country
Commercial banks. Are financial institutions responsible for carrying out money business in a country by safeguarding people's deposits and lending to others on behalf of customers
Development bank. Is a financial institution which specializes in medium and long term credit for development purposes
Foreign exchange banks. Are financial institutions that buy and sell foreign currencies
Savings banks. Are financial institutions that keep money for small sellers Pass books are used and current or deposit account are not operated
Agricultural bank. This is a financial institution that holds money for lending agricultural development

TERMS USED IN BANKING

Bill of exchange. Is a document which promises the barer to be paid a certain sum of money after a specified period of time and without any condition. A bill of exchange is similar to a post dated cheque and it can be endorsed for payment to any named person other than the drawee
Treasury bill. Is an income yielding paper used by the government to lend or borrow money from the public in a short period of time usually less than one year where the barer is entitled to a fixed rate of interest
A bond. Is a piece of paper drawn by a borrower promising to pay a lender a certain amount of money (principle) at a specified date (maturity date) and to pay a given amount of interest per year or for a long period of time. It can be drawn by the government, city council, municipality etc
A cheque. Is a document written by the current account holder to his/her bank requesting it to pay a specified sum of money to the person to whom it is written

Shares. Are liquid assets of a company which can be sold and sold in a stock exchange market. Or a share is a unit of a loan of a joint stock company

COMMERCIAL BANKS.

These are financial institutions which bridge the gap between the deficit spending unit (borrowers) and surplus spending unit (lenders). Commercial banks are essentially dealers in credit or borrowed funds.

Commercial banks carry on their businesses which savings made from a surplus spending unit. They also create credit on their own accounts and initiate investment in short term and at times medium term undertakings

Examples of commercial banks in Uganda include:

Cairo, Stanbic, Barclays, Centenary, Equity, Orient, Crane bank etc

FUNCTIONS OF COMMERCIAL BANKS

1.Commercial banks accept and safe guard people's deposits and pay them on demand. This is the principle function of commercial bankthere are three types of deposits or accounts operated by commercial banks:

Saving account. It is an account where people deposit their money on a regular basis. It is intended for people who earn money in small amounts. It has the following features:

- On this account cheques are not used but instead pass books are given.
- The depositor earns a lower interest rate than that of a fixed deposit account,
- Withdrawals are made usually after notice of 7 days

Current accounts: are accounts for people who keep their money for safety.

- Depositors do not earn interests
- Withdrawals are on demand without notice
- Cheques are used on this account

Fixed deposits/time deposit account. It is an account where people keep a specified amount of money for a specified period of time e.g. one having 1 million and does not want to use it presently may put it on a fixed deposit account for a period of 3years. Depositors earn high interest

2.The offer credit facilities to those who are in financial need. These facilities can be given in form of loans either on short, medium and long term loan

3.They act as agents of payment s or transfer of money in that they carry on the function of transferring money from a customer's account on instructions to another customers account by means of :

- Cheques
- Bank drafts
- Credit transfer
- Standing orders
- Travelers' cheques

4. Discounting bills of exchange. Bills of exchange and promissory notes can be exchanged for money before their maturity dates at a discount by commercial banks

5. They assist in international trade whereby commercial banks render highly specialized services in the transfer of documents and finance between importers and exporters. They give permission to payment of money abroad and do supply information regarding foreign markets and the credit worthiness of the foreign traders

6. They provide facilities for safe custody of valuable property and documents for their customers for example insurance policies, wills, land tittles, jewellery, important certificates etc

7. They offer advise to investors regarding the possible suitable areas of investment eg purchase of shares, bonds, treasury bills

8. They act as trustees and administrators on behalf of their customers for example keeping wills of customers, land tittles, academic documents, marriage certificates, insurance policies etc

9. They implement monetary policies of the central bank. this is done through tools like open market operation, selective credit control, special deposits etc to as to achieve the desired objectives like economic stability

10. They promote saving habits among people through offering high interest rates on saved deposits

11. They sponsor community development programs like health programs, sports, education etc which facilitate social transformation

12. They promote infrastructural development such as roads in areas where they are established

13. They act as referees for their clients. This is often done if there an inquiry on the financial integrity of their customers

14. They create credit/money out of deposits received and later lent out

ASSETS AND LIABILITIES OF A COMMERCIAL BANK

Assets are possessions of the commercial banks and their claims against other people, institutions, government etc. They are items that bring in income and profits

These include:

i. Cash held and due from other banks
ii. Commercial bank reserves with the central bank
iii. Discounted bills by the commercial banks and those purchased
iv. Retained profits
v. Investments made by the bank
vi. Loans and over drafts which are advanced to customers
vii. Fixed assets like premises, buildings, furniture owned by the comercial banks
viii. Commission of acceptance and endorsements made by commercial banks on behalf of customers
ix. Confidence/good will that people have in commercial banks

LIABILITIES

These are claims against the assets of the bank by de[positors and creditors or are things that a commercial bank owes to the public. They may include the following:

i. Money borrowed from the central bank by the commercial bank
ii. Deposits on current, savings and time accounts
iii. Money kept in form of cash and the reserves made by the central bank
iv. Public/government funds usually deposited in the commercial banks and the commercial banks have to effect payments
v. Dividends payable to share holders
vi. Share capital

vii. Acceptance (documents), receivables and guarantees on before of customers

ROLES OF COMMERCIAL BANKS IN THE DEVELOPMENT OF AN ECONOMY

1. They offer employment opportunities to people in countries were they are established. Commercial banks employ skilled, semi skilled and unskilled labour hence stimulating their incomes and standards of living. For example people worker as cleaners, managers, tellers, loans officers etc
2. They facilitate the process of capital accumulation through promoting saving and investments. This expands the productive capacity of the economy thus accelerating economic growth and development
3. Commercial banks promote domestic and international trade by providing easy means of payment like use of cheques, bank drafts etc
4. They are a source of government revenue. Profits earned by commercial banks are taxed by the government in form of corporate tax and this enables it to execute its duties thus achieving development objectives
5. They act as a medium through which the central bank or government implements its monetary policies aimed at achieving desirable economic objectives
6. They promote economic transformation since they monetize the economy. Establishment of commercial banks promote the use of money as a medium of exchange thus reducing the large subsistence sector in developing economies
7. They give advise to investors by carrying out feasibility studies, financing workshops and securing market for the out put produced

PROBLEMS FACING COMMERCIAL BANKS IN LDCS

1. Political instability in some parts of the country. This discourages commercial banks from lending out money to people due to high degree of uncertainty
2. Inadequate collateral security. This limits people from acquiring loans from commercial banks there by limiting their activities. This is due to low level of income of people
3. Inadequate skilled labour. There are few trained people in the banking sector which leads to inefficiency
4. Unfavorable government policy of charging high taxes. This reduces profit margins of commercial banks which makes the banking sector unattractive to many investments
5. Under developed infrastructure. This limits the activities of commercial banks in those areas with poor roads, unstable power supply, etc
6. High liquidity preference. Many people prefer holding their wealth in cash form which limits the activities of commercial banks such as credit creation
7. Existence of a large subsistence sector/low level of monetization. This implies low incomes and savings thus limiting activities of commercial banks like accepting deposits and lending money to people
8. High marginal propensity to consume. This limits saving with commercial banks there by limiting their activities such as credit creation
9. Inadequate statistical equipments such as computers which help to store data for proper recording keeping
10. High level of inflation. This forces commercial banks to charge high interest rate on borrowed funds which discourages borrowers and credit creation
11. The low income of people/general poverty. This limits the level of saving which in turn limits funds available to commercial banks to be given inform of loans
12. Government interference in commercial bank activities. Governments in LDCs interfere with the management of commercial banks for example some are closed unknowing for example the green land bank. This makes the public to lose trust in such banks thus affecting their performance

13. Inadequate credit worthy customers. This limits credit creation process in commercial banks thus discouraging their expansion

14. High level of competition. Local commercial banks face a problem of stiff competition from well established foreign commercial banks and this reduced the profitability of these banks

ROLES OF FOREIGN COMMERCIAL BANKS IN AN ECONOMY/IN THE COUNTRY
POSTIVE ROLES

1. They provide employment opportunities to local people especial when they employ labour intensive techniques. This increases income level of people and reduce the unemployment problem. For example many people are employed in Crane bank, Cairo, Stanbic, Equity, Barclays etc
2. They promote good political and international relationships between the host country and other countries thus promoting political stability
3. They provide revenue to the government through taxes and other sources. This enables the government to execute its duties
4. They create competition in the banking sector which leads to efficiency and better services offered
5. They encourage investment in the private sector through giving loans to the private individuals thus promoting private sector activities
6. They facilitate infrastructural development in areas where they are established for example they extend power in such areas, construct roads, hospitals etc thus improving the welfare of people in the country
7. They help in mobilizing savings by offering reasonable interest rates on the saved money. This helps in rising domestic capital for economic development
8. They lead to development of managerial skills and competence of local banks through the training they offer to such banks
9. They accelerate monetization of the economy through encouraging the use of money thus reducing the large subsistence sector in many developing countries
10. They sponsor community development programs like sports, education etc. this helps to reduce illiteracy rates and develops talents of local people
11. They promote technological transfer and development thus promoting efficiency in the banking sector. This is through the use of automated machines in these banks
12. They implement policies of the central bank aimed at achieving desired goals like economic stability. For example implementing a restrictive money policy to reduce inflation
13. They encourage foreign investment as they tend to encourage foreign capital inflow thereby filling the saving investment gaps in low developing countries
14. They widen consumer's choice due to a variety of services offered by these foreign banks. Foe example they accept deposits, give loans, technical skills, insurance services etc

NEGATIVE ROLES

1. They worsen the unemployment problem since most of them are owned by foreigners who prefer employing people from their countries for most of the senior posts
2. They discourage savings among people since they charge high interests on deposits and demand high minimum balance on deposit accounts
3. They increase the rate of capital outflow inform of profit repatriation since they are owned to foreigners thus leaving host countries under developed
4. They tend to out compete the local commercial banks due to stiff competition extended on them which retards their development

5. They worsen the problem of income inequality between nationals and foreigners. This is because people employed in these banks earn high incomes compared to those employed in local banks
6. They lead to regional imbalance in development since most of them are located in urban centers thus limiting monetization in rural areas
7. They interfere with government policies especially when they are large and owned by giant foreign countries

NATIONALISATION OF COMMERCIAL BANKS

This refers to the transfer of ownership and control of private commercial banks to government control

REASONS FOR NATIONALISATION OF COMMERCIAL BANKS

1. To allow the government to control/regulate the rate of money supply to a desirable level
2. To limit profit repatriation by foreigners who own commercial banks
3. To limit over exploitation of customers by foreign commercial banks inform of high interest rate
4. To increase the availability of job opportunities by giving jobs to nationals which would have been taken up by foreigners
5. To ensure a fair distribution of commercial banks in the country as compared to the private commercial banks that are mainly urban based
6. To allow easy planning in resource allocation and control in the country
7. To minimize wasteful competition in the banking sector and duplication of services
8. To encourage the development of local financial institutions that can be outcompeted by well established foreign commercial banks

DISADVANTAGES OF NATIONALISATION OF COMMERCIAL BANKS

1. It increases inefficiency in the banking sector due to lack of competition
2. It increases bureaucratic tendencies in the banking sector which results into unnecessary delays in decision making and implementation
3. It promotes corruption and embezzlement in the banking sector
4. It stains economic and political ties of the nationalizing country and the mother country where the bank originates
5. It leads to loss of confidence in the financial sector by potential foreign investors as they are scared of losing their asset
6. It leads to out flow of expatriates in the banking technical and managerial skills
7. It limits consumer's choice since nationalizing commercial banks forces many foreign commercial banks to leave the banking industry
8. It reduces individual initiative since benefits that are gained by a free market are blocked thus limiting domestic and foreign investments

QN: Account for nationalization of commercial banks in your country

Explain the arguments for and against nationalization of commercial banks in your country

CONFLICTING OBJECTIVES OF COMMERCIAL BANKS/HOW COMMERCIAL BANKS HARMONISE PROFITABILITY, SECURITY AND LIQUIDITY OBJECTIVES

Commercial banks are faced with the dilemma of achieving various objectives namely liquidity, profitability, security and convertibility (shiftability)

If they increase lending so as to earn profits, it will not meet customers' demands which make them loose confidence and therefore deposit less. In the same way, if they maintain liquidity to attract the confidence of their customers they would not get profits as there will be no funds for lending

The principle of profitability can be ensured in the following ways:

1. Lending money to borrowers at an interest rate
2. Discounting bills and selling securities

3. Investing in profitable projects like industries, construction of houses, agriculture which do earn the profits
4. Charging commission charged on the services rendered to customers for example commission charged on standing orders, keeping valuable documents, operating current accounts and withdrawals, exchanging foreign currency for local currency etc
5. Investing in government securities such as bonds and treasury bills
6. Keeping time deposits with other banks to earn high interest rate on it hence making profits
7. Through accepting time deposits from banks and non banks so as to use that money for makings profits

Liquidity is comprised by using the following ways:

1. Keeping money at hand through a cash ration
2. Keeping assets in liquid form e.g. keeping money in bonds, treasury bills, bills of exchange, cheques etc and this money is referred to as money at short notice or near money
3. Regulating the withdrawal periods and methods of fixing days or time of withdrawals in order to reduce on the frequent demand
4. Giving some short term loans which are paid after a short period of time usually a year. This means that money will be maintained within the commercial banks
5. Limiting credit or credit squeeze a policy of limiting loans so at to leave some money in banks
6. Maintaining accounts with other banks and non-banking intermediaries of which it can withdraw money incase of financial crisis
7. Borrowing from other financial institutions and the central bank since it is the lender of last resort to ensure liquidity in commercial banks
8. Ensuring that borrower's deposits securities are available in liquid or near cash which may be liquidated incase of problems

Security can be ensured by:

1. Asking collateral security on the loans granted
2. Giving short term loans which are less risky

CREDIT CREATION PROCESS/MONEY CREATION

This is the process through which commercial banks create new deposits out of the initial deposits from customers through lending out excess funds to credit worthy borrowers. It is therefore a process through which commercial banks expand the volume of credit from initial deposits by lending out excess funds

Through experience commercial banks realized that not all customers need money at a given time therefore they keep a small percentage of their total deposit in cash which can cater for their day to day requirements for their customers and then lend out the balance

The process of credit creation operates basing on the following assumptions:

- ✓ It assumes that the public is always willing to deposit money with commercial banks
- ✓ The banks must be willing to give loans to customers
- ✓ Customers must be willing to borrow money from the banks
- ✓ The loans advanced are often either deposited in the same bank or another commercial bank
- ✓ The customers to the bank hold their money on a fixed account and clear their bills with cheque payment i.e. money does not go out of the bank
- ✓ There is a fixed percentage of customers' deposit kept in cash (cash ratio)
- ✓ There must be an initial deposit

TERMINOLOGIES ASSOCIATED WITH CREDIT CREATION

1. **Reserve ratio**; This refers to the fraction of total deposits that is not lent out but remains for reservation. This depends on the banking laws of a country and it is greatly influenced by the economic stability of the country
2. **Cash ratio/cash reserve**. This is the fraction of the total deposits which remain in the bank inform of cash to meet the cash requirements of the depositors
3. **Legal reserve requirements/minimum legal reserve requirement**. This refers to the fraction of total deposits, commercial banks are by law required to deposit with the central bank
4. **Special deposits**. This is the amount of money put in the central bank by the commercial bank during periods of inflation to reduce on the lending capacity and hence reducing money supply
5. **Liquidity ratio.** This refers to the proportion of the total deposits in commercial banks that is kept in liquid assets i.e. assets which can be easily put into cash

DESCRIPTION OF HOW COMMERCIAL BANKS CREATE CREDITS

- Commercial banks create credits by receiving deposits and lending part of it to credit worthy borrowers
- Assuming the initial deposit in bank A is 100,000/= and the cash ration is 20%
- 20% of shs. 100,000/= (20,000) is kept in cash form in the bank A to meet daily demands of clients and the remaining shs.80, 000/= (100,000-20,000) is lent out to trust worthy borrower in bank B
- 20% of 80.000=16000/= is kept in cash form in bank B to meet cash demands of clients and the remaining shs. 64000 (80,000-16000) is lent out to the trust worthy borrower in bank C
- 20% of 64000 =12800/= is kept in cash form in bank C to meet daily cash demands of customers and the remaining 51200 (64000-12800) is lent out to a trust worthy borrower in bank D
- The process continues until the initial deposit defuses into the system i.e. when the bank has no capacity to lend out money
- At the end of the process, the final deposit is given by:

  Final deposit= $\frac{1}{\text{Cash ratio}}$ x initial deposit

Credit multiplier= $\frac{1}{\text{Cash ratio}}$

The credit creation process above can be summarized as in the table below incse of a multi-bank model

Bank	**New deposit**	**Cash ratio (20%)**	Loanable funds
A	100,000	20,000	80,000(100,000-20000)
B	80,000	16000	64000
C	64000	12800	51200
D	51200	-	-

Total credit created = Credit multiplier x initial deposit

$$\frac{1}{\frac{20}{100}} \text{x } 100{,}000$$

= shs. 500,000/=

NB. Credit multiplier is the number of times by which an initial deposit in a given bank multiplies itself to give a final change in deposits

Or
The number of times initial deposit in a bank is multiplied to give total credit created/total deposit
Examples:
Given that the microfinance bank has an initial deposit of shs. 400,000/= and the required cash ratio is 25%. Calculate:

i. Credit multiplier
ii. Total deposit created

Credit multiplier = $\frac{1}{25\%}$

$=\frac{1}{\frac{25}{100}}$

=4times

Total deposit created= credit multiplier x initial deposit
= 4 x 400,000
= shs 1600,000

Given that the commercial bank's final deposit is shs. 157500. Calculate the initial deposit if the cash rate 40%,
Solution:
Credit multiplier = $\frac{1}{40\%}$

=2.5times

Final deposit/income deposit= $\frac{1}{\text{Cash ratio}}$ x initial deposit

Let initial deposit be **Z**
= 157500= 2.5Z
Z= $\frac{157500}{2.5}$
Z= shs 63000

Given that the initial deposit is shs. 1000/= and the cash ratio is 20%, describe the credit creation process in a multi-bank model up to the 5th bank using a table
Given the initial deposit 10,000/=, cash ratio of 10%. Calculate:
Loanable fund
Preservation fund
From the 1st bank up to the 6th bank

SINGLE BANK MODEL. This assumes that there is only one commercial bank in the economy so that the cash down and cheques signed are honored by a single commercial bank so the money lent out may find its way back in the same bank therefore the cash does not go out of the banks
Assume one bank with many customers has an initial deposit of 10,000/= and the cash ratio of 15%

Complete the table

CUSTOMER	DEPOSITS	CASH RATIO	PRESERVATION FUND	LOANABLE FUNDS
P				
Q				
R				
S				

T				

FACTORS THAT INFLUENCE CREDIT CREATION PROCESS

1. Level of interest. A high interest rate on borrowed money discourages borrowing from commercial banks which limits the credit creation process while a low interest rate encourages borrowing from financial institutions which promotes credit creation process
2. Size of bank deposits. Large bank deposits increase the amount of loanable funds which promotes the process of credit creation while small deposits limit the amount of money to be lent out hence limiting the credit creation process
3. Size of the cash ratio. A high cash ratio limits the amount of money available to be lent out hence limiting credit creation while a low cash ratio leads to large amount of money to be lent out which promotes the credit creation process
4. Level of liquidity preference. High liquidity preference leaves a small amount of money to be lent out which limits the process of credit creation while low liquidity preference leaves commercial banks with more loanable funds which promotes credit creation process
5. Nature of distribution of commercial banks. Even distribution of commercial banks throughout the country increases bank deposits which avails more loanable funds hence promoting the credit creation process while uneven distribution of commercial banks limits bank deposits which limits loan funds hence hindering the process of credit creation
6. Availability of collateral security. Shortage of collateral security limits banks from offering loans to the public hence liming credit creation while presence of collateral security allows commercial banks to extend credit facilities to the public hence promoting the credit creation process
7. Availability of credit worthy borrowers. A large number of credit worthy borrowers encourages commercial banks to give out loans there by promoting credit creation while limited credit worthy borrowers discourage lending by commercial banks which discourages credit creation process
8. Degree of accountability. A high level of corruption among bank officers limits a number of borrowers as they only offer loans to those who give them bribes which limits the process of credit creation while low levels of corruption lead to a large number of people who access loanable funds hence promoting the credit creation process
9. Nature of the prevailing monetary policy. A restrictive monetary policy such as setting high bank rate reduces the amount of loanable funds which limits credit creation while an expansionary monetary policy such as setting a low bank rate increases the amount of loanable funds hence promoting credit creation
10. Income level. High income levels promote saving with commercial banks which avails enough loanable funds hence promoting credit creation while low income levels discourage savings with commercial banks which limits the amount of loanable funds there by discouraging credit creation
11. The public confidence in commercial banks which allows them to open up accounts and their savings. High Public confidence promotes credit creation while low public confidence in commercial banks limits credit creation process
12. Under multi-bank model, the number of commercial banks also determines rate of credit creation. More commercial banks promote the process of credit creation while less or few commercial banks slow/limit the process of credit formation

Explain the factors that limit the process of process of credit creation by commercial banks

- High interest rate
- Low income levels
- A restrictive monetary policy

- Limited credit worthy borrowers
- Inadequate collateral security
- High level of corruption among bank officers
- Unfair distribution of commercial banks
- High rate of liquidity preference
- Small bank deposits
- Existence of political instability in some parts of the country
- Large subsistence sector
- Limited knowledge about services offered by commercial banks
- Public confidence in commercial banks
- Limited number of commercial banks

THE CENTRAL BANK/BANK OF UGANDA

Is a government financial institution set up by an act of parliament whose aim is to control the quantity and use of money to facilitate the implementation of certain monetary policies.
This is the state owned and controlled financial institution that is charged with controlling and guiding other financial institutions
A central bank is not for profit making, not used by individuals and it's not supposed to compete in other banks in business

FUNCTIONS OF A CENTRAL BANK

1. It acts as a banker to the government. The government keeps its reserves from taxes and exports in the central bank, selling treasury bills, paying interests from public debts etc
2. It acts as an agent and adviser to the government. The central bank advises the government on important issues such as devaluation, inflation, taxation, foreign exchange control etc
3. It acts as a banker to other banks. The central bank keeps a certain proportion of the total deposits of the commercial banks as required by the law
4. Issuing and redeeming notes and coins with in the country's territorial boundaries. It is the sole institution with the duty of printing and rehearsing money into circulation and to withdraw (redeem) worn out money
5. It controls all activities of the commercial banks. The central bank regulates the activities of commercial banks in the country in order to ensure economic stability in the country. It has authority to close down any financial institution it considers to be a danger to the economy
6. It acts as an agent of payment of the government. The government pays ministers and international debts through the central bank which issues cheques on behalf of the government
7. It regulates money supply in an economy. The central bank through restrictive and expansionary monetary policies ensures the balance between money supply and money demand to stimulate economic stability
8. It acts as a lender of last resort to commercial banks when they are in financial crisis. Commercial banks take their assets, bills of exchange and treasury bills to be discounted by the central bank
9. It is the manager and custodian of foreign currencies. It maintains and controls importation of foreign currencies, controls foreign exchange rates against other currencies. NB all foreign exchange that enters the country has to be recorded by the central bank
10. It keeps funds of international institutions working in the country
11. It connects a country to other foreign financial institutions. In giving loans to the country the donors deal with the central bank
12. It publishes annual reports and quarterly reports concerning domestic activities and the performance of the economy on the international trade

13. It guides the government in the budgeting process. The central bank carries out research regarding the performance of various sectors of the economy on which the government bases to draw realistic budget

ROLE OF THE CENTRAL BANK IN THE ECONOMY

1. It encourages utilization of resources by ensuring a conducive investment climate through favorable economic policies. This may include favorable interest rates
2. It influences proper allocation of financial assistance to sector following the order of priority. This enables realization of the benefits associated with unbalanced growth strategy which may be appropriate for the development of LDCs
3. It minimizes the economic hazards like inflation and deflation through either restrictive or expansionary monetary policies. This help in ensuring economic stability necessary for growth and development
4. It helps in controlling financial activities of foreign banks, domestic and other institutions which helps in maintaining a stable banking sector. This facilitates development since it increases the rate of capital inflows and reduces capital out flow
5. It regulates the exchange rate which helps in ensuring proper and efficient utilization of foreign currency by maintaining stable rates. This also helps in promoting international trade
6. The central bank helps in supervising and directing the activities of commercial banks so as to ensure a sound banking system. This in turn increases the level of savings, capital accumulation, investment etc leading to economic development
7. It runs training institutions for banking related services for proper manpower development in low developing countries. This helps in proper handling of financial activities necessary for growth and development
8. It guarantees loans from abroad which other institutions can not afford. This means that the central bank borrow money on behalf of the government thus enabling it to carry out development banks
9. It enables the government to finance its on going economic activities such as industrialization, building of infrastructures like good hospitals through extending financial assistance to the government

THE MONETARY POLICY

This refers to the deliberate government through the central bank to regulate money supply in order to influence the level of economic activities in a country to achieve the desired development objectives

FORMS OF MONETARY POLICY

Expansionary monetary policy. This refers to guidelines/action taken by the government through the central bank to increase money supply so as to increase the level of economic activities

Contractionary or restrictive/aggressive monetary policy. This refers to guidelines/action taken by the government (through the central bank) to reduce money supply so as to lower the level of some economic activities

OBJECTIVES OF A MONETARY POLICY

1. To ensure price stability. A contactionary monetary policy is used in periods of inflation so as to reduce money supply, check aggregate demand and lower prices hence ensuring price stability for example selling treasury bills. An expansionary monetary policy can also be used to increase money supply and influence prices upwards to pull an economy out of a deflationary situation

2. To influence the level of employment/to achieve full employment. An expansionary monetary policy like lowering bank rate increases investment and expands employment opportunities hence achieving full employment
3. To ensure equitable distribution of income. This can be done through selective credit control where commercial banks can be encouraged to lend to people who are going to invest n activities of the unprivileged people for example agriculture and rural infrastructure e.g. hospitals, schools etc
4. To influence economic growth rates. An expansionary monetary policy lowering bank rate, giving instructions to commercial banks to extend more credit to productive activities so as to increase production promotes economic growth rate. A restrictive monetary policy can also be under taken to lower rapid economic growth rates in some sectors so as to have a balanced growth economy
5. To encourage growth of the financial sector. The central bank undertakes monetary policy measures that help to expand activities of financial institutions e.g. an expansionary monetary policy promotes credit creation and this can increase investment in commercial banking
6. To improve the balance of payment position. An expansionary monetary policy like extending more credit to producers for export increases the volume of export and export earnings which helps to improve the balance of payment position
7. To influence the level and/or nature of investment. The government uses monetary policy to direct investment towards desired areas/activities. For example the government can advise commercial banks to give more credit to agricultural sector to develop it. A restrictive monetary policy can also be used to discourage investments in a certain sector for example discouraging commercial banks to give credit to that sector
8. To ensure stability in foreign exchange rates so as to maintain a stable exchange value. This can be done through the use of a restrictive foreign exchange control or expansionary monetary policy
9. To ensure that government deficits are financed at a low rate i.e. securing funds from the cheapest source

TOOLS OF MONETARY POLICY

These are instruments or weapons employed by the government through the central bank to increase or reduce the supply of money in circulation so as to achieve development objectives like increasing employment levels, price stability etc

Tools of monetary policy include the following:

1. **Bank rate**. This is the rate of interest at which the central bank lends money to commercial banks. During inflation, the central bank increases the bank rate which discourages commercial banks from borrowing from the central bank which leaves them with very little money to be lent out to the public. Ti forces commercial banks to charge high interest rate on the money lent to the public which discourages borrowing hence reducing money supply. During deflation, the central bank charges a low bank rate which enables commercial banks to charge low interest rates on borrowers which attracts them to borrow hence increasing money supply. NB it is also known as **discount rate**
2. **Legal reserve requirements/variable reserve ratio**. This is the proportion of the commercial banks' total deposits that must be kept in central bank by law. A high legal reserve requirement reduces the amount of money that commercial banks remain with to lend out which leads to low money supply. However a low legal reserve requirement leaves commercial banks with more money to lend out which increases money supply
3. **Open market operation (omo)**. This is the selling and buying of government securities such as bonds and treasury bills. During inflation, the government through the central bank sells securities to the public which reduces the amount of money in circulation thereby checking

inflation. However, to increase money supply in circulation, the central bank buys the securities from the general public thus leaving money with people

4. **Selective credit control**. This refers to a situation where the central bank encourages commercial banks to give loans to some specific sectors of importance/priority and denying other sectors from acquiring loans so as to reduce money supply in circulation. However , when the central bank wants to increase the amount of money in circulation it encourages commercial banks to give more credit to certain sectors like agriculture with several linkages
5. **Special deposits/compulsory deposits**. Are amounts of money that the central bank requires commercial banks to occasionally deposit with it on top of legal reserve requirement. The central bank charges high special deposits to reduce the amount of money in circulation and charges low amount of special deposit increases amount of money in circulation
6. **Moral suasion/persuasion**. This is when the central bank appeals, persuades and advises commercial banks to adopt a particular monetary policy in respect to prevailing economic situation. The central bank advises commercial banks to adopt a restrictive money policy to reduce the amount of money in circulation. It also persuades commercial banks to adopt an expansionary monetary policy to increase amount of money in circulation
7. **Margin requirement**. This refers to the difference between the amount of the loan advanced and the value of the collateral security pledged. The central bank increases margin requirement to discourage people from borrowing money from commercial banks so as to limit money supply while the central bank lowers the margin requirement to encourage people to borrow money so that money is increased in circulation
8. **Rationing of credit**. This is where the central bank reduces the amount of money it lends to commercial banks in order to check inflation while relaxing of rationing of credit is aimed at expanding amount of in circulation
9. **Cash ratio/liquidity ratio**. This refers to the proportion or percentage of the commercial bank's total deposit that is kept in cash form to meet the daily demands of the customers. To increase money supply in circulation, the central bank lowers the cash ratio and to reduce money supply in circulation, the central bank increases the cash ratio
10. **Currency reform.** This is when the government through the central bank deliberately withdraws the old/weak currency and replaces it with another/stronger currency. This is applied when there is too much money in circulation resulting into total loss of money value and confidence in the local currency

- ***Explain how tools of monetary policy can be used to control inflation in an economy***
- ***How can the central bank reduce the amount of money in circulation?***
- ***Discuss the aggressive monetary tools used by the central bank in your country to regulate inflation***

FACTORS THAT INFLUENCE THE EFFECTIVE OPERATION OF MONETARY POLICY IN A COUNTRY/IN AN ECONOMY

1. Level of liquidity preference. High liquidity preference reduces the effective operation of monetary since level of savings/bank deposits is low but low liquidity preference ensures more effective operation of monetary policy due to increased deposits which encourages credit creation
2. The level of liquidity in the commercial banks. High level of liquidity in the commercial bank indicates poor or low level of lending and borrowing which limits effective operation of the monetary policy while low level of liquidity in the banks indicates high level of lending and borrowing and so monetary policy will be more effective
3. Distribution of commercial banks. Even distribution of commercial banks in the country makes operation of monetary policy more effective since all the tools can be applied in the

country but uneven distribution of commercial banks limits the effectiveness of the monetary policy because some tools can not be applied where there are no such banks
4. People's knowledge and popularity of services offered by commercial banks like open market operation. When many people are aware of and use open market facilities, the monetary policy will be more effective but when they are not aware of open market operations, this limits effective operation of the monetary policy
5. Size of the subsistence sector. Large subsistence sector indicates a low level of monetization of the economy and this limits the effectiveness of monetary policy. On the other hand, a small subsistence sector indicates a high level of monetization of the economy which can promote effective operation of monetary policy.
6. Level of corruption in the country. Where most people involved in the implementation of monetary policy are corrupt, operation of monetary policy will be less effective. For instance
7. Implementation of selective credit control will be less effective where loans are given on bribery basis. When the level of corruption is low, monetary policy operation can be more effective.

8. Level of development of the money markets. Highly developed money markets encourage effective operation of the monetary policy compared to a poorly developed money market.
9. Level of effective use of commercial banks. When most people use commercial banks for saving and borrowing purposes, the operation of monetary policy will be more effective compared to when there is less use of commercial banks.
10. Political influence on commercial banks and the banking sector in general. When there is high level of political interference in the operations, this will limit the effectiveness of monetary policy measures compared to situation when there is less political interference in the activities of commercial banks.
11. Level of organization and consistency of government objectives. When government objectives are well planned and consistent for example directing credit to productive investment, monetary policy operation will be more productive but where there conflicting and inconsistent government objectives, the effectiveness of monetary policy will be low
12. Level of dominance of foreign commercial banks. When there is high dominance of foreign commercial banks in an economy, it limits the effective operation of the monetary policy since these banks are not under direct control of the central bank and also they tend to maintain high liquidity. Less dominance of foreign commercial banks helps to promote effective monetary policy

FACTORS LIMITING THE OPERATION/EFFECTIVENESS OF THE MONETARY POLICY

1. Under developed money and capital markets. This limits the selling and buying of government securities such as treasury bills which limits the operation of open market operation
2. High liquidity preference in commercial banks. This leaves commercial banks with a lot of money to lend out to the public which makes it hard to reduce the amount of money in circulation
3. Inadequate collateral security. This limits borrowing of the public from commercial banks which fails the central bank to increase money supply and aggregate demand, selective credit control etc thus limiting effectiveness of the monetary policy
4. Predominance of foreign commercial banks. These banks are not under direct control of the central bank , they normally keep high liquidity and contradict with other monetary tools thus limiting effectiveness of the monetary policy

5. High liquidity preference in the economy. Many people prefer holding their wealth in cash form which limits saving and borrowing thus making the monetary policy ineffective in reducing amount of money in circulation
6. Inconsistent and conflicting government objectives. The government pursues a restrictive monetary policy to reduce money in the circulation along side excessive government expenditure for example increasing salaries of civil servants, printing money for political campaign etc which increase money supply thus limiting effective operation of the monetary policy
7. Foreign influence by the World Bank and IMF. This limits the operation of the central bank in implementing the monetary policy to attain economic stability for example liberalizing foreign exchange market leads to a fall in the value of local currency, giving credits to certain sector
8. Uneven distribution of commercial banks. Commercial banks are mainly urban based which leaves rural people with a lot of money which fails the central bank to reduce the amount of money in circulation through open market operation
9. High level of corruption in the banking industry. This limits control of money supply through selective credit control since loans are offered to non priority sectors due to corruption thus making the monetary policy ineffective
10. Ignorance of people about services offered by commercial banks. This limits saving and borrowing as a means of ensuring economic stability by the central bank
11. Limited credit worthy borrowers. This limits lending by commercial banks to the public which fails the government to fight deflation
12. Existence of political instabilities in some parts of the country. This forces the government to increase money supply on the measures to ensure political stability in the country which makes it hard to fight inflation
13. Large subsistence sector. This results in limited used of the commercial banks since whatever is produced is for home consumption. This makes it hard to use monetary tools like selective credit control, open market operation etc hence limiting the effectiveness of monetary policy
14. Persistent inflation. This make people to hold their wealth in cash form to meet the ever increasing prices of goods and services thus making it difficult to reduce money in circulation by the central bank

Suggest ways of improving the implementation of monetary policy in your country
Solutions

1. Reducing liquidity in commercial banks
2. Low level of liquidity preference
3. Even distribution of commercial banks
4. Increase People's awareness and use of omo
5. Anti corruption measures
6. Increase monetization of the economy
7. Develop money markets
8. Low level of political inference/reduce political interference
9. Well organized and consistent government objectives
10. Reduce dominance of foreign commercial banks

FINANCIAL INTERMEDIARIES

Are financial institutions established to mobilize funds from surplus spending units (lenders) and direct them to deficit spending units (borrowers) who wish to carry out investment
Financial intermediaries are divided into two types namely:

1. Banking financial institution/intermediaries

2. Non banking financial institution/intermediaries

BANKING FINANCIAL INTERMEDIARIES

These are financial institutions that receive deposits from the public, give out short term loans to trust worthy customers and create credit or new deposits e.g. commercial banks

NON-BANKING FINANCIAL INTERMEDIARIES. Are financial institutions that receive deposits from the public, give loans but do not create new deposits/credit e.g. insurance companies

DIFFERENCES BETWEEN BANKING AND NON-BANKING FINANCIAL INTERMEDIARIES

1. Banking financial intermediaries usually give out short term loans, but non-banking financial intermediaries give out medium and long term loans
2. Banking financial intermediaries create credit/new deposit through the use of cheques, but non-banking financial intermediaries do not create credit. They only lend out money
3. Banking financial intermediaries prefer investing in less risky venture yet non-banking financial intermediaries undertake high investment risks
4. Banking financial intermediaries charge higher interest rates on loans and pay lower interest rates on deposits, but non-banking financial intermediaries charge lower interest rates on loans and pay higher interest rates on deposits
5. Banking financial intermediaries require high valued collateral security, but non-banking financial intermediaries do not require a lot of high valued collateral security
6. Banking financial intermediaries are mainly profit motivated but non-banking financial intermediaries like development banks are development oriented

SIMILARITIES

1. The all deal in loanable funds
2. They all act as intermediaries in bringing borrowers and lenders together
3. They all deal in sell of government securities
4. All aim at economic growth and development

EXAMPLES OF NON-BANKING FINANCIAL INTERMEDIARIES

- Insurance companies; these are institutions that undertake to protect other institutions or individuals against losses caused by insured risks after accepting premium
- Post office savings bank. Are financial institutions which operate savings accounts that enable them to receive deposits from low income savers for example Post bank Uganda?
- Development banks. These are financial institutions established to provide medium term and long term loans for development projects for example Uganda Development Bank (UDB), East African Development Bank (EADB)
- Credit and savings societies or hire purchase firms and cooperative societies. These are institutions, which accept deposits and shares for credit and other purchases and my lend out such funds or goods
- Building societies. These are societies which mobilize funds for the purpose of building commercial or residential houses for their members
- Housing finance. This is a financial institution that receives deposits and lends out for long term housing purchases to assist those who want to build or buy houses for example Uganda Housing Finance co-operation/Housing Bank Limited
- Social security funds. These are non-banking financial intermediary set up to workers save for the future to be used when they retire. For example National Social Security Fund (N.S.S.F)

POSITIVE ROLES OF NON- BANKING FINANCIAL INTERMEDIARIES IN DEVELOPMENT OF MY COUNTRY

- They bridge the gap left by commercial banks, like by mobilizing/accepting deposits from low income groups, giving loans to individuals who can not qualify for commercial bank loans
- Non-banking financial intermediaries like development banks promote development through long term lending
- They contribute to infrastructural development in the country for example road construction, construction of health centers, schools etc. this improves on the welfare of people
- They promote development of both agriculture and industry for example development banks give loans to farmers and this enables them to operate on a large scale
- They create and provide job opportunities to the people in an economy that is to say people work as managers, accountants in such institutions thus solving the problem of unemployment
- Promoting rural development by funding different rural development projects like rural electrification, rural water projects, feeder road maintenance by development bank and other institutions
- Foreign owned non-banking financial intermediaries strengthen international relationships between countries for example Development
- They encourage the indigenous people to participate in the development of their economy by involving them in different development programs like bore drilling feeder roads clearing etc
- Provision of revenue to the government in form of taxes paid. This enables the government to extend social services to its people
- Encouraging the growth of investment/ business activities by providing insurance to businesses. This stimulates economic growth and development

NEGATIVE ROLES OF NON-BANKING FINANCIAL INTERMEDIARIES

- Foreign owned non-banking financial intermediaries encourage capital outflow/ profit repatriation this leaves the recipient country under developed
- Foreign owned non-banking financial intermediaries also discriminate local labour. They prefer employing foreigners in high management jobs and employ local people in low level jobs
- Regional imbalance is promoted. Most non- banking financial intermediaries are urban based and leave most rural areas under developed
- They promote income inequality. These non-banking financial intermediaries give loans to few people discriminatively and leave a majority without loans. This creates a gap between those who have access to loans and those without it
- They sometimes tend to interfere with the monetary policies set by the central bank like by increasing money through lending contrary to action taken by the central bank

REVISION QUESTION

Outline the aims of Uganda Development Bank

What are the merits of development banks in an economy?

The following are aims of development banks:

- To provide long term loans to individuals, institutions, etc for development purpose
- To provide loans to sectors ignored by the commercial banks
- To attract foreign technical assistance and channel it to fields that are vital for development
- To act as a channel through which the Uganda government undertakes risky but vital ventures like dam construction

Merits of development banks in Uganda/in an economy:

- ❖ They provide technical assistance to the projects they finance in terms of expertise, equipment etc
- ❖ They provide loans to investors at low interest rates and the loans are usually of long term nature
- ❖ They facilitate large scale agriculture, development of social infrastructure, industrial projects etc
- ❖ They assist in the importation of equipment that may be necessary for the projects they finance
- ❖ The promote economic growth and development by financing risky but essential projects

Distinguish between the following:

i. Standing order and credit transfer
ii. Demand deposits and time deposits
iii. Credit squeeze and liquid money

Solutions
Standing order is an instruction by an account holder to his bank to pay a specified sum of money to a named person or firm at regular intervals.
While
A credit transfer is a system of money transfer by which commercial bank customer instructs his/her bank to make payments to the accounts of specified people or firms
Demand deposit refers to money placed on current account at a commercial bank, which is usually withdrawn on demand
While
Time deposits refer to money placed on fixed deposit account or banked for a specified period of time and withdrawal is only made from after notice is made
Credit squeeze is a deliberate government effort through the central bank to restrict or limit credit expansion for a given period of time
While
Liquid money is money in cash form (that is bank notes and coins)

Define the following terms:

- ❖ Supplementary reserve requirements
- ❖ Aggregate money demand in closed economy
- ❖ Aggregate money demand in an open economy

Solutions
Supplementary reserve requirements are deposits over and above the cash and liquid assets of commercial banks which are kept in a frozen form by the central
Aggregate money demand in a closed economy. Is the total amount of money required for expenditure on consumption (C), investment (I) and on government expenditure (G) i.e. AD=C+I+G
Aggregate money demand in an open economy. Is the total amount of money required for consumption (C), investment (I), government expenditure (G) and net trade balance (X-M)

State three differences between a bank loan and a bank overdraft
Solutions
A bank loan is charged interest on the whole amount borrowed/lent, yet on a bank over draft interest in charged on the actual amount overdrawn

A bank loan maybe given to any one who has a collateral security whether he/she is an account holder or not but a bank overdraft is given to current account holders

A bank loan is usually given for a long period yet a bank over draft is given for a short period

A bank loan has a security pledged against it, but no security is need when obtaining a bank overdraft

Why money is considered a dynamic force in economics (because of the functions it performs/its merits)

Solutions

- ❖ Promotes trade and commerce since it is a measure of value
- ❖ Rewards factors of production/encourages hard work
- ❖ Encourages specialization in the production process
- ❖ Makes possible the operation of price mechanism
- ❖ Promotes savings and hence investment
- ❖ Promotes transformation of an economy from subsistence to a modern or commercial one

Why may a country undertake an expansionary monetary policy?

- ❖ ***Guide: use the objectives of monetary policy***
- ❖ To increase the level of employment in the country
- ❖ To increase the rate of economic growth
- ❖ To expand the growth of the financial sector
- ❖ To increase the level and nature of investment
- ❖ The improve the B.O.P position/through export promotion
- ❖ To pull the country out of a depression by influencing prices upwards
- ❖ To stabilize exchange rates

Under what circumstances may a country undertake a contractionary monetary policy?

- ❖ ***Guide: give objectives of monetary policy and any logical points***
- ❖ When there is inflationary pressure that needs to be reduced.
- ❖ When there is need to reduce the high rate of economic activities
- ❖ When it wants to stabilize exchange rates
- ❖ When there is need to reduce the level of investment especially on particular sectors/activities
- ❖ When the country needs to borrow money from the public
- ➢ Define money as used in Economics
- ➢ Describe the evolution of money
- ➢ Present the true qualities of good money
- ➢ Examine the functions money can perform
- ➢ Explain the different forms of banks in your country
- ➢ Explain the functions of commercial banks
- ➢ Examine the role of foreign commercial banks in the development of your country
- ➢ Present the problems facing commercial banks in your country
- ➢ How do commercial factors achieve the conflicting objectives of liquidity, security and profitability?
- ➢ What is meant by the term credit creation?
- ➢ Explain the factors influencing credit creation process in your country
- ➢ Under what circumstances may credit creation process be restrained?
- ➢ Distinguish between banking financial intermediaries and non-banking financial intermediaries
- ➢ Explain the role of non-banking financial intermediaries in your country

INFLATION

It is defined as a situation where there is a persistent rise in the general price in the general price level of goods and services in an economy over a period of time.

General prices covers the prices of another of commodities .At the time of inflation, the value of money is also persistently fall.

HOW TO MEASURE INFLATION

Inflation can be measured using the consumer price index [C.P.I].This is the variation in prices between one period (base year) and another (current year)

C.P.I=$\frac{\text{Current year}}{\text{Base year}}$X100 (PTx100
PO

OR

Where pt =current year price

Po=base year price

EXAMPLE:

COMMODITY	PRICE IN BASE YEAR IN 1998	PRICE IN CURRET YEAR 2003
SUGAR	800	1500

Determine the consumer price index and interpreter answer

C.P.I=$\frac{\text{Current year}}{\text{Base year}}$ X 100

$\frac{1500}{800}$ X100

$\frac{1500}{8}$

=187.5%

This means that the price of a commodity (sugar) has risen from 100% to 187.5% .The price has increased 87.5 %(187.5-100%) hence the rate of inflation 87.5%

NB: If the value of inflation [C.P.I] is less than 100%, this means there has been a deflation or prices have fallen .When the CPI is equal to 100% than there has been no price changes

STATE OF INFLATION

This is the rate /speed at which prices are rising /changing over time in the economy .Inflation can be classified according to the rate of price changes

CREEPING INFLATION OR MILD INFLATION /GRADUAL INFLATION

This refers to a situation where by persistence increase in general price level proceeds at a slow rate ,usually not exceeding 10%.This state of inflation is un noticeable by the general public

TROTTING INFLATION/WALKING INFLATION

This refers to a situation where by continuous increase in general prices is moderate and the annual rate of inflation is still a single digit (ranges from 3%-9%)

HYPER OR GALLOPING /RUN AWAY INFLATION

This is where the general price level increase at a very high rate ,the increase taking place within hours or weeks .In this case from double digits to triple digits i.e. the general price level in the economy increase at a high rate of over 20%-100% or even more per annum

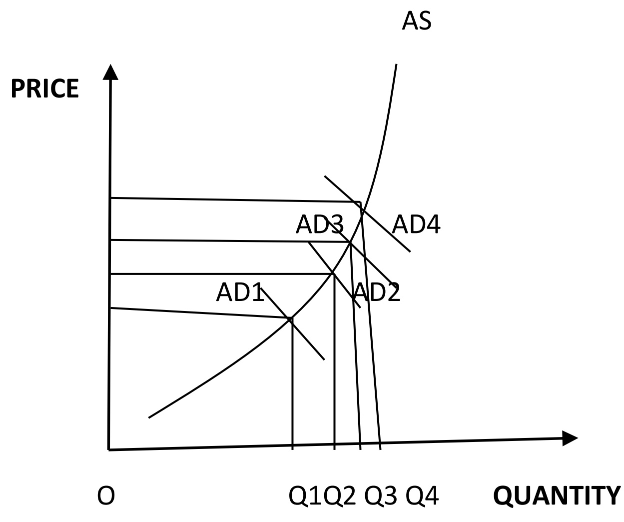
TYPES OF INFLATION /THEORIES OF INFLATION

Types of inflation are given according to the causes of the inflation in an economy .This can also be called classification and theories of inflation and include the following.

DEMAND PULL INFLATION /EXCESS DEMAND INFLATION

This is the persistent increase in the general price arising from excessive aggregate demand for goods and services over aggregate supply. It is inflation which occurs when aggregate demand. A situation where too much money is chasing too few commodities

ILLUSTATION OF DEMAND PULL INFLATION



Aggregate demand1, aggregate demand2, aggregate demand3 and aggregate demand4 represent different levels of aggregate demand. An increase in demand from AD1-AD2is a companied by proportionate increase in output OQ1toOQ2.However any increase in aggregate demand beyond AD3is followed by less than proportionate increase in output.

At AD3, the economy attains output ceiling set by full employment and increase in aggregate demand beyond AD3 Lord John Keynes described it as **true inflation**

CAUSES OF DEMAND PULL INFLATION

1. Increase in money supply due to an expansionary monetary policy like purchase of securities ,printing more money
2. High government expenditure which is financed by borrowing instead of taxation
3. When there is increased exports and reduced imports so that the volume of goods available for the consumers is reduced
4. Relaxed fiscal policy resulting in reduction in direct taxes hence increased disposable income
5. Rapid increase in population especially in urban centres caused by rural urban for goods and services in urban areas thereby causing shortages and increase in prices for example increased changes
6. Political instabilities in certain parts of the country .This affects the actual output levels leading to an increase in demand for the few goods
7. High or rising population growth rates resulting in increased aggregate demand
8. Increasing in export earnings and increase in salaries and wages causing excess demand.

POLICY MEASURES OR SOLUTIONS TO CONTROL DEMAND PULL INFLATION

1. Selling of government securities or use of restrictive monetary policy to reduce money supply hence reducing aggregate demand e.g. treasury bills
2. Increasing taxes on incomes of people so as to reduce disposable income and aggregate demand
3. Reduction of government expenditure on wages. This can lower aggregate demand
4. Improvement of infrastructure to help increased supply in areas of shortages this can help to push down prices in such areas.
5. Importation of essential commodities from cheaper sources to reduce scarcity
6. Price control especially the maximum price legislation on essential goods and services should be put in place to control price increase in the economy
7. Reducing political instabilities in order to stimulate production hence ensuring constant supply of commodities through out
8. Adoption of wage policy involving reduction in wages or controlling wage levels (wage restraint) such that it is stable hence reducing the demand for goods and services.
9. Reducing exportation of essential commodities to ensure that there is enough supply for the local people
10. Reduced government borrowing from the central bank. This can help to reduce government expenditures which would otherwise increase money supply and push up prices

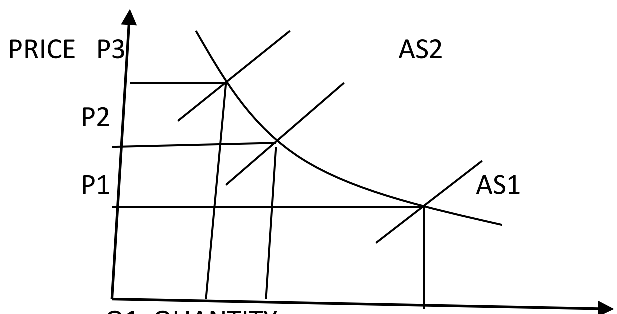
COST PUSH INFLATION

This is a persistence increase in general prices caused by increasing costs of production or increase in the cost of inputs i.e. increase in factor cost (profits, rent, wages and interests) and costs of raw materials

When the costs of production rise, producers will be forced to reduce their output. As output reduces and prices of commodities increase or will increase.

ILLUSTRATION OF COST PUSH INFLATION

AS3



0 Q3 Q2 Q1 QUANTITY

Cost push inflation can be further divided into

RAW MATERIAL PUSH INFLATION
Is one that arises from increase in the price of raw materials which push up prices of commodities.

WAGE PRICE INFLATION
This is inflation resulting from workers' demand for high wages which push up the prices.

WAGE-WAGE INFLATION
This is an increase in general price level due to comparative wage increase. It occurs when the workers of one firm demand for wage increase after realizing that the workers of another similar firm have been paid higher wages /have had a wage increase

PROFIT PUSH INFLATION
This is caused by the business people who to increase their profits .They therefore cause inflation by increasing prices of their products.

PRICE WAGE INFLATION
This is inflation that arises from increase in prices which push up wages resulting into further price increase

CAUSES OF COST PUSH INFLATION
1. High costs of raw materials due to competition for them or due to their exhaustion
2. Increase /high wages and salaries which may be caused by trade unions pressure or government legislation of minimum wages
3. High transport costs on raw materials especially for land locked countries and even increasing transport costs for final goods to the markets
4. High fuel costs due to international crisis .These are caused by reduction in supply of fuel from the producing countries.
5. High levels of taxation on firms (produces) which always make them to increase the prices of their products they produce.
6. High costs of borrowing loans from financial institutions i.e. high interest rates will force borrowers to increase the prices of their products.
7. High cost of advertising producers will be forced to sell their products at high prices/price so as to cover advertising costs.
8. Greed /desire by business people for excessive profits also make them to increase the prices of their products.
9. Expectation and speculative behavior of business people /announcements effect of the budget
10. Political instability /unrest which tend to discourage production and also increase costs of factor inputs

MEASURES OR SOLUTIONS TO CONTROL COST PUH INFLATION:
1. Provision of investment incentives like provision of subsidies which can help to lower down the costs of production of firms hence leading to reduced prices of commodities produced
2. Improvement in infrastructures especial transport network in order to lower down the costs of transport hence reducing prices of commodities
3. Reduction in the rate of interest on loans which can make borrowers to reduce on prices of products they produce.

4. Price control measures should be emphasized in order to reduce on the profits levels and wage rates so as to control price increase
5. Relaxed fiscal policy especially use of selective taxation and tax holidays in order to lower down costs of production
6. Providing non-monetary rewards to labour like food in order to reduce their demand for higher wages
7. Reducing political instability to lower down prices of faster input and to ensure smooth flow of production

STRUCTURAL OR BOTTLE NECK INFLATION/SCARCITY INFLATION

This is a form of inflation arising out of supply rigidities that is shortages in supply of commodities .The general prices of goods will increase because the supply of the goods cannot expand the match with the increasing demand.

CAUSES OF STRUCTURAL INFLATION

1. Failure in agricultural sector due to natural factors /calamities like floods, drought, pests and diseases and others
2. Political instability in the country which hinders the production process and also to scare away investors hence cutting down output.
3. Break down in infrastructures like roads, railway lines and tele-communications net work may lead to fall in output and due to shortage, the general prices of the products will rise.
4. Speculation by business people who create artificial shortage by hoarding goods will lead to increase in general price level.
5. Scarcity of input necessary in the production process like inadequate spare parts for the industries, shortage of raw materials, limited managerial skills and others.

MEASURES TO CONTROL STRUCTURAL INFLATION:

1. Privatization of public enterprises in order to help to increase efficiency and increases output leading to reduced prices
2. Provision of investment incentives like subsidies, granting tax holidays in order to stimulate investment leading to increased output and fall in prices.
3. Improvement of infrastructures like roads and communications to help to move surplus output from areas of plenty to areas of scarcity so as to help to reduce prices.
4. Reducing political instability in order to attract investors or investments and encourages production throughout the year.
5. Modernization and improvement in agriculture in order to ensure constant supply.
6. Price control especially use of minimum price legislation to reduce speculation by sellers or producers.
7. Liberalization of the economy in order to help to increase supply of goods and services which can lead to price reduction.

IMPORTED INFLATION:

This is the type of inflation which results from importing goods or raw materials from countries or regions experiencing inflation

CAUSES OF IMPORTED INFLATION:

1. Importation of commodities from countries experiencing inflation
2. Rising prices in the international market like increased prices of fuel products which form the major source of energy in developing countries.
3. Devaluation of the local currency which makes imported goods more expensive
4. Land locked countries experience and incur high transport costs on imported products that lead to high price levels in the economy.

MEASURES OR POLICIES TO CONTROL IMPORTED INFLATION:

1. Adoption or implementation of import substitution policy in order to produce goods locally which were formerly imported.
2. Discouraging imports from countries experiencing inflation.
3. Subsiding importers or producers who import raw materials in order to reduce costs of production
4. Reducing political instability

GENERAL CAUSES OF INFLATION IN LDCs [UGANDA]

1. Excessive demand compared to the amount of goods and services available in the economy causing demand pull inflation .The output both local and foreign producers `doesn`t match with the ever increasing demand
2. High costs of production .High costs of raw materials, increasing transport costs, high costs of advertising, increasing wages, high interest rates on loans etc..Increase costs of production which is shifted to the buyer inform of high prices leading to cost push inflation
3. Supply rigidities especially in the agricultural sector due to natural factors like drought, pests and diseases, floods and storms etc. which adversely /great reduce the level of output there by pushing the prices of food items up causing structural inflation.
4. Political instabilities which disrupt production in some places like Northern Uganda leading to shortage in supply hence causing structural inflation
5. Excessive government expenditure especially on unproductive ventures like organizing state functions, buying military equipment etc causes increase in money supply. This eventually ends in causing price increase
6. Excessive printing of money by the central bank of Uganda increases the supply of money in the country and since the money supply is not matched by adequate output, prices of the few commodities are forced upwards hence inflation.
7. Ever-escalating prices of petroleum products also causes inflation in Uganda .This is because petroleum products are used as fuel in transport and as energy to move machines. This leads to increase in production costs which eventually push prices of commodities.
8. Break down of/under developed infrastructure inform of roads, railways lines and communications net work leads to follow in output and due to shortage ,the general prices of the products
9. Increase in population resulting from high population growth rates which leads to excess demand for the inadequate goods or services hence causing price increase e.g. Uganda`s population growth rates according to 2002 census is at 3.4 % which is one of the highest in the world
10. Devaluation of the local currency (Ugandan shs.) is also a cause of inflation .This makes the imports more expensive and since Uganda depends on some basic imported commodities ,even prices and in the country are being forced up
11. Desire for excessive profits by business people causes profit push inflation .Many traders in Uganda increase prices with the aim of earning more profits hence causing inflation
12. Speculation by business people who decide to increase prices of goods and services towards budget time also causes inflation .These people try to maximize profits because they may not be sure of what the budget may perfect.
13. Importation of commodities from inflation prove countries (country`s experiencing inflation particularly raw materials and some consumer goods which make the importers /producers to sell their final products at high prices.

EFFECTS/CONSEQUENCES OF INFLATION [POSITIVE EFFECTS OR CONSEQUENCES]

1. Mild inflation stimulates effort and hard work. People tend to work hard during inflation so that they can have enough income in order to maintain their standards of living
2. Mild inflation stimulates investment due to high profits. Commercial producers will be encouraged to invest in the production of goods and services so as to benefit from the high prices by increasing their profit level.
3. Encourages innovation and creativity. Gradual inflation encourages people to become more creative and innovative order to increase their earnings
4. It creates more employment opportunities Low rate of inflation may increase employment opportunities .This is because it encourages investment which directly increases job opportunities in the economy
5. It results into increased tax revenue during inflation, government revenue increase as a result of changing taxes on high incomes of people
6. Borrowers /debtors again in real terms since they pay less than what was borrowed ,.When prices rise, the value of money fall and by the time of paying back the loan ,it will have with value since it can buy less goods and services than before
7. Increased resource utilization .A low rate of inflation may promote exploitation of idle resources in the country there by increasing the productivity or GDP of the country
8. Promotes forced savings, during inflation any situation people are forced to save their money inform of assets or investment in order to benefit in future than holding money in cash form.
9. Increase producers ` profit margin resulting from selling output at high prices.
10. Increase level of output thus stimulates growth. Low rate of inflation promotes productivity leading to increased output hence economic growth.

NEGATIVE EFFECTS OF INFLATION [ADVERSE CONSEQUENCES]

1. Savings are discouraged due to constant loss in the value of money; people resort to spending money to buy luxurious cars etc, which are non productive assets
2. Worsens B.O.P position .High rates of inflation leads to B.O.P problems .It discourages exports and promotes imports .Exports become expensive to foreigners where as imports become cheaper hence there will be more expenditure on imports than earning from exports
3. Reduces production as inflation increase the work of production. Hyper inflation causes high costs of production which may force the inefficient firms to close down as they no longer afford high costs of input causing a reduction in output.
4. Makes planning difficult .High rate of inflation makes government planning difficult to implement because the financial targets keep on changing due to fall in value of money .Plans will be undervalued because of continuous increase in prices of materials and also reduces government real income
5. Leads to loss of confidence in the currency. This is because continuous fall to perform its primary functions of medium of exchange store of value, acting as means of different payments. People will prefer to keep other assets other than the local currency
6. High inflation rates discourage lending as debtors get less in real terms. This is because by the time they are paid, the amount of money lend out ,it will have lost its purchasing power.
7. Fixed income earners further as their real income falls. Fixed income earners like civil servants will have their S.O.L lowered because their incomes doesn`t increase at the same rates as inflation hence buy less goods and services than before
8. Unemployment results as some firms close down .High rate of inflation may force producers to reduce the labour force to cut down costs of production while other may substitute workers with machines, others close down there by leaving workers unemployed.

9. Worsens the problem of income inequality .When it gets out of control ,it causes income inequality ,since the commercial producers charge very high prices for their products thereby exploiting the buyers (fixed income groups)
10. It encourages malpractices like competition, smuggling in the economy as people tend to look for high profits
11. Hyper inflation makes the government in power unpopular and this may result into social and political instabilities like theft, burglary ,prices and demonstration
12. High rate of inflation leads to increased industrial unrest in the economy. This may result from constant demand for high wages so as to meet the increasing cost of living.
13. High rate of inflation leads to production and consumption of low quality goods .This is due to fear of high costs of production which leads to low standards of living
14. High rate of inflation encourages capital flight /massive resource out flow as investors shift their investment to other countries with stronger currencies
15. People are strained in an attempt to cope up with rising costs of living this because people forego leisure and this lowers down their standards of living.

POLICIES/MEASURES THAT CAN BE ADPOTED TO CONTROL INFLATION:

Restrictive monetary policy .This policy is designed to control money supply and include:

1. Open market operation, where the government through the central bank sells securities to the public aimed at reducing money in hands of the public there by reducing aggregate demand hence fall in prices.
2. Currency reform, where the government with draws the old currency of the strong value. This can help to bring back confidence in the currency and can attract both local and foreign investments ,output will increase on prices
3. Controlled issuing of currency in order to reduce money in circulation leading to reduction in aggregate demand hence fall in prices
4. Selective credit controls
5. Increasing minimum reserve ratio to commercial banks.
6. High bank rates. High interest rate.

TIGHT FISCAL POLICY

This involves any measures aimed at influencing government expenditure and level of taxation in order to stabilize the economy and include:

1. Increasing direct taxes so as to reduce people disposable income which reduces aggregate demand hence pushing down prices of commodities.
2. Reduction in government expenditures like through retrenchment ,checking allowances of civil servants etc in order to reduce money in circulation thus reduces aggregate demand hence pulls down prices
3. Privation of public enterprises to stimulate production and also helps to improve efficiency and increase output there by leading to fall in prices.
4. Liberalization of trade ,which leads to increased supply of goods and services and reduces inflations
5. Improvement of infrastructure like roads, railways to enable movement of resources (supplies) from areas of surplus to areas of scarcity hence helping to push down prices
6. Reducing political instability in order to encourage production leading to increased output hence full in prices
7. Over valuation of domestic currency in terms of foreign currency ,such that raw materials are imported at a lower price and making exports available due to its being expensive outside
8. Increasing output of consumer goods from luxury goods

9. Price controls involving maximum price legislation for essential goods and services hence controlling price increase in the economy
10. Import ,increase importation of essential goods like drugs to reduce scarcity but avoid importing from countries experiencing inflation
11. Provision of investment incentives like tax holidays ,subsidization of some producers to increase production there by leading to a fall in prices of commodities
12. Reduce exportation of essential goods to ensure there is enough supply for the local people
13. Modernization and improvement of agriculture in order to reduce effect of natural factors like drought that brings shortages

POLICY /MEASURES BEING UNDER TAKEN TO CONTROL INFLATION IN UGANDA /POLICIES ADOPTED:

1. Fiscal policy, where government increased direct taxes which reduce disposable income hence lowering down aggregate demand which push down prices.
2. Reduction of government expenditure .Expectation of unproductive ventures are being reduced ,retrenchment ,allowances of civil servants are also being consolidated
3. Promotion of savings because it reduces the purchasing power of people.
4. Leading to reduction of money in the circulation
5. Selling of securities to the public is being used to control or reduce money in circulation, aggregate demand reduces and prices falls
6. Privatization drive is being used to bring in more people into production of goods and services and also improves efficiency thereby increasing output and resulting into lower prices.
7. Liberalization of the economy is being done to bring in more private investors thus increases output of goods and services which also reduces prices
8. Improvement of infrastructures in form of roads.Is being used to improve surplus output from areas of priority to areas of scarcity so as to help to reduce prices.
9. Government importation of commodities from low cost producing commodities like Japan, China and India to help to control imported inflation.
10. Modernization and improvement of agriculture is also being emphasized to ensure constant supply and increase in output which also reduces prices of food items.
11. Controlled issuing of currency is helping to regulate the amount of money in circulation so as to influence prices downwards
12. Government has reduced its borrowing from the central bank and is encouraging the ministries to estimate their budgets economically .This is helping to reduce government expenditure which would have increased money supply and push down prices.
13. Reducing political instability
14. Currency reforms

OBSTACLES FACED BY THE UGADAN GOVERNMEN IN CONTROLLLING INFLATION:

1. Ever increasing population growth rate of about 3.4% (2002 census) causes continuous increase in demand for goods and services and leads to demand pull inflation
2. Persistence political instabilities in some parts especially Northern Uganda which retards production, increases government expenditure thus **pushing up prices.**
3. Increasing government expenditures on fighting insecurity ,paying large number of the members of parliament and ministries etc which increase money in circulation leading to price increase
4. Under developed infrastructures inform of roads etc which create shortages in some areas and also increase transport costs which eventually push up prices of commodities

5. Inability to control natural factors like drought etc which reduces output especially agriculture sector hence increases prices
6. Fuel crisis, an external factor which influences price level in the country .When world fuel prices increase even prices of goods and services increase in the country
7. Failure by the government to control rural urban migration which increase the demand for goods and services in urban areas thereby causing shortages and increase in prices
8. Failure by the government to control some trade unions pressure for wage increases which increase money supply and eventually leads to price increases
9. Frequent duplication of the local currency that makes imports more expensive hence worsening imported inflation more especially where imports use consumer goods
10. Low level of entrepreneurship in the country which leads to low levels to low levels of production hence leading to price increase

SOME TERMS AND RELATED CONCEPTS OF INFLATION

HEAD LINE INLFATION
This is inflation resulting from persistence increase in general price levels of both food and non food items (consumer goods and services)

UNDER LYING INFLATION
This is inflation resulting from a persistence increase in general price level of only non food items i.e. inflation that excludes food prices

SUPPRESED INFLATION/PREEDED INFLATION /CONTROLED/INGDENT INFLATION
This is a situation where during inflation government puts in place measures to restrict demand so as to minimize price increase like using price controls, rationing of items etc
STAG INFLATION
This is a situation where high rate of inflation co-exist with high levels of unemployment and stagnant out put

COSTS/DEMERITS OF STAGFLATION
- Decline in investment
- Problem of income inequality that is widening the gap between the rich and the poor
- Loss of confidence in the country`s currency
- Increasing costs of living due to increasing prices and small income
- Social tensions like strikes ,demonstration
- Decline in welfare etc

STAGNATION:
This refers to undesirable period of static economic activities in an economy .It is characterized by no new investment, no new job opportunities, constant G.D.P growth rate etc.

INFLATION SPIRAL/PRICE WAGE INFLATION
This is a situation in which a persistence rise in prices of goods and services leads workers to demand for higher wages which increase the cost of production leading to a further rise in prices which again leads to a further rise in prices which again leads to demand for higher wages.

DIS INFLATION
This refers to decline in the rate of inflation in an economy e.g. from 57% to 20%

OPEN INFLATION
This is a situation where the persistence rise in general prices is not interfered with by the government through price controls

REFLATION
Refers to deliberate government policy to stimulate production by increase prices or increase in money supply or credit after a deflation or fall in prices
OR
Policies that aimed at mild increase in prices so as to stimulate economic activities in order to pull economy out of depression

INFLATION TAX
This is a situation where government deliberately causes rise in prices through increasing money supply to pay for its expenditure other than increase taxes to meet the expenditures
OR
A situation where government hopes for the promotion of inflation by increasing taxes to pay for its expenditures.

DEFLATION
This refers to the decline in general price level in country due to fail in aggregate demand

CHARACTERISTICS OF A DEFLATIONARY SITUATION IN AN ECONOMY
- Low prices levels
- Low level of investment
- Low level of aggregate demand for goods and services
- Low level of employment
- Excess capacity in industries
- Economic stagnation
- Low levels of economic activities

INFLATIONARY GAP AND DEFLATIONARY GAP

INFLATIONARY GAP
Is where aggregate demand exceeds aggregate supply at full employment level of income

DEFLATIONARY GAP
Is where aggregate supply and aggregate demand of full employment level of income

Under what circumstances may inflation be desirable in the economy?
1. When there is need to stimulate and increase employment, inflation may be desirable as it increase income
2. When it is used by the government as a method of forced saving instead of increasing taxes which may become unpopular.
3. When there is need to stimulate economic growth through the effect of excess demand that increases profits and investments

4. When there is a need to pull an economy out of deflation or recession by increasing investments, employment, incomes, demand and others
5. When there is need to re-distribute incomes from the wage earners with low marginal propensity to save to profit earners with high marginal propensity to save.
6. Where the marginal efficiency of capital is low, an inflationary situation will rise it and therefore encourage investment
7. Where there is excess capacity or underutilized resources so that it stimulates increased output due to rise in production of economic activities
8. When there is need to stimulate investment in an economy, mild inflation may be desirable.

UNEMPLOYMENT PROBLEM:

Is a situation where labour is willing and able to work at the ongoing wage rate but cannot find jobs at a particular period of time **OR**

Unemployment is a situation where some members of the labour force are idle during a particular period of time.

HOW TO DETERMINE THE LEVEL OF UNEMPLOYMENT IN AN ECONOMY

Unemployment is determined or measured using the employment rate

UNEMPLOYMENT RATE:

Refers to the proportion in percentage of the unemployed labour force to the total number of labour force of an economy at a particular time. it's given by the formula:

$$\text{Unemployment rate} = \frac{\text{number of unemployed}}{\text{total labour force}} \times 100$$

Example

A country has a total population of 30m people, 8m of working population have no jobs, and total labour force is 20m people .Calculate the unemployment rate

$$\text{Unemployment} = \frac{\text{number of the unemployed}}{\text{Total labour force}} \times 100$$

$$\frac{\text{5million}}{\text{20million}} \times 100 =$$

Total labour force of a country is made up of the employed labour force and the unemployed labour force

FACTORS TO BE CONSIDERED WHEN DETERMING YHE UNEMPLOYMENT RATE

WORKING AGE:

1. The person not working or unemployed should have attained the legal minimum working age (i.e. 18 years in the case of Uganda) and not above the maximum working age
2. The unemployed persons must be willing and able to work at the ongoing wage rate at a given time

3. The duration of time spent unemployed .The researcher must consider the length of time a person is without a job before classifying him or her in a particular unemployment bracket
4. The person unemployed must be physically and monetary fit so as to be considered among the unemployed labour

Unemployment can be either voluntary or involuntary.

VOLUNTARY UNEMPLOYMENT

Is a situation where jobs are available but labour force is not willing to take on the jobs at the current on- going wage rates

CAUSES OF VOLUNTARY UNEMPLOYMENT IN AN ECONOMY:

REVISION QUESTIONS

- Examine the causes of voluntary unemployment in your country
- Account for the existence of voluntary unemployment in an economy

1. **Low wage rates /low remunerations.** Some people of the working age may refer to remain unemployed when they regard the current wage rate as too how to meet their current equipments.
2. **Laziness of the unemployed.** An individual of the working age may be unemployed of because of laziness and fear of work
3. **Un favourable location of the available job.** Labour force may prefer to remain unemployed when he/she considers the place where the job is available as unfavourable like due to political instability
4. **Poor working conditions.** Labour can decide to remain unemployed in an economy when he/she consider the existing jobs to have poor working conditions like existence of harsh administration ,poor health standards at the place of work etc ,working in toilets
5. **The available jobs may be socially undesirable.** In such a situation a labour force may prefer to remain unemployed so as to maintain personal integrity rather than take on sub standard jobs e.g. a toilet attendant, morcery attendants
6. **Expectation of better jobs in the future.** When some labour force expected to get better jobs in the new future, they may not take up the current existing jobs making them polarity unemployed
7. **Desire for leisure.** Some labour force becomes voluntary unemployed just because they prefer to enjoy leisure instead of working
8. **Changing jobs.** Labour force may become voluntarily unemployed in the short minute as they shift from one job to another .Here they would be unemployed during the period of searching for another job.
9. **Poor health of labour force.** Some people who are physically sick may become voluntary unemployed as they seek for treatment or find alternative ways of survival
10. **Decision to live on posted savings.** Some labour force in an economy becomes voluntarily unemployed when they take decision to retire early from work and live on what they have saved over time

11. **Good economic back ground of the unemployed.** Some individuals of the working age who came from rich families may see no need to take on the available jobs, making them voluntarily unemployed

QUESTION

What measures can be taken to reduce the level of voluntary unemployment in an economy

INVOLUNTARY UNEMPLOYMENT

I a situation where labour is willing and actively looking for a job but cannot find any at the on- going wage rates.

CAUSES OF INVOLUNTARY UNEMPLOYMENT IN AN ECONOMY (Uganda)

1. **Rapid population increase or high population growth rate**. A high population growth rate increases the labour force on an economy, and if not matched with an equal growth in job creation results in involuntary unemployment.
2. **Poor education system.** An education system that mainly trains job seekers like most art coerces results in involuntary unemployment as the labour force cannot get themselves jobs
3. **Discrimination in the labour market**. Where there is discrimination in the labour market based on sex, age ,religion and others make those discriminated to be involuntarily unemployed
4. **Ignorance of job opportunities**. Some labour force become involuntarily unemployed due to lack of information on some available jobs.
5. **Rural –urban migration.** Labour force that have rural areas for urban areas in search for jobs may become involuntarily unemployed when they abandon some jobs in un secure places and move to secure areas where there may be no jobs
6. **Political instabilities.** Insecurity in some parts of the economy like Northern Uganda may make some labour force to become involuntarily unemployed when they abandon some jobs in un secure places where there may be no jobs.
7. **Change in seasons.** Seasonal variations in an economy due to climatic changes like in agric failure to tame nature makes some labour force to be involuntarily unemployed at particular periods e.g. during dry seasons in agriculture sector
8. **Structural adjustment programmers [SAP].** International monetary funds [IMF] conditionality like of retrenchment make the labour force who have been laid off of work to become involuntarily unemployed
9. **Technological progress.** Technological progress and increased use of capital intensive methods of production results in involuntary unemployment of labour force as they are replaced by machines in the production process
10. **Physical and mental incapacitation.** Labour force with physical and mental inabilities like those who are lame, blind, and others may be involuntarily unemployed. This situation is called residual unemployment.
11. **Changing in jobs.** In short run labour force may be involuntarily unemployed during the period of shifting from one job to another.
12. **Limited co-operant factors.** Shortages of other factors of production especially capital and land usually limit further investments and hinder creation of more jobs hence making some labour force involuntarily unemployed

Revision questions

Account for the existence of involuntary unemployment in your country

TYPES OF UNEMPLOYMENT

Unemployment can be grouped or classified according to their causes

Common types of unemployment

1. Seasonal unemployment
2. Technological unemployment
3. Structural unemployment
4. Frictional unemployment
5. Casual unemployment
6. Cyclonal unemployment
7. Disguised unemployment
8. Hidden unemployment
9. Residual unemployment
10. Open urban migration

SEASONAL UNEMPLOYMENT

This is the type of unemployment which occurs as a result of climatic or seasonal variations e.g. in agriculture sector climatic variation from rain season to dry season makes some of the farmers unemployed e.g. harvesters and agriculturalists

CAUSES OF SEASONAL UNEMPLOYMENT IN AN ECONOMY

1. Failure to tame nature like floods ,sunshine etc make most farmers to become unemployed when sunshine dries crops
2. Climatic changes e.g. in agriculture sector cause seasonal unemployment e.g. from rain season to dry season make farmers
3. Period changes /variation in demand
4. Some goods are demanded during particular periods like Christmas cards during Christmas, examination cards during examination time. After the expiry of such periods in such goods become unemployed

SOLUTIONS ORMEASURES /REMEDIES TO SEASONAL UNEMPLOYMENT

1. Modernizing agriculture so that it is less dependent on nature like using immigration system of farming during dry season
2. Equipping labour force with multiple skills through training enables them to change from one task to another during particular periods hence making them continuously employed
3. Diversification of agricultural sector e.g. introduction of drought resistant crops for dry seasons helps farmers to keep working even during particular periods
4. Industrialization of the economy like by setting up processing plants ,these are usually less affected by nature
5. Diversification of the whole economy by introducing various economic activities likes trade, tourism, mining etc. This helps labour force to another when one is stopped by climatic changes hence keeping them employed.

TECHNOLOGICAL UNEMPLOYMENT

Is that which occurs as a result of changes in the method of production when machines replace labour like in industries

CAUSES OF TECHNOLOGICAL UNEMPLOYMENT

1. Change in the production method ,where machines re[place labour rendering labour unemployed
2. Technological transfer where new and efficient production techniques are transferred from mainly developed countries to develop countries, Labour force is displaced from production.
3. Inadequate skills to cope with the increasing technological progress [a document makes some labour to fall off from employment production] e.g. a typist who fails to adjust to using computers today becomes technologically unemployed
4. Poor education system which trains labour force that cannot cope with the technological demand of today make such labour unemployed

SOLUTIONS

1. Use of appropriate technology i.e. Labour intensive method of production in case of developing countries like Uganda and help to solve technological unemployment.
2. Economic diversification of the economy so as to help absorb the displaced labour in other economic activities such as tourism and other service sectors
3. Educational reform involving re-training labour force like through in-service training to enable to cope with the modern techniques of production e.g. ensuring that all workers become computer literate
4. There should be proper man power planning such that all labour force being released from the training institution are equipped with the current technological advancements.

STRUCTURAL UNEMPLOYMENT /SECULAR UNEMPLOYMENT:

Is that which occurs as a result of imbalances in the supply and demand for labour and changes in the demand for products in an economy

CAUSES OF STRUCTURAL UNEMPLOYMENT IN AN ECONOMY [UGANDA]

1. **Changes in demand due to changes in personal tastes and preferences**. A decline in demand for certain products like back cloth etc directly decrease the demand for labour used in their production hence making such labour unemployed.
2. **Technological advancements cause** structural unemployment when the use of capital intensive method of production results in machines displacing labour force
3. **Exhaustion of raw materials /minerals to make** workers formerly employed in industries that use such raw materials like kirembe copper mines, stone quarries and others
4. **Long periods of training /immobility of labour** .Highly trained labour like doctors .engineers, lawyers become unemployed for some time when they lose their jobs since they can`t easily take up other alternative jobs
5. **Political instabilities** e.g. in Northern Uganda due lord`s resistance army authorities cause unemployment due to changes in demand patterns e.g. most disco workers in the North are unemployed due to decline in might disclose due to insecurity
6. **Structural adjustment programmers** of the international monetary fund like retrenchment , privatization make some labour unemployed through being laid off

7. **Deflation in the economy** due to break down of industries political instabilities ,low prices especially for agricultural products and stress all reduce the level of investment and hence increasing unemployment.

SOLUTIONS OR MEASURES /REMEDIES TO CONTROL STRUCTURAL UNEMPLOYMENT IN AN ECONOMY [UGANDA]

1. The government should maintain political stability this helps to attract foreign investors and even promote local investment thus creating more employment opportunities .This also helps to ensure continuous production of commodities and hence continued employment
2. Diversification of the economy especially the small scale industries to enable labour easily shift from one economic activity to another like when raw materials get exhausted
3. Look for raw sources of raw materials through discoveries or conducting extensive research to develop substitute's materials like synthetic fibers that can be used in production hence keeping labour employed
4. Encourage the use of appropriate technology in the case of Uganda government should encourage the use of labour intensive method of production which will increase the employment of labour to solve unemployment
5. Equip labour with multiple skills this enabling labour to easily shift from economic activity to another hence reducing structural unemployment
6. Provision of credit facilities to local investors this for instance helps labourers that have lost jobs to strait economic activities and even be able to employ more labour thus reducing structural unemployment's

FRICTIONAL UNEMPLOYMENT /TRANSITIONAL /NORMAL /SEARCH.

Is that one which occurs when labour is changing jobs in the short run **OR**

Is one that arises due to temporary adjustment in the forces of demand and supply for labour. In this situation or case, labour force becomes unemployed during the process or period of moving or changing from one job to another .It is therefore a temporally type of unemployment

CAUSES OF FRICTIONAL UNEMPLOYMENT IN AN ECONOMY

1. Ignorance of the existence of job opportunities. A labourer who leaves one job many become temporally unemployed if he/she lacks information on other jobs to immediately take on hence frictional unemployment ends when the worker gets a job
2. Changes in tastes market and demand. The decline in demand for commodities due to changes in tastes may force employees to lay off some workers experience frictional unemployment as they look for other jobs
3. Technological progress /advancement and increased use of capital method of production make some labour force to suffer from frictional unemployment as they are replaced by machines
4. Political instabilities in the country, results in structural breakdown like break down of industries, transport network etc. Thus rendering some labour force unemployed as they move to look for jobs in stable region of the country

5. Specialized training of given jobs or limited skills .Highly trained labourers with limited skills become frictionally unemployed when they lose jobs because it takes some time before they again get employed.
6. Geographical immobility of labour force. A labourer may experience frictional unemployment due to difficult in movement from previous employment to area with new job like due to poor transport net work
7. Discrimination in the labour market. Some labour force after losing jobs become frictionally unemployed due to discrimination in the labour market like based on sex, age. Such labour spent some time looking for jobs where they are not discriminated against.

SOLUTIONS:

1. Advertising of existing jobs or season of job centers. The government should encourage employees to provide information on available jobs like by adverting through direct media such as radios, newspapers etc. This is to reduce the time for frictional unemployment as labour will easily take up the job.
2. Setting and improving infrastructure .The government should improve infrastructures like roads to easy movement of labour to places where jobs exist.
3. Encourage employees to recruit labour force basing on merit and not discrimination there by enabling labour force looking for jobs where they can be quickly absorbed.
4. Encourage the use of appropriate technology in case of Uganda government should encourage employees to use labour intensive method of production .This helps to ensure that there are ready job opportunities hence reducing frictional unemployment
5. Maintain political stability .The government should ensure stability through out of the country .This helps to avoid break downs in infrastructures; industries etc and ensure that labour force is not forced to abandon their job
6. Equip labour with multiple skills .The government should put in place training programmers and re-training programmes that provide various skills to labour .This enables a labourer who leaves one job to easily be absorbed in alternative jobs. Hence reducing both the time of searching for new jobs and frictional unemployment

CASUAL UNEMPLOYMENT

Is one that arises due to temporary nature of work or due to valuation in the demand for labour services

In this case labour is only employed when there is a task or demand for their services after doing the task they become idle .Casual unemployment is common among contract workers e.g. builders, road construction, painters

CAUSES OF CASUAL UNEMPLOYMENT

1. Working on contract basis .The worker who is employed on contract basis immediately becomes unemployed as soon as the contract is over e.g. road construction contract
2. Seasonal demand for certain type of labour force and some products. Some workers are only demanded during certain periods or season and after which become unemployed e.g. a builder will be employed when a construction is taking place after which he/she becomes unemployed.

SOLUTIONS MEASURES/REMEDIES TO CASUAL UNEMPLOYMENT

1. Workers should be encouraged to make new contracts before the 1st one ends or they should be encouraged to look for contracts elsewhere before the expiry of the current ones
2. Equip labour with multiple skills ,so that when one contract ends they can use another skill to sign new contracts or change to new jobs without being unemployed
3. Advertising of existing jobs on contract basis or simply advertise the available jobs. Employers should be encourage to advertise jobs on contract so as to help workers whose contracts are about to expire to immediately take on new contract jobs, in additional employers should encourage and help workers whose contracts are about to expire to look for new contracts where they can immediately take on jobs.

CYCLICAL UNEMPLOYMENT /MASS UNEMPLOYMENT /KEYNESIAN UNEMPLOYMENT

Is one arising out of fall or decline or deficiency in aggregate demand or one that occurs in times of depression in a trade cycle

When demand falls firms or industries will have to reduce their output and even lay off some workers or over dose down completely hence making labour unemployed.

CAUSES OF CYCLINAL /MASS UNEMPLOYMENT

1. Fall in the level of incomes or earnings like due to restrictive monetary policy results in fall in aggregate demand, foreign production and hence decline in employment of labour
2. Decline in the level of exports like due to trade restrictions causing decline in the labour force employed in the export sector hence mass unemployment
3. Increased volume of imports ,this reduces the available foreign exchange ,reduce demand for locally made goods resulting in unemployment of labour
4. Reduced government expenditure reduces development of infrastructure ,uses money supply that in turn reduces prices resulting in fall in economic activities and hence increase in unemployment
5. Decline in the level of investments. This causes unemployment of labour as few people will be employed in existing firms.

SOLUTIONS

1. Reduction in tax rates ,the government should lower tax rates so as to increase the level of disposable income and aggregate demand thus stimulating production and expanding employment
2. Expansionary monetary policy .The government should adopt measures that increase money supply e.g. reducing the bank loans ,increase investment levels and aggregate demand resulting in expansion of employment levels
3. Increased government expenditure. This will bring about a number of multiply effects like improved infrastructure, increase in aggregate demand, increased investment and hence creation of more jobs.

4. Encouragement of private investment like through providing tax holidays ,tax exemptions etc .This will measure incomes of investors and their aggregate demand for goods and services to increase resulting in increased output and creation of more jobs
5. Increasing the volume of exports like through diversification of exports joining economic integration etc .This will increase foreign exchange earnings increase investments through export thus creating more jobs to absorb unemployment
6. Reducing import by setting up import substitution industries this will increase the incomes of local people their aggregate demand , improves investments hence more job opportunities.

DISGUISED UNEMPLOYMENT

Is a situation where by labour force appears to be actively involved at work but the marginal product is either negligible zero or negative. In this situation there are very many workers or some can be removed without causing any reduction in total output or product.

CAUSES OF DISGUISED UNEMPLOYMENT

1. High population growth which results in abundant labour involved in the production process. This makes the work available inadequate to keep a given labour force fully employed
2. Limited skills to carry out production process labour force with inadequate skills end up crowding in jobs that do not demand for advanced skills like casual work making them less productive and fully employed
3. Lack of information about the existing jobs. Some work force end up crowding in jobs where they are not fully employed just because they have no information on the available jobs elsewhere.
4. Poor land tenure system. This causes overcrowding in some places there by reducing the amount of land to keep labour fully occupied .The amount of work on the piece of land will be shared among many workers like family members may not be fully employed.
5. Desire by some employees to store/keep work force for future use .This causes disguised unemployment as the workers full employment in the future
6. Limited capital to acquire the required tools, machinery and equipment .This causes disguised unemployment in that many workers using poor tools will be involved at work where their marginal product will be negligible zero/negative
7. Nepotism in some sectors, cause disguised unemployment due to over recruitment of workers like based on tribe, political party.
8. Poor man power planning many cause disguised unemployment for instance poor education system that trains job seekers may end up crowding in certain jobs

SOLUTIONS/REMEDIES FOR CURBING/ REDCING DISGUISED UNEMPLOYMENT

1. Encouraging reduction in population growth rates. This helps to reduce the size of the labour force in the long run hence reducing disguised unemployment

2. Educational reform with emphasis on training of people to become job makers. This helps to reduce the level of disguised unemployment as most labour force fully get occupied in their given jobs
3. Advertising of existing jobs or creation of jobs centers .This can help reduce or even eliminate disguised unemployment as most labour force fully get occupied in their given jobs
4. Facilitating easy access to land. The government should put in place measures that enable people to easily acquire access land like through land acts. This will help the unemployed to get fully occupied hence reducing disguised unemployment i.e. land commission in Uganda.
5. Providing credits to local investors. People who are unemployed should be given loans that they can invest so as to create themselves jobs. This reduces disguised unemployment resulting from employers trying to retain labour for future use i.e. micro-finance in Uganda, N.G.Os like sent a cow, a goat projects.
6. Encouraging employers to recruit workers basing on merit .This will help to reduce disguised unemployment resulting from Nepotism during recruitment i.e. basing experience, qualification skills.

HIDDEN UNEMPLOYMENT:

Is a situation where labour appears to be fully involved at work but largely unproductive due to the use of inappropriate tools, inadequate skills or education ,lack of motivation ,hunger etc

It's a form of unemployment related to disguised unemployment

CAUSES OF HIDDEN UNEMPLOYMENT

1. In appropriate skills or training. This makes labour to be involved in an activity where their output is small in comparison to their potential.
2. Moral sickness. This makes a worker not to be fully involved in the production process
3. Inadequate supervision of labour force reduces their active participation in production making them sometimes idle
4. Use of inappropriate tools in the production process, making labour largely unproductive or under utilized

POSSIBLE SOLUTIONS TO HIDDEN UNEMPLOYMENT

1. Providing the appropriate tools like machinery, makes labour to actively productive, hence reducing hidden unemployment
2. Introduction of on -job training, This enables labour to acquire the appropriate skills for production and hence reducing hidden unemployment
3. Improvement on the welfare of the workers by providing medical care for the sick good diet etc to ensure healthy workers who are fully involved in the production
4. Appropriate motivation of workers like by providing allowances, regular counselling, be involved in the production process .hence Hidden unemployment is reduced.
5. Proper and regular supervision of labour .This enables them to actively get involved in the production process thereby reducing hidden unemployment caused by inadequate supervision

RESIDUAL UNEMPLOYMENT
Is one that arises due to physical and metal incapacitation of a potential labour force e.g. due to blindness, deafness, extreme lameness etc .which disabilities do not allow labour to actively and fully get involved in the production
CAUSES OF RESIDUAL UNEMPLOYMENT

Physical or mental incapacitation like madness, lameness etc may cause a person to be unemployed

SOLUTION

1. Encourage employees to change their attitude towards potential labour force with disabilities and have their employed
2. Providing labour with disabilities with credit or loans or appropriate resources like broilers for the blind .In addition such labour can be organized into association or club when there given credit for investment purposes so as to provide them jobs i.e. UNAB
3. Equipe people with physical and mental abilities with education, equipment etc that can make productive activities e.g. teach the blind how to use broilers etc. There by making them employable
4. Medical treatment. potential labour with disabilities that can be corrected should be taken to provide such treatment e.g. Butabika hospital .After treatment such labour force can be equipped with employable skills like luzira prison

OPEN URBAN UNEMPLOYMENT/URBAN

Is a situation where labour in the urban areas has no jobs mainly involuntarily resulting majorly from massive movement of labour from the rural areas to the towns to look for jobs

CAUSES

1. Rural –urban migration. people who move from rural-urban become unemployed in the town when they fail to get jobs hence open-urban unemployment
2. Rapid population growth i.e. faster than the rate of job creation makes some labour unemployed especially in the towns
3. Inappropriate education system that mainly trains labour for white collar jobs common in urban areas make labour to become unemployed when fail to get such jobs in the urban centers
4. Lack of information about existing jobs in urban areas, makes some labour force in the towns unemployed
5. Low rate of industrialization. This results into few jobs in urban areas hence causing unemployment to many urban drivellers of the working age.
6. Technological progress and increased use of capital intensive methods of production .This makes many workers to be displayed from rural areas .Such labour force therefore becomes unemployed in towns i.e. computers ,tractors in rural areas.
7. Discrimination in the labour market. This makes some labour in the urban areas unemployed due to tribal ,nepotism during recruitment of workers etc
8. Retrenchment policy under structural adjustment programmers (SAP) results in open urban unemployment when labour in the towns are laid off and later they fail to get alternative jobs

9. Limited co-operant factors like land, capital or existence of poverty .These limited potential investors from setting up of more firms in an economy and also causes open urban unemployment.

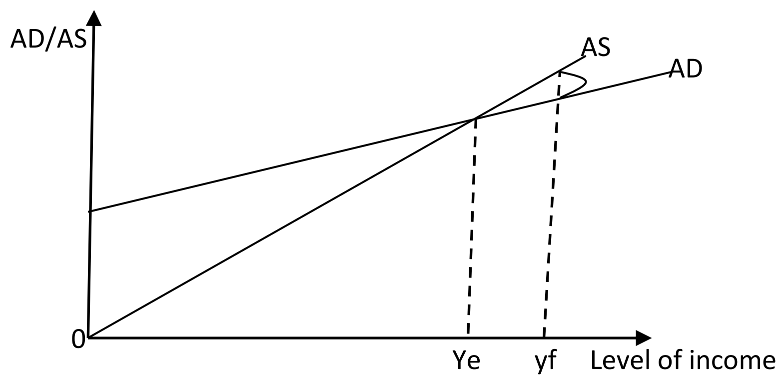
POSSIBLE MEASURES TO REDUCE URBAN UNEMPLOYMENT

1. Rural transformation programmers aimed at existing job opportunities in the rural areas should be set up like encouraging the set up of more small scale industries in the rural areas helps to create more jobs and thus reduce movement of labour to towns where they will be employed i.e. rural electrification
2. Educational reforms that involve training of people to become job creators i.e. vocationalization of education helps labour to get self employed and thus reduce unemployment including open urban unemployment
3. Encourage reduction in population growth rate like through family planning measures such as birth controls helps to reduce large population and also reduces open urban unemployment in the future
4. Encouraging the use of appropriate technology in developing countries like Uganda promoting the use of labour intensive method of production helps to reduce open urban unemployment and other forms of unemployment
5. Provision of credit to local investors .This helps to create jobs for such investors and absorbed hence reducing urban and other forms of unemployment
6. Advertising of the existing jobs through various Medias like radios and news papers makes the unemployed in towns to get jobs hence eliminating/reducing urban unemployment.
7. Diversification of the economy with help to expand investments in different economic activities in all parts of the country, more jobs will be created to absorb even those previously employed in towns.
8. Privatization .This will help to improve and create more investment and employment in the country and hence open urban migrations

KEYNESIAN THEORY OF UNEMPLOYMENT

The Keynesian theory of unemployment states that unemployment arises due to **deficiency** in effective aggregate demand for final good s and services especially in time of economic recession and **depression**. Due to low demand for final products, firms or producers are force to reduce their output, income levels fall because of low earnings, investment is discouraged and therefore less labour and capital are employed .This theory was put side by **John Maynard Keynes**

AN ILLUSTRATION OF THE KEYNESIAN THEORY OF UNEMPLOYMENT



The level of unemployment Ye.Yf on the graph above is due to deficiency in demand df .Due to local demand for final products producers will be forced to reduce their employment and also lay off some workers hence making them unemployed.

SOLUTIONS TO UNEMPLOYMENT ACCORDING TO KEYNES

According to JM Keynes the massive solution or immediate to the unemployment problem is increasing aggregate demand.

1. Increasing government expenditure on goods and services for example by increasing salaries and wages .This will help to increase aggregate demand ,stimulate investments and create more employment opportunities
2. Reducing tax rates or taxation levels. This will increase disposable consumer income increase the level of demand thus promoting investment loading to creation of more employment opportunities
3. Using expansionary monetary policies like purchase of treasury bills and bonds this will increase amount of money in circulation , increase capital accumulation in investments and hence more jobs will be created
4. Encouraging private investments through providing in countries like tax holidays , tax exemptions etc. This will help increase incomes of investors and also increase their demand for goods and services and in return expand employment opportunities due to increased investments
5. Subsidization of consumer prices for specific goods .This will increase aggregate demand a multiplier effect will continue tips to expansion of employment opportunities

To a bigger extent , the theory is irrelevant because of the following

IRRELEVANCE OR INAPPLICABILITY OF THE KEYNESIAN THEORY OF UN EMPLOYMENT IN UGANDA OR LDCs

1. **I**ncrease in money supply leads to increase is disposable income of people leading to raise in the aggregate demand for goods and services which is not matching with aggregate supply thus causing demand pull inflation
2. The existence of a big subsistence sector makes the theory irrelevant in LDCs /Uganda since it assumes a high monetized economy yet Uganda /LDCs are dominated by subsistence production and barter exchange which have no multiplier effect.
3. Under developed money and capital markets also makes the theory irrelevant in LDCs /Uganda these are under developed i.e. there is a small exchange market.
4. Openness of the economy makes the theory irrelevant in LDCs /Uganda because it assumes a closed economy yet Uganda participates in international trade where some labour force can easily get jobs At times, unemployment in Uganda results due to fall in demand for goods and services in both local and foreign markets as the theory assumes thus making it relevant.
5. In Uganda, there is an element of industrialization thus making the theory relevant since it assumes a high industrialized economy.
6. Investment climate can affect employment levels as mentioned by Keynes and therefore portion of investment in Uganda through measures like tax holidays, exemptions etc to expand the level of employment. This makes the theory relevant because Keynes suggested by Keynes thus making the theory relevant.
7. Use of expansionary monetary policies in Uganda have tended to increase employment levels e.g. lowering bank rates as suggested by Keynes thus making the theory relevant.

8. In the long run, as the supply of cope rant factors increases. This increases the level of output, capital accumulation and employment opportunities as the theory assumes thus making it relevant to LDCs
9. The existence of big subsistence sector makes the theory irrelevant in LDCs /Uganda since it assumes a high monetized economy yet Uganda /LDCs are dominated by subsistence production and barter exchange which have no multiplier effect.
10. Under developed money and capital markets also make theory irrelevant because it assumes a well functioning capital and money market yet in LDCs / Uganda these are under developed i.e. there is a small exchange market.
11. Openness of the economy makes the theory irrelevant in LDCs /Uganda because it assumes a closed economy yet Uganda participates in international trade where some labour force can easily get jobs from other countries.

IRRELEVANCE OR LIMITATIONS OF KEYNESIAN THEORY OF UN EMPLOYMENT

To a larger extent the theory is irrelevant to Uganda because of the following reasons:

1. Unemployment in LDCs is basically on the supply side. This makes the theory irrelevant since it assumes that unemployment arises from the demand side yet in Uganda demand at times exceeds supply due to political instabilities ,shortage of co operant factors ,particularly capital which leads to supply rigidities
2. It ignores that LDCs are mainly agro based economies. This makes it irrelevant since it assumes a high industrialization economy which can be affected by deficiency demand for final goods and services .The deficiency doesn`t affect agro based economy because of the subsistancial nature of agriculture in such economies.
3. Existence of unemployment in LDCs makes the theory irrelevant since it assumes conditions of full employment yet in Uganda there are idle resources e.g. land which is underutilized.
4. The expansionary monetary policies, Keynes suggests as a solution to unemployment are inflationary in nature thus making the theory irrelevant in Uganda /LDCs e.g. increase in money supply will lead to from other countries.
5. Existence of weak private sector in most LDCs/Uganda makes the theory irrelevant because it assumes a strong private sector which responds quickly and effectively to changes in demand yet Uganda is dominated by weak private sector which can respond to rapid changes in demand.
6. In Uganda, it is export multiplier that manly contributes to expansion of employment which makes the theory irrelevant because t only considers investment as the major contributor to employment creation.

GENERAL CAUSES OF UNEMPLOYMENT:

1. Technological progress and increased use of capital intensive method of production .This also causes unemployment in Uganda which is technological most especially in the production process where there is use of machines instead of human labour e.g. tractors ,combined ox-plough which usually lay off which might implied.
2. Ignorance of labour force about the existing job opportunities .Some labourers in Uganda are unemployed because of lack of information about existing jobs in other parts of the country's

3. Poor land tenure system in Uganda also causes unemployment most especially disguised unemployment. This is because in most rural areas of the country some land lords own very large pieces of land and yet they are poor. This makes those who are tenants unemployed because they are denied rights and accessibility to such land.
4. Changing jobs causes' frictional unemployment in the country .This is because some labour force after leaving one job become unemployed in the short run when they are still looking for alternative jobs.
5. Poor educational system which tend to train more job seekers because of its theocratic nature instead of job creators. This makes the white collar labour force unemployed after failing to get white collar jobs.
6. Changes in tastes and preferences, market, demand and foreign prices. Some people in Uganda are unemployed because of changes in demand against their products .While others especially in the agric sector become unemployed after abandoning agriculture due to the falling prices for agric products both local and foreign.
7. Limited co operant factors of production especially capital and land also accounts for the existence of unemployment in the country. Inadequate capital makes many employers to operate on small scale thus providing few jobs to the abundant supply of labour while some workers become unemployed because they do not find what to work with e.g. machines.
8. Hostile climatic changes e.g. prolonged droughts; landslides also contribute to seasonal unemployment in Uganda most especially in the agriculture sector where farmers are unemployed during such conditions
9. Rural urban migration causes unemployment in the country .Labour force who move from various rural areas of the country to urban centers like Kampala, etc with the aim of looking for jobs become unemployed when they fail to get such jobs
10. Poor attitude towards work also explains the existence of unemployment problem in Uganda .This is common in some tribes like karamajongs which discourage men from working thus making them idle.
11. Discrimination in the labour market based on age, sex, tribes etc is also a major cause of unemployment in Uganda .Some employees in the country prefer offering jobs to specific type of labour force like women and this makes men with similar skills who are discriminated unemployed
12. political instabilities and unrest in some parts of the country have also contributed to high unemployment rate in the country e.g. wars which are persistent in Northern Uganda made many potential labourers disabled and this discourage investment in such areas .In addition to that political unrest inform of riots have also disorganized business environment in most urban centers e.g. Walk to work.
13. Structural adjustment programmers of I.M.F and World Bank have also contributed to high unemployment rate .In the process of implementing their programmers like retrenchment, privatization many worker have failed to get alternative jobs'
14. Physical and mental incapacitation also causes residual unemployment in the country .This is because some labourers who are blind ,deaf and lame are without jobs because some employers do not employ them while others lack skills that would provide them jobs'

NEGATIVE EFFECTS /COSTS OF UN EMPLOYMENT:

1. It increases the level of dependence/it worsens dependence burden .This is because all the unemployed in the country would have to rely on the incomes and output of the employed for their survival.
2. It worsens the problem of wealth and income inequality .The gap between the employed widens and this creates negative effects like social divisions, exploitation of the poor.
3. It increases the level of social crimes .Un employment in the country in the country results in moral decay since it promotes social evils like theft

4. Unemployment makes the ruling government unpopular and this can promote political instabilities .Because it is easier to convince a un employed person to join rebel groups against the government, all people can resist government.
5. It reduces government revenue thus slowing down the process of economic growth and development due to poor service delivery from the government
6. It results in wastage of trained man power .Un employment as a result of poor education system makes the government to waste the labour force that has been trained and also to lose resources used entraining such man power.
7. It results in decline in the level of skills acquired .This is because un employed labour force experience knowledge decay because the skills acquired are inactive thus leading to a decrease in productivity .
8. It may promote brain drain where skilled labour force that fail to get jobs in the country move to other countries where they hope to get better paying jobs thus exposing the country to shortage of skilled man power e.g. there are 1000s of doctors who are Ugandans working in Austria ,Germany yet there is shortage of doctors in Uganda.
9. It increases government expenditure on maintaining the unemployed controlling the effects of unemployment e.g. in Uganda the government borrower's food items from other countries and international institutions to cater for the unemployed in some parts like karamoja.
10. It discourages investments in education which promotes illiteracy most especially when educated fail to get jobs.
11. It increases social unrest /instabilities in families most especially when the man is unemployed and fail to support the family in terms of buying necessities, a conflict may arise between him and the wife's
12. It increases rural urban migration and its negative effects most especially seasonal unemployment.ss
13. It leads to under exploitation of resources due to low levels of income of people in the country thus wasting some of these resources.

QUESTIONS:

1. What measures are being taken to control unemployment in your country?
2. What measures should be taken to reduce unemployment problem in LDCs.
3. Examine the measures that have been taken to solve the problem of unemployment in your countries
4. What attempts could be done to reduce the unemployment problem in your country?

MEASURES BEING TAKEN TO SOLVE THE PROBLEM OF UNEMPLOYMENT:

1. Educational reform is being under taken by the government of Uganda to reduce the un employment problem .The education system is now emphazing training of people to become job makers through emphasizing training of people to become job makers through teaching vocational subjects at all levels e.g. agriculture ,entrepreneurship, computer ,science education etc
2. Population control measures are being taken by the government to reduce on the high population growth rate through mass sensitization of people about the dangers of high population growth rate, encouraging the use of family planning methods like giving free condoms so as to equate the growth rate with the rate at which jobs are created.
3. Encouraging the use of appropriate technology is one of the measures being taken to reduce un employment in Uganda i.e. the government is encouraging the use of labour intensive technology most especially in agriculture sector to absorb the abundant semi and unskilled labour.

4. Liberalization of the economy is being done by the government through removing unnecessary restrictions on trade, on foreign exchange and on the market. This attracts many potential investors both local and foreign to participate in different economic activities thus creating more employment opportunities.
5. Setting and improving the of infrastructure like roads, power supply ,encouraging even distribution of banks etc is being taken to solve the unemployment problem e.g. the wide spread power supply has facilitated many economic activities mostly in urban areas thus creating more jobs e.g. the government allocated 50bshs for maintenance of 10,000 km National roads in the 2010s
6. Privatization of public enterprises is being implemented in Uganda as a way of creating more employment opportunities in the long run .This is because private enterprises aim at maximizing profits thus expanding their scale of operation to maximize such profits
7. Providing credit facilities to local investors through different micro finance institutions and commercial banks at a reduced interest rate e.g. the government allocated 44.5 b shs according to the National budget of 2010/2011 for youth employment, 6.2 b shs for Kampala traders and other municipalities to expand their businesses
8. Ensuring political stability in all parts of the country so as to create a concussive investment climate. This has attracted many potential local and foreign investors to engage in different economic activities thus creating more job opportunities e.g. Kony defeated in Northern Uganda, ADF in Western Uganda and the government is organizing peace talks with the opposition to create harmony in the country.
9. Adverting of the existing jobs is also being under taken as a measure to reduce unemployment .Jobs are being advertised through various medias like radios ,televisions and news papers especially Monday New Vision
10. Modernization of agriculture is being encouraged in Uganda through different organization to set up to implement specific projects like PMA, NAADS, NARO etc to make agriculture a year round economic activity and to reduce on seasonal unemployment e.g. more resistant variety of crops are being supplied to farmers e.g. Genetically Modified Seeds[GMS].
11. Facilitating access to land is also being used I Uganda to solve the disguised unemployment caused by the poor land tenure system e.g. land acts are being implemented and amended to ensure proper ownership of land in all districts and pieces of land where they are. The land Act of 2010.
12. Economic integrations is being carried out by the government of Uganda through participating actively in the revival of East African Community so as to expand the market size ,increase investment and thus creating more job opportunities.
13. Uganda is also setting up institutions to encourage investment as a way of reducing unemployment in the country e.g. Uganda Investment Authority [UIA] has been established to provide information about investable areas and opportunities , guiding investors on how to acquire trading license etc

FACTORS LIMITING GOVERNMENT SUCCESS IN SOLVING UNEMPLOYMENT IN UGANDA:

1. Political instability and unrest
2. High population growth rates
3. Poor state of infrastructures
4. Continued use of expatriates /foreign man power
5. Inability to tame nature /hostile climatic conditions
6. Limited supply of capital
7. Slow growth rate of the economy and continued discrimination in the labour market
8. The use of capital intensive technology

THE CONCEPT OF UNDER EMPLOYMENT:

It refers to under utilization of labour force /resources inform of labour working less time than the desired or labour engaging in jobs below his/her skills

CHARACTERISTICS OF UNDER EMPLOYMENT:

- The marginal productivity of labour is negligible or negative
- Labour force working for fewer hours than the desired
- Labour working in a job level of requirement is below the level of skills or training attained by labour force.
- Labour force working in a job paying a salary /wage below the statutory minimum wage

CAUSES OF UNEDR EMPLOYMENT:

1. Inadequate co-operant factors particularly capital, entrepreneurship and land
2. Excess supply of labour forces some labourers to take on any available job even at a very low pay
3. Poor working conditions e.g. inadequate protective equipment may make labourers to put in less effects than their full potential
4. Discrimination in the labour market e.g. basing on politics, sex, and tribe may influence employment of people without appropriate skills thus making such labour force work at a slow rate
5. Poor man power planning
6. High population growth rate
7. Poor technology used can also limit productivity of workers
8. Poor health of labour force
9. Negative attitude towards work towards work as some labourers may put in less effects after taking on jobs as a last resort
10. Poor land tenure system
11. Inadequate supervision of labour force
12. Ignorance of people about the available jobs

THE CONCEPT OF FUL EMPLOYMENT:
This is where all people /all factors of production willing to work can get employment.
OR
Is a situation where everybody that is willing and able to work at an acceptable wage rate is employed.
OR
Is a situation where unemployment rate is 3% or less due to frictional unemployment
It should be noted that full employment doesn`t mean 0 unemployment since it isn’t possible for any economy to employ all the labour force in a given time period in a given times

CONDITIONS NECESSARY FOR ACHIEVING FULL EMPLOYMENT:

1. The government should ensure the proper man power planning such that time offered of training in institutions matches with the available jobs so as to reduce discrepancy between demand for labour and supply.
2. The government should provide adequate co-operant factors e.g. capital
3. The government should encourage free mobility of labour from one job to another or geographical area to another by subsiding the economy
4. Controlling population growth rates
5. Adopting appropriate education system

6. Maintain political stability in all parts of the country
7. Developing Rural Ares should be undertaken.
8. Removal of all social barriers to employment of labour e.g. by encouraging trade unions to remove all forms of restrictions on entry of new workers
9. The government should take measures that increase the level of aggregate demand like paying high wages ,influencing both private and public investments

QUESTION:

Under what circumstances may your country achieve full employment?

- Adequate co-operant factors
- In case there is man power planning
- High degree of political stability in all parts of the country
- Appropriate education system
- Optimum population /when the population growth rate is equating the rate at which jobs are created
- Even distribution of resources.

REASONS WHY IT IS DIFFICULT TO ACHIEVE FULL EMPLOYMENT:

1. Faster development and growth of urban areas compared to the rate of rural /urban migration .This makes it difficult to eradicate open urban unemployment thus failing to achieve full employment because many people who migrate from rural areas hoping to get jobs in urban areas fail to get them.
2. High population growth rate in an economy which is faster than the rate of jobs creation meaning that some labour force will continue to remain unemployed thus making it difficult to achieve full employment
3. Heavy dependence on nature which in un reliable for example in case of agriculture sector which normally brings about seasonal unemployment there by reducing the changes of attaining full employment in an economy. This is because people are only employed during favorable particular seasons and unemployed in hostile climatic conditions.
4. Use of inappropriate technology e.g. use of capital intensive methods of production yet has abundant supply of labour .This causes technological unemployment as human labour is replaced by machines thus making it impossible to achieve full employment.
5. Existence of a large subsistence sector retards the level of investments and productivity of labour in the country. Production for home consumption and on a small scale doesn`t provide enough jobs for labour force thus making it difficult to achieve full employments
6. Immobility of FOP both occupationally and geographically causes different types of unemployment in the country e.g. disguised unemployment, frictional employment. This is mainly caused by poor infrastructures like feeder roads, poor banking system which hinder people to move to other areas where jobs are and failing to achieve full employment
7. Shortage of co-operant factors of production like capital that will help to improve labour productivity causes under and unemployment of labour .This is because most firms operate on small scale and employ less thus failing to achieve full employment.
8. Poor man power planning by government where the rate of growth of the labour force is greater than the rate of job creation and this lead to excess labour .In addition to that the labour force produced in most institutions doesn`t satisfy the current demand in the job market thus causing high unemployment and failing to achieve full employment
9. Heavy capital out flow from the country limit investments which would be necessary for increasing job opportunities .This is because most enterprises are owned by foreigners who tend to repatriate all the profits they make and mainly employ foreign labour. This contributes to un employment rate thus making it difficult to achieve full employment

10. Trade union activities of restricting entry of new workers in their professions so as to maintain high wage levels of the employed labour causes unemployment to labour force deny the opportunity of entering into the job market .Such actions make it difficult to achieve full employment.
11. Social barriers like discrimination in the labour market based on sex, age, tribe etc makes it difficult to achieve full employment in the country. This is because all those discriminated become unemployed
12. Political instabilities and unrest existing in some parts of the country .These are also major obstacles in achieving full employment because they reduce the level of investment since many potential investors are not sure of the security of their property and life which is important in creating jobs. In addition to that the employed labour are driven out of jobs and some are made disabled thus worsening the un employment problem e.g. the recent walk to work demonstration , Kabaka Crisis, Northern Uganda war which had persisted for a long period of time.
13. Low level of aggregate demand limits the level of investment which would be necessary for expanding employment level and driving the country towards employment opportunities .Hence due to low investments, full employment is very difficult to be achieved.

QUESTIONS:

- Why is your country striving to achieve full employment?
- Explain the objectives of reducing unemployment in your country.
- Why is it necessary to reduce the high unemployment rate in your country?
- Why is unemployment a great concern to your country?
- Under what circumstances may an economy fail to achieve full employment?
- Explain the unemployment burden in your country?
- Account for persistent unemployment problem in your country.

PUBLIC FINANCE AND FISCAL POLICY

Public finance is a branch of economics which is concerned with state/public revenue and state/ public expenditure

OR

It is the branch of economics which is concerned with the various sources of public revenue and different areas where the state spends money in order to achieve major objectives of national development
OR
It is a science that deals with finance of public authorities with regard to income and expenditure

COMPOSITION OF PUBLIC FINANCE
Outline the components of public finance
i. Public revenue
ii. Public expenditure
iii. Public debts
iv. Fiscal policy
v. Financial administration

PUBLIC REVENUE
Public revenue refers to the total income of the state. It includes methods used by the state to raise revenue and principles of modern taxation

PUBLIC EXPENDITURE
It refers to the total amount of money which the government spends on social services like defense, education, health etc

PUBLIC DEBTS
It refers to the total amount of money which the central government, local authorities and public corporations borrow from internal and external sources

FISCAL POLICY
It refers to the deliberate use of taxation, government borrowing and government expenditure to regulate the level of economic activities

FINANCIAL ADMINISTRATION
This refers to preparation and approving of the budget and auditing of all government ministries and other state bodies

THE ROLE OF PUBLIC FINANCE IN UGANDA
1. It regulates the process of economic growth through monetary and fiscal policies for example government uses fiscal decentralization strategy to stimulate local revenue, collection and proper expenditure by districts
2. It influences investment levels for example reduction in some taxes encourages individuals and firm to invest in such sectors. The government allocated shs 46billion for investment and commercialization most especially in agriculture sector in 2010-2011 budget
3. It is a means of acquiring revenue for recurrent and development expenditures. The government gets revenue from taxation, borrowing from internal and external sources
4. Public finance through its fiscal tools like taxation controls consumption or use of un desirable products for example to reduce the environmental hazards caused by second hand vehicles, taxes on imported second hand vehicles was increased by 10% in 2006-2007 budget, discouraging beers like senator and eagle by 30%

5. Public finance improves the BOP position of the country. Government has to put in place strategies aimed at improving the volume and quality of exports and reduce the volume of exports
6. Determines the employment levels in the country through Policies aimed at increasing production and raising the level of investment or increase the employment opportunities in different sectors. The government through public expenditure allocated shs 4billion start up loan for un employed graduates in 2010-2011budget, in the 2011/2012 sh44.5b for youth employment
7. Protects local industries and local producers for example in order to encourage industries producing sugar, taxes on imported sugar was increased from 10-20% in 2003-2004 budget, in the financial year 2011/2012 tax on sugar was reduced by 50%.
8. It reduces disparities in the distribution of incomes for example the government has put in place strategies to achieve the goals of poverty eradication plans which is aimed at increasing the incomes of the people. Government expenditure on primary and secondary education is also intended to promote prosperity for all
9. It is used to control inflationary and deflationary tendencies there by stabilizing prices for example government has increased expenditure on infrastructure like roads, water in order to increase productivity of essential goods and provision of services
10. Through government expenditure public finance ensures the building of necessary social and economic infrastructure such as roads, hospitals schools which enhance improved SOL of people in the country
11. It encourages technology development in the country i.e. the government removed VAT on computers and accessories in 2006-2007 budget, the government provided ICT cable to major towns, it also panned to complete the interconnectivity of the entire country by laying over 1500km of optical fibre in 2010-2011 budget

SOURCES OF PUBLIC REVENUE

1. Taxes; this is the most important source of public revenue and includes both direct and indirect taxes
2. Fees and licenses
3. Fees; this is a payment for a particular service provided by the state like in schools, hospitals
4. Licenses; this is a charge imposed by public authority to grant permission to an individual or firm to perform or benefit from a certain service like trading licenses, driving licenses, import license
5. Rent; this is paid on government property used by the public like market stalls
6. Fines; these are penalties charged on wrong doers who offend state laws
7. Gifts and grants; the government usually obtains gifts or grants in form of money or fiscal items from nations, organizations, other governments as well as international bodies like world bank
8. Compulsory saving schemes for example social security fund (NSSF) in Uganda
9. Government at times engages in activities that are profit making and hence direct profit earnings
10. Loans or borrowing; a government can borrow from within the country (domestic debt) or from outside the country (external debt)
11. Disinvestment (privatization); the sale of state owned firms to individual or private sector enables the government to get revenue. For example Ugandan government has sold off very many state owned firms like UCB Ltd
12. Deficit financing (printing more money) to enable government to finance its development expenditures

13. Floating of government securities and bonds; that is the government through the central bank raises revenue through selling its securities like treasury bills
14. Many governments have engaged in gambling i.e. selling national rotary for example crash for cash. There they get a lot of revenue
15. Tolls like road tolls and bridge tolls

TAXATION

A tax is compulsory contribution levied by public authority irrespective of the exact amount of services rendered in return to the tax payer. It is anon quid proquo payment

TAXATION; this is a legal and compulsory transfer of money from the public to the government as a source of government revenue and for other purposes. Taxes differ from other forms of government in that a tax payer gets no direct benefit from the tax paid. One may benefit indirectly by use of various services which the government produces like education, health etc

OBJECTIVES/ NEED FOR TAXATION/IMPORTANCE OF LEVYING TAXES

1. To raise revenue for the government which enables the to finance development and recurrent expenditures for example on education, health, rehabilitating
2. To protect domestic firms and producers from un fair foreign competition through imposing import duties which increases prices of imports hence discouraging them in an economy.
3. To ensure equitable distribution of income through charging high taxes on the rich progressive tax and subsidize the poor in order to improve their standards of living
4. To discourage production or consumption of demerits like high taxes on cigarettes is aiming at reducing its consumption in order to protect peoples' health in the country
5. To improve or maintain BOP position by discouraging imports through imposing heavy import duties and encourage exports through low taxes in order to attain favorable BOP position
6. To control demand pull inflation through imposing high direct taxes on incomes of individuals which reduces their disposal incomes hence lowering level of demand for goods and services
7. To control or regulate monopoly powers in the country through changing specific and lump sum on monopolists in order to reduce their profit margins
8. To influence resource allocation through imposing low taxes on some sectors like health, education etc which attracts people to invest in them hence promoting balance in development
9. To influence the level of economic growth in an economy. This is achieved by regulating government on productive and essential activities like tax revenue is used to finance road construction, agriculture activities (PMA and NAADS) etc to increase out put in the country
10. To promote regional economic integration. This is achieved through imposing taxes on products of non member countries and trade will be carried on among the member states without taxes hence strengthening trade and regional co operations
11. To retaliate against taxes imposed by others countries. Taxes are imposed as away of revenge against other countries that would have earlier on imposed heavy duties on goods coming from other countries

NEGATIVE ROLES

1. They reduce the welfare of the consumers by reducing disposable income and reducing consumption thus poor standards of living

2. They can increase income inequality if heavy taxes are imposed on commodities which are consumed by the poor
3. They can cause price increase especially indirect taxes which are shifted on the consumers in form of high prices of commodities
4. The encourage smuggling if taxes are not uniform in neighboring countries and this leads to low tax collection thus retarding development in most developing countries
5. They “kill” the incentive to work when they take a big percentage of income of the tax payer. This increase the level of un employment as people resort to enjoying leisure than work
6. They protect domestic industries and shield them from competition which would encourage them to improve the quality of their production thus ending up producing poor quality products
7. They reduce personal savings by reducing disposable income (DY) since DY is personal saving minus taxes. This in turn reduces investment especially if tax revenue is not channeled to investment
8. They re-allocate resources from taxed to non taxed goods. This can cause un employment in the taxed sector and production of luxuries goods than essential goods which are taxed
9. They can cause un rest, strikes and political instabilities if they are fixed at high rates. This also discourages production
10. They put the burden of looking after the poor on the rich and this discourages the poor from working very hard since they are assured of free or subsidized commodities

REVISION QUESTION

Explain the role of taxation in an economy (Refer to the above but the tense changes i.e. promotes, improves, controls)

NB. Importance, merits use the present simple tense i.e. “ies”

PRINCIPLES/CANONS OF GOOD TAXATION/RULES

According to Adam Smith, the canons of taxation are the criteria by which a tax system should be judged. These are rules that provide guidelines to be followed when designing the system of taxation. These include the following;

REVISION QUESTIONS

Explain the principles or canons of taxation in an economy

What are the qualities of good taxation in an economy?

1. **Principle of convenience**; this rule states that the assessed tax should be collected at ideal times convenient for the tax payer to pay the tax in respect to time, season or availability of income for example at harvesting periods or end of the month for civil servants. And the method of how to pay the tax should be well known by the tax payer.
2. **The principle of simplicity**; the nature of tax, method of assessment and tax collection should be simple and easy to be understood by tax payers and tax collectors. Because a complicated tax leads to misunderstandings, disputes and delays in payments
3. **Principle of certainty**; this rule emphasizes that the nature of the tax, base and the amount should be clearly understood to the tax payer and tax collector without any doubt
4. **Principle of economy or cheapness**; the cost of collection and administration of the tax should be low compared to the tax revenue collected (yield of a tax). I.e. the cost of collection ought no to exceed 5% of the tax yield

5. **Principle of productivity**; the government should be able to calculate in advance what it will yield and at what rate the revenue would flow inform of taxes. A good tax should be able to encourage effort and initiate and not to discourage investments in the country
6. **Principle equity**; this canon is based on humanitarian consideration the burden of the tax should fall equitably on the tax payer and amount to be paid should be in relation with the income level. There should be vertical equity (different payments according to incomes). People with higher incomes should pay higher taxes than those with low incomes or there should be horizontal equity where people of the same incomes and situations are placed under equal treatment in taxation. Equity also considers minimum social sacrifice and maximum social benefit i.e. the tax payer should sacrifice less when paying a tax but benefit more from the tax paid
7. **Principle of elasticity/fairness**; the tax should change according to the prevailing conditions in the economy or should be able to respond easily to changed economic circumstances
8. **Principle of diversity (comprehensiveness);** a good tax system should have a wide base or source i.e. have a variety of sources and should cover different incomes or prosperity of individuals in the economy
9. **Principle of consistence**; i.e. a good tax should be in line with the national policies and economic objectives of a country especially in allocation of resources
10. **Principle of low net restraining effect**. It should leave a tax payer in a desirable economical status without greatly affecting his consumption and investment decisions
11. **Automatic stabilization of the economy**; a good tax should have a stabilizing influencing in the economy in terms of investment, employment and others

CHARACTERISTICS OF A GOOD TAXATION SYSTEM

1. It should be comprehensive i.e. taxes should be levied on as many tax bases as possible and should be of many types. It should therefore cover different people earning incomes in different ways
2. It should impose a minimum tax burden on the tax payer i.e. a tax payer should be able to pay the assessed tax with the least burden
3. A good taxation system should be efficient i.e. cheap in its assessment, administration and collection. Therefore the tax imposed should be easily administered without involving high administrative costs in terms of time, efforts and financial resources
4. A good taxation system should be optimal i.e. a maximum balance should be maintained between tax revenue services rendered through public expenditure and the work effort forth coming from tax payers in order to in crease output
5. A good taxation system should consider the principle of double taxation i.e. should not imposed on the tax payer on the same base more than once
6. It should promote equity, social and economic justice. It should be progressive in order to distribute the tax burden equitably (the higher the income the higher the tax charged and the lower the income the lower the tax charged)
7. A good taxation system should channel and direct resources to priority areas
8. It should help to achieve national objectives. It should promote economic stability, economic growth (inject revenue in areas which are productive and should expand incomes and employment)
9. It should be convenient i.e. collected at such a time when the tax payer is able to pay (when he/she has the money to pay)
10. Is should be buoyant/flexible i.e. the revenue should change with changes in national income of the economy or the rates should adjust according to the economic changes

11. Neutrality: the tax system should have minimum distortion for example on consumption, relative prices, production and investment

TERMINOLOGIES USED IN TAXATION

TAX RATE: This is the amount of tax revenue which the government intends to charge on each unit or value of the tax base

TAX AVOIDANCE: this is a situation where a tax payer dodges paying a tax by exploiting loopholes in the tax system
Or
Is a situation where a tax payer uses legal means not to pay the tax imposed for example a person going back to school and becomes a student or avoiding buying a commodity on which a tax has been imposed

TAX EVASION: this is the deliberate refusal of a tax payer to pay the tax assessed on him/her and it is illegal i.e. a person hiding at the time collecting the tax

State reasons why people evade paying taxes in Uganda:

i. Unfair assessment
ii. Discontent about provision of services by the government
iii. Low income levels
iv. Lack of adequate information about taxes
v. Political sabotage
vi. Relaxing in the tax system
vii. Desire to retain all their earnings

TAX BASE; it refers to the range of economic activities or items on which taxes are levied. It looks at how many sectors the tax system covers

TAXABLE CAPACITY; is the ability of an individual or firm to pay the tax levied without affecting the tax payer's standards of living.
OR
It is the extent to which a tax payer is able to pay a tax assessed on him and again remains with income which can sustain him in an average desirable standard of living

Taxable capacity of a nation refers to the percentage of a country's GDP that is with in the capability to contribute to the public revenue in form of taxes. It should be noted that this capacity depends on the collection machinery, level of corruption among the tax collectors and tax administration

INCIDENCE OF A TAX; It refers to the final resting place of a tax i.e. who actually bares the money value of the tax. There are two types of tax incidence namely:

Formal incidence: This refers to the first impact of a tax which is suffered by the person who actually pays the tax due to the authorities

Effective incidence: this refers to the ultimate impact of the tax which is borne by the person who suffers the reduction in his/ her disposable income

IMPACT OF A TAX; this is the immediate person or a firm on which a tax is imposed or it is the 1st resting place of a tax i.e. who eventually pays the tax

TAX BURDEN; it refers to how a tax payer feels when the tax is imposed on him inform of money loss or goods and services foregone. Tax burden is of two types;

Real burden of a tax; This is the fore going of commodities as a result of paying the tax

Money burden of a tax; this is the money loss as a result of paying tax

TAX STRUCTURE; This is the composition of a tax according to either mode of payment i.e. direct or indirect taxes Or the percentage of income paid as tax i.e. progressive, proportional, regressive and digressive

TAXABLE INCOME; this is the amount of income which is subjected to taxation

TAX REBATE; it refers to a tax refunded by the government to a tax payer under special considerations. For example to encourage investments, the government may refund taxes originally paid on imported raw materials

TAX LIABILITY; is the amount of money a tax payer is required to pay within a given period of time

TAX HAVENS; is a situation where certain countries lower their tax rates in order to attract foreign investments

EQUITY; this is the principle of taxation which states that the amount of tax imposed on each individual should be according to his/her ability to pay. It is in two forms

Horizontal equity; refers to taxing all people with the same level of income uniformly
Vertical equity; refers to taxing people at different levels of income differently i.e. people with higher levels of income should be taxed highly compared to others with low income

DEAD WEIGHT TAX; this is a tax which when imposed causes the tax payer to abandon economic activity which initially forms the tax base

CAPITALISATION OF TAX; this is where the firm converts profits into capital assets so as to pay less corporate tax

TAX DESIGN; this is the formulation/framing of a tax structure which will maximize the public revenue from a given tax base. It involves who or what to tax

TAX YIED; this is the amount of tax revenue obtained given the tax rate

TAX EXEMPTION; this is the elimination of a person from paying a given tax due to status for example lame, blind, housewives etc. It is also being given to investors to attract them

TAX ALLOWANCE; this is the allowance made to a tax payer on which he does not have to pay a tax for example tax free allowances for children, wife which are deducted from the personal income before tax is calculated/assessed

TAX SHIFTING; this is the attempt to pass the burden of tax to other members of the society who ultimately pay the tax. It can be forward shifting where a firm legally liable to pay customs and excise duties on its products attempt to recover tax increase by raising the product prices i.e. shifting the tax to consumers or backward shifting which involves a firm reducing prices of its inputs i.e. shifting the tax to the suppliers of goods (inputs) or lateral shifting which involves the firm reducing dividends paid to its share holders so as to pay tax

CLASSICATION OF TAXES

Taxes can be classified according to:

i. According to tax income ratio/Average rate of a tax
ii. According to final resting place(tax incidence)

ACCORDING TO TAX INCOME RATIO

This the volume of the tax amount paid divided by the income (how much of the income will be paid in terms of tax. In this class we have:

Proportional tax: this is a tax whose average rate is constant irrespective of the size of income of individuals on which it is levied i.e. it can be 30% on all individuals' income

Progressive tax. This is a tax whose average rate increases with increase in income. people of different incomes have to pay different rates of taxes and this implies that high income earners will pay high taxes those with low incomes will pay lower taxes for example Pay As You Earn (PAYE)

Tax payer	Income	Tax rate	Tax liability
A	400,000	4	16000
B	600,000	7	
C	800,000	10	
D	1000,000	15	

Tax liability= tax rate x income

Tax liability for A= 4/100x400, 000 = <u>16000/=</u>

Mention any two effects of a progressive tax

i. Increased government revenue
ii. It leads to equitable distribution of income and wealth
iii. Tends to discourage investors
iv. Savings are discouraged since it leaves people with less income
v. It is a disincentive to work since it increases with increase in income levels
vi. It may arouse resentment among the population

Regressive tax; this is a tax whose rates fall as the income or spending power of the individual increases. This is when the burden of the tax follows more heavily on low income earners. such a tax is usually indirect tax like expenditure tax. For example if it charged on a certain commodity a lower income earner will pay a higher ratio in relation to his income compared to a high income earner

Example, suppose the price of a bicycle is 10,000/= and the tax imposed is 6000/=. On buying the lower income earner of 5000/= pays the same tax as that one earning 70000/=. Calculate the tax ratio of low income earner and that of a high income earner

Price of bicycle = 10000 + 6000 = 16000/=

Tax ratio of low Y Earner = 16000/5000x 100 = 320%
Tax ratio of high Y Earner = 16000/7000 x 100 = 228.6%

Outline the effects of a regressive tax

i. Low tax revenue is realized due to tax avoidance
ii. It encourages tax evasion in that people with low income may deliberately dodge taxes assessed on them
iii. Social unrests may result i.e. people can resort to strikes, riots etc
iv. Income gap is widened between the low income earners and high income group
v. It reduces the consumption of goods
vi. It widens the income gap between poor and the rich

Digressive tax. This happens when the tax is only mildly regressive up to a particular rate beyond which the same tax rate is charged

CLASSIFICATION OF TAXES ACCORDING TO FINAL RESTING PLACE

DIRECT TAXES

These are taxes imposed on income or property of individuals or firms who directly pay them. The burden and the incidence of tax cannot be shifted to another person

EXAMPLES/TYPES OF DIRECT TAXES

1. **Income tax**. This is a tax levied on individuals' income like Pay As You Earn (PAYE). Its advantageous in that fit can be progressive as well as proportional if well assessed
2. **Corporation/company tax**. This is a tax imposed on company's profits. In Uganda this tax is at 30%
3. **Estate duty/Death duty**. This is a tax imposed on the property of the deceased
4. **Capital gains tax**. This is a tax imposed on the gains made by a seller of capital assets whose value have appreciated over time
5. **Gift tax**. This is a tax imposed on the value of wealth being transferred from one person to another. However, there have been academic arguments as regards who should pay the tax the dower or the donee
6. **Property tax**. This is a tax assessed by tax authority on the assets owned by the individuals for example houses, land, machinery etc
7. **Sur tax.** This is a tax imposed on individuals with a very high level of income exceeding a certain specified limit
8. **Graduated tax**. It is a tax levied on the citizens or residents of the country basing on one's income and property
9. **Poll tax**. It is the tax imposed at a fixed rate on every head of the family
10. **Wealth tax**. This is a tax imposed on wealth or accumulated savings.

ADVANTAGES OF DIRECT TAXES

1. Direct taxes are more certain as the tax payers are more informed with the amount of tax they are going to pay, the time and mode of payment. Even the government is certain of how much revenue it is likely to collect. Hence satisfying the principle of certainty
2. They are equitable i.e. they satisfy the quality of equity as one of the principles of a good tax. This is because they are progressive in nature and they increase with increase in ones' income and do fall directly to the persons according to how much income/wealth they have

3. They are elastic (flexible) since they can be changed depending on the needs of the economy i.e. it can be increased or decreased to achieve the desired goals of a country
4. They satisfy the canon of simplicity i.e. they do not have any complication in their assessment, administration and collection as compared to the indirect taxes. Tax collectors and tax payers can easily understand the calculations and the mode of payment
5. They are economical i.e. easy to collect and at relatively low costs like pay as you earn which is deducted at the source by the employer
6. Certain direct taxes are convenient since they can be paid in installments or after income has been realized like salary earners pay at the end of the month
7. They facilitate automatic stabilization of the economy for example direct taxes can be used to stabilize price levels and employment in the economy. Hence reducing inflation and economic instabilities
8. They cultivate a sense of civic responsibility among the tax payers. They are concerned about the affairs of the state and how their taxes are being used in the collection and this can help to check on government expenditure
9. They reduce income inequality among the people. It tends to redistribute income with in an economy since they are progressive in nature
10. Like any other tax, they contribute to government revenue which can be used to provide social services to its people like medical facilities, road construction, power supply etc

DISADVANTAGES OF DIRECT TAXES

1. They encourage tax evasion and avoidance since they are a big burden to the tax payer. Tax payers may understate their incomes so as to dodge paying the taxes
2. They discourage production most especially the corporate tax and wealth tax since they act as a disincentive to effort and initiative. If such taxes are high, people may prefer to tax their incomes inform of leisure which is not taxed
3. It may cause capital flight in the country as foreign capital holders transfer their capital to other less taxed countries. Hence lowering government revenue, employment opportunities etc
4. Some times direct taxes inconvenience the tax payers particularly when they are paid in lump sum and in advance. There fore since they are very difficult to pay and the formalities associated with them further inconvenience the tax payer
5. Direct taxes are discriminative in nature especially income tax which may not be paid by low income earners hence leading to loss of revenue to the government. This also discourages saving by the rich people
6. At times, direct taxes are un economical since the cost of collection especially in the developing countries and particularly in the rural areas is very high
7. Direct taxes may create resentment since the burden of the tax is heavily held by the tax payer
8. Direct taxes reduce the level of investments and savings in the country since individuals and business firms are left with small amount of money for re-investment
9. Direct taxes are generally un popular among the population especially in developing countries with high rates of poverty

INDIRECT TAXES

These are taxes levied on goods and services. They are also known as outlays or out lay taxes/expenditure taxes/consumption taxes or hidden taxes. It can be either specific or **advalorem tax**

A specific tax is a tax imposed on each unit of out put provided while **advalorem tax** is the tax calculated according to the value of the commodity. For example if the value of a good is 3000/=, and the Advalorem tax is 20% of the value, then the tax is 20/100 x 3000 = 600/=

Examples of indirect taxes include:

i. Excise duty
ii. Customs duty
iii. Sumptuary tax
iv. Octroi tax
v. Sales tax/
vi. Turn over tax etc
vii. Value Added Tax (VAT)

EXCISE TAX/DUTY. This is a tax imposed on home made goods and services like tax on sugar beer etc

Objectives of levying excise duty in Uganda

i. To raise revenue for the government
ii. To discourage the consumption of certain goods like cigarettes

Effects of excise duties

i. Increased costs of production that result in inflation due to high prices
ii. Producer's and consumer's choices are distorted resulting in inflation due to high prices
iii. It is regressive and hence result in widened income inequality since it affects the poor more
iv. If properly levied can provide fairly high revenue with minimal public protest

CUSTOMSDUTY/TAX. This is a tax imposed on goods either entering or leaving the country i.e. a tax either on imports or exports.
Import duty: This is a tax imposed on goods entering a country

Objectives of levying import duties in Uganda

i. To raise government revenue
ii. To protect domestic and infant industries against completion and dumping
iii. To improve the country's BOP position through reducing imports
iv. To retaliate against import duties imposed by other countries on Uganda's exports
v. To discourage imports especially luxuries and socially un desirable goods for example taxes on second hands vehicles

Export duties. These are taxes imposed on goods leaving a country i.e. taxes on exports
Objectives of export duties

i. To raise government revenue
ii. To control the volume of exports so as to avoid shortages at home

Effects

i. Increased government revenue
ii. Reduced demand pull inflation due to availability of goods in the domestic market

SUMPTUARY TAX. This is a tax imposed on commodities considered harmful to the health to discourage their consumption and production for example a tax on alcohol drinks. It is also known as *prohibitive tax*

Effects of sumptuary tax

i. They help to generate relatively high government revenue with minimal public protest since they are levied on commodities with inelastic demand
ii. Improved standard of living of the people
iii. Increased problems of income inequality since they are regressive

OCTROI TAX. This is a tax imposed by a country on goods passing through its territory in transit to another country for example Kenya imposes octroi tax on imported goods passing through its territory to Uganda

TURN OVER TAX. This is a tax imposed on the total sales of a business regardless of the stage of production and distribution. In Uganda this tax has been replaced by Value Added Tax (VAT)

VALUE ADDED TAX. This is a tax imposed on the value of a commodity at each stage of production. In Uganda VAT is charged at 18% of the increase in the value of a commodity

Advantages of VAT in Uganda

i. It is difficult to evade since it is hidden in the price of the commodity
ii. It brings efficiency in business management since it encourages proper maintenance of books of accounts
iii. It is not a disincentive to resource allocation since it does not lead to shifting of resources to other sectors
iv. It encourages exports and taxes on exports are refundable
v. It leads to increased government revenue because it is comprehensive
vi. It is economical in terms of administration and collection
vii. It reduces corruption since it is paid through banks

Disadvantages

i. It requires proper record keeping by individuals/firms but Uganda still has poor record keeping
ii. It is quite complicated and not too easy to understand especially in developing countries like Uganda
iii. VAT tends to be regressive since all taxable goods are treated equally
iv. It is quite expensive especially to small firms in terms of record keeping expenses and payments
v. It increases cost of production which finally leads to cost push inflation
vi. It may encourage tax evasion since it's highly dependant on cooperation, honesty and good will of the tax payers
vii. It requires massive education to tax payers in Uganda

Outline the limitations of VAT in Uganda

i. Most business people in Uganda do not keep proper accounting records
ii. It is difficult to understand and complicated to calculate
iii. Inefficiency and dishonesty by the tax collectors and the government tax organizations which lead to increased loss of tax revenue to the government
iv. Limited cooperation among the tax payers hence resulting into increased tax evasion

TYPES OF GOODS UNDER VAT

Zero rated goods: these are goods where there is no payment of VAT on out put but producers can claim any VAT on inputs or these are goods that do not bear any tax (VAT) but the supplier of such goods can claim a tax refund if he paid taxes on outputs for example drugs, foodstuffs etc

Exempt goods: these are goods which are not liable to VAT and no credits is given for any tax paid on inputs for example houses (immovable)

Standard rated goods: these are goods which must have Value Added Tax paid on them like motor vehicles, beer, sugar etc

SALES TAX*.* This is a tax levied on the level of transactions which take place between the buyers and the sellers. Sales tax include *single stage sales tax*: this is levied once at the first sales and purchase

Multi-stage sales tax: this is levied every time a sale of the same units of the commodity takes place. It is difficult to administer

ADVANTAGES OF LEVYING INDIRECT TAXES

1. They are used by the government in its economic policies like protection of home industries against dumping and improving on terms of trade
2. Indirect taxes are more comprehensive and there fore they are reliable sources of government since they cover many goods and services
3. Indirect taxes are difficult to avoid and evade since they are part of the price of the commodity bought and consumed
4. Indirect taxes are more convenient to the tax payers because they are paid when the consumers spend on goods and services
5. They are a source of government to finance its expenditures
6. They help to check on consumption of harmful goods like cigarettes which result in improved health of the people
7. Indirect taxes are more economical in collection since they are collected by the sellers and producers and passed into the government thus reducing government on man power
8. Generally Indirect taxes are less felt i.e. the burden of is less felt and resented since they are part of the prices of the commodities bought
9. Indirect taxes help to correct the BOP position through increasing import duties resulting in reduced volume of imports
10. Indirect taxes are flexible (elastic) since their rates can easily be adjusted upwards or down words to meet the economy's requirements
11. When indirect taxes are selectively imposed they can help in income re-distribution by levying increasing taxes on commodities consumed by rich people and using revenue to subsidize for the poor
12. They are impartial (neutral) or do not discriminate consumers. They are paid by all groups of consumers and this helps to increase tax revenue
13. They guide in resource allocation i.e. priority areas are less taxed and non priory areas are heavily taxed. Savings and investment activities in priority are guided by indirect taxes

Revision questions**:**

Present the advantages of indirect taxes over direct taxes in an economy or your country

What are advantages of direct taxes over indirect taxes in an economy?

DISADVANTAGES OF INDIRECT TAXES

1. They are regressive in nature (the rate of a tax increases with a decrease in the tax base0. This is mainly with low income earners and they are very much affected plus the poor. Most especially if they are imposed on essential consumer goods like fuel, soap, salt sugar etc the rich will not feel the effect of indirect taxes and there fore create income inequality
2. They are inflationary in nature i.e. they rise price of commodities, costs of production, wages etc because of tax shifting
3. Unlike direct taxes, these do not cultivate a sense of civic responsibility and consciousness to the tax payer. This is because the tax payer that does not know that he is paying a tax because it is contained in the prices of goods he buys
4. It involves the government in inspecting and checking the records, the stock of the producer, wholesalers and retailers to ascertain whether they are paying taxes
5. Revenue collected in the financial year can not be predicted with certainty. This is due to the difficulty of estimating the effects of indirect taxes and the demand for products
6. They are sometimes difficult to understand for example VAT and this violate the principle of simplicity
7. They have adverse effects on production and employment in a country. Their imposition raises the prices of commodities and if these have elastic, then the quantity demanded decreases as well as production and employment
8. Their effects on resource maybe negative for resources will move away from taxed to non taxed areas or low taxed areas
9. The more people consume, the more indirect taxes they pay

WHY LDCS RELY MORE ON INDIRECT TAXES THAN DIRECT TAXES

In spite of the above disadvantages, LDCs rely more on indirect taxes as a source of government, this can de explained by the following reasons:

1. Indirect taxes are comprehensive and therefore they are more liable source of government revenue unlike direct taxes which only cover some incomes and property of individuals
2. Unlike direct taxes which are easy to evade and avoid leading to limited scope of revenue mobilization makes developing countries to depend on indirect taxes which are difficult to evade and avoid since they form part of the price of the commodity bought
3. Indirect taxes are convenient are convenient to the tax payers since they are only paid when the consumers spend money unlike direct taxes which inconvenience the tax payers since they are at times paid in advance and lump sum
4. Unlike the direct taxes which are expensive to collect, indirect taxes are economical to collect since they do not require large man power and others expenses
5. Indirect taxes help to improve the peoples' health standards since they check on consumption of demerit goods like cigarettes unlike direct taxes which can not reduce consumption of harmful goods
6. Indirect taxes are less felt and resented since they are part of the price of the commodities bought unlike direct taxes which directly affect the incomes and property
7. Unlike direct taxes. Indirect taxes particularly high import duties help to correct the country's' BOP position by reducing volume of imports
8. Unlike direct taxes which are less flexible, indirect taxes in Uganda are more flexible since their rate can be adjusted to meet the changing requirements of the country

9. Unlike direct taxes which discourage hard work, indirect taxes in Uganda are not a disincentive to effort and initiative since they encourage hard work so as to afford commodities
10. Indirect taxes in Uganda increase tax revenue since they are impartial they are paid by all groups of consumers unlike direct taxes which discriminate some people from paying the taxes
11. Indirect taxes help to re-distribute income in Uganda when selectively imposed un like direct taxes which can not easily be used to re-distribute income since the are usually rejected
12. Unlike direct taxes, indirect taxes can be used to protect the domestic and infant industries from well established foreign firms
13. The narrow tax base in LDCs partly due to the absence of large scale business units and the big size of the subsistence sector in these economies. These limits the opportunities for raising adequate revenue through the direct taxes hence the reliance on indirect taxes

FACTORS THAT INFLUENCE/DETERMINE THE TAXABLE CAPACITY OF A COUNTRY/BASE

1. The political climate of the country. A politically stable country has high taxable capacity due to high levels of economic activities and income compared to periods of economic instabilities in the country which do not favor economic activities to take place thus leading to low taxable capacity
2. The level of distribution of income of income in the country. Even distribution of income in the country results in high taxable capacity compared to when there is uneven distribution of income which leads to low taxable capacity
3. Level of development of economic activities. High levels of development of economic activities in the country result in high taxable capacity due to high income levels from such activities unlike when there is low level of development of economic activities which lead to low taxable capacity
4. The level of development social and economic infrastructures. Highly developed social and economic infrastructure in the country also results in high taxable capacity due to high level of production and income from the many investors attracted by such infrastructures. When the social and economic infrastructure are poorly developed implies low taxable capacity because it discourages investors
5. Political will of the tax payer towards the development of the country (attitude of the tax payer). A positive attitude of tax payers towards taxes in the country result in high taxable capacity as they are willing to pay taxes while a poor attitude of tax payers towards taxes lowers the taxable capacity
6. The tax system and its administration. Well organized tax system and tax administration implies high taxable capacity of the country since it promotes investments which increase both incomes and tax revenue unlike when the tax system is weak with poor tax administration which leads to low taxable capacity
7. Level of industrialization of the country. High level of industrialization ensures stable income and high taxable capacity compared to when there is low level of industrialization which is characterized by low taxable capacity because of the unstable incomes from perishable agricultural output
8. Level of commercialization of the economy. High level of commercialization of country results into high taxable capacity due to high productivity and high incomes unlike when the country has a big subsistence sector which implies low taxable capacity because much of the out put is un marketed

9. Level of technology used when there is advanced technology used in production of goods and services this implies high quality goods being taxes thus it is possible to charge high taxes on such goods leading to high taxable capacity. While poor technology used leads to production of low out put of poor quality leading to low taxable capacity due to low taxes charged on such goods

Revision question

What factors influence/ determine the taxable capacity of a country?

Account for the low taxable capacity/base in your country in your country

1. Tax evasion and avoidance done on large scale in LDCS. This is more with the rich, politicians etc. Also high level of smuggling reduces the tax revenue thus leading to low taxable capacity in the country
2. Poor infrastructures in the country is a cause of low taxable base. The roads in particular are poor especially in the rural areas, poor and un stable power supply etc which limit the level of economic activities and also reduces access to all tax payers resulting in a low tax base
3. Large subsistence sector in Uganda is also responsible for low tax base because much of the out put is not marketed hence not taxed causing low tax base
4. Tax exemption by the government like exempting collective investment firms from paying withholding taxes reduce entities to be taxed and result in a low tax base in Uganda for example was exempted for 25 years
5. High level of unemployment in Uganda most especially in urban areas reduces the number of tax payers and taxable incomes resulting into low taxable capacity
6. The small industrial sector in Uganda is also a cause of low tax base because it re3sults in small number of firms to be taxed most of which are agro based processing industries like oil processing industries
7. Political instabilities in some parts of the country for example in Northern Uganda has lowered the level of economic activities and also discourages tax collectors resulting in a low tax base
8. Limited diversification or few economic activities in Uganda mainly comprising of a agriculture, service providers and few industries meaning that there are few tax entities resulting in low tax base
9. Poor identification of the sources or activities that can be taxed in Uganda limits the type of taxes imposed and also reduces the number of tax payers resulting in low tax base
10. The wide spread poverty and income inequality limits the taxable capacity and the scope of rising the tax revenue. Uganda's per capita income is one of the worlds' lowest
11. There is high population growth rate which has increased the dependence ratio hence lowering taxable income limiting investment and savings
12. A relatively small wage earning class. The inflation facing the countries implies low real income (low purchasing power). This makes income tax to fall on the small proportion of the population. Also the small wage earning class contributes to low tax base in such countries
13. The incompetence of the administration machinery charged with the responsibility of taxation. It is characterized with corruption most especially in URA. This limits the revenue collected and leads to a narrow tax base

Account for the narrow tax base in Uganda

MEASURES THAT CAN BE TAKEN/HAVE BEEN TO WIDDEN THE TAX BASE/CAPACITY IN YOUR COUNTRY

1. The government of Uganda can improve or build infrastructures especially roads, banking system, health facilities etc so as to stimulate economic activities and widening the tax base
2. The Ugandan government can undertake an industrialization promotion strategy like giving loans to industrialists at low interests so as to expand the sector and widen the tax base
3. Ugandan government can improve on the level of security through out the country particularly in Northern Uganda so as to promote economic activities and ease access to tax payers hence widening the tax base
4. The Uganda government can undertake further diversification of the economy like by attracting different investors so as to increase economic activities and incomes thereby widening the tax base
5. The Uganda government can put in place measures aimed at expanding employment opportunities for example extending assistance to farmers like on land adjacent to out growers, investing in public goods which can help to expand the tax Uganda government can diversify the sources of taxes by reviewing the tax laws, introducing new taxes like T.V tax, car tax etc that can help to expand the tax base
6. To widen the tax base, Uganda government can build a comprehensive tax payers' data base which should be updated regularly to include new tax payers there by widening the tax base
7. In order to widen the tax base, Uganda can encourage commercialization of the economy through measures like joining economic integration, adopting export promotion strategies
8. The government can put in place measures that increase investment like extending credit to investors that can increase level of economic activities, increase incomes there by widening the tax base
9. The Uganda government can undertake extensive tax education to instill awareness in the public which can increase the number of tax payers and widen the tax base
10. Steps can be taken to improve tax administration by offering attractive remuneration to the staff, recruitment and training of the personnel to improve on their effectiveness
11. Steps have been taken to acquire adequate facilities in the form of transport, computer facilities for strong analysis of data of tax collection etc. This is expected to enhance efficiency and raise taxation
12. Disciplinary action against corruption staff officials has been put in place to strengthen and supervise those in charge of taxes in order to weed out corruption and corrupt tendencies. This calls for more efforts from the public and the government inspector general

THE STRUCTURE OF TAXATION IN UGANDA

Tax structure is the composition of a tax according to the mode of payment i.e. direct and indirect taxes, the proportion/percentage of income paid as a tax i.e. progressive, regressive and proportion and the characteristic features of the tax system

Institutional arrangement: the tax to be levied is decided by the parliament at the passing of the national budget. The Uganda Revenue Authority (URA) is responsible for tax assessment and collection

Taxes levied include:

Income tax which is collected in form of :

- ***Corporate taxes*** levied on limited companies currently at the rate of 30% of net profit on both resident and non resident companies and 20% – 45% for mining companies

- ***Individual income tax*** is levied on income earned by individuals in form of profit, salary, rent, dividends etc. a tax payer is allowed shs 130,000 per month which is not taxed. The taxed income is taxed at a progressive and this is known as PAYE (pay as you earn). It is illustrated below
- Total monthly employment — Monthly PAYE Tax
- 0 – 130,000 — 0
- 130,001.00 – 235000.00 — 10% of excess
- 35001.00 – 410,000.00 — shs 10,500 + 20% of excess
- 410,001 and over — shs 45,500 + 30% of excess

- *Rental income tax* which is 20% computed at 80% of the gross rent

- **Customs duty**: these are charged on imports. These rates depends on the type of the commodity and the source (commodities from East African community and COMESA countries are charged lower rates than those from else where). Exports are not charged taxes. The coffee stabilization which was charged on coffee exports 30% was abolished in 1997

- **Value Added Tax**: VAT was introduced in Uganda in July 1996. It replaced sales tax which was charged on locally produced and imported goods and Commercial Transaction Levy (CTL) which was charged on services. Presently the rate is 18% of the value added on the product at each stage of production. Only businesses which have annual sales of shs 500,000 and more are registered for VAT. In practice, the VAT payable to the URA is the difference between VAT charged on sales and VAT charged on purchases done by the business

- **Excise duty** is charged on locally produced goods. It is imposed on factories which pass it fully or partly to others units (whole sales, retails and consumers) the maximum can be charged is 50% and currently minimum charged is 10%

- **Non-tax source of revenue** include charges on motor vehicle licenses, traffic defaulters, dividends from companies where the government has shares, rent to government properties and several forms of licenses (e.g. fisheries, timber)

- **Local administration taxes** are charged by KCC, municipalities, towns and districts etc. revenue from these sources is spent on source. Graduated tax which was charged on individuals was abolished effective July 2006

- Uganda mainly depends more on indirect taxes rather than direct taxes. This is due to low income levels, a small ratio of formal employment, a small industrial and commercial sector and the dependence on subsistence agriculture

- **Dominance of indirect taxes especially on foreign trade**. This is a reflection on the degree of dependency on trade and the openness of the economy

- **The tax base is still very narrow because of poverty**, reliance on imports and a large non-monetary sector. This leads to low tax collections and tax Deeping (high tax rate on the few in an attempt to raise the revenue)

- **Weak tax collection machinery lacking adequate skilled man power**, operating facilities, a comprehensive and integrated tax payer's data base, high level of corruption among the staff

- **The ratio of revenue to GDP** is still very low i.e. 13.4% in 2005/2006

- **Tax avoidance and evasion**. The rate of tax evasion high especially through defaulting and capitalization however tax avoidance is low since most indirect taxes are levied on essential commodities

IMPLICATIONS OF UGANDA'S TAX STRUCTURE

POSITIVE IMPLICATIONS

1. The removal of taxes on exports encourages this sector to expand and generate more foreign exchange
2. The levying of taxes on consumer goods like cigarettes and beer reduce their consumption because they are harmful especially if consumed in excessive amounts
3. Customs duties imposed on imports reduce completion from imports thus enabling infant industries to take off easily
4. The reduction of taxes on commodities from East Africa and COMESA countries encourages trade in the region which also improves on the relationship between these countries
5. The increase in VAT from original 17% to 18% increases tax revenue even a street beggar who buys anything taxed at source becomes tax payer. This expands the tax base
6. The tax holidays extended to certain categories of investors encourages investment in the country thus creating more employment opportunities and reducing the problem of un employment
7. The abolition of graduated tax implies increased disposable income especially among the poor thus improving their standards of living

NEGATIVE IMPLICATIONS

1. Over reliance on taxes on imports implies that the major source of revenue is un certain thus making government planning difficult
2. Revenue collected is very low relative to government expenditure leading to deficit financing through external and internal borrowing and depending on foreign Aid inform of grants with strings some of which are not in line with national interest. Heavy borrowing worsens BOP problem
3. The tax base is very narrow and the few items which are taxed pay highly. This kills the incentive to invest and leads to inflation
4. Exemptions are normally in favor of foreign investors which is un fair to local investors thus discouraging the supply of local investors
5. High taxes especially on fuel encourage smuggling from neighboring countries where taxes and prices are lower e.g. fuel
6. There are multiple taxes on similar items like imports are charged import duties, excise duties, VAT, income tax(on profit and on dividends) plus local administration taxes (like license fees, contribution on garbage collection etc) encourage tax evasion
7. Taxes being approved by the parliament and changes usually take time. This delays and weakens in the use of taxation as a tool of fiscal policy
8. Economic integration has encouraged reduction and removal of taxes on some commodities. This reduces tax revenue and reduces effectiveness of taxation as a tool to protect domestic industries

9. Too much emphasis on regressive indirect taxes widens income inequality and its adverse effects like social unrest
10. Indirect taxes are inflationary in character as they lead to increase in costs of production and prices of goods which lead to poor standards of living of the poor

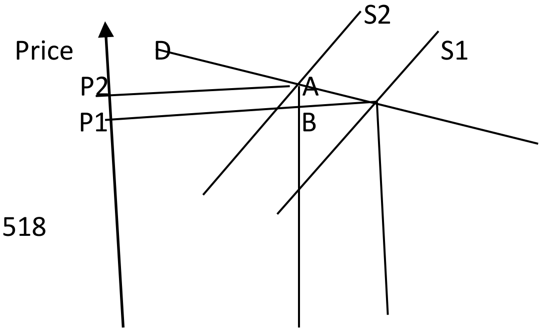
PROBLEMS OF TAXATION/FACING TAX ATHOURIES IN UGANDA (LDCs)

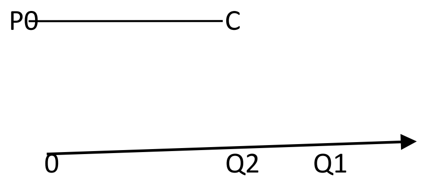
1. Determining the taxable capacity. Taxable refers to ability of the tax payer to pay the tax assessed on him/her and yet retain a sufficient proportion of the income (disposable) which can enable him/her to live in the life he/she accustomed to
2. Inadequate facilities to collect the tax and to store records for example transport, computers to manipulate figures, books for data collection
3. Shortage of qualified personnel to assess and collect the taxes like managers, accountants, tax collectors, record keepers, auditors etc
4. Frequent changes in business premises and employment which make it difficult to trap tax payers most especially in the informal sector where so many businesses are un registered
5. People earn income in different ways. It is difficult to recognize small earnings which could total to large sums for example bribes, offers etc
6. Evasion, tax payers try to evade taxes and the government spends a lot of money in tracing them thus becoming un economical
7. Tax payers are scattered and difficult to trace. This also increases costs of collection
8. Inflation in the country and this leads to loss in real value of money collected from taxes which are assessed before inflation
9. Corruption among the taxes collectors who some times assist tax payers to evade taxes in exchange of bribes. This leads to low tax revenue correction
10. The tax base is still very narrow because of few industries and the large subsistence sector leading to low contribution to GDP thus limiting government to meet its responsibilities
11. Loopholes within the tax law which makes it possible for most potential income earners to avoid taxes. This is because it takes time to revise laws to bridge the loopholes by the parliament
12. Political instabilities in some parts of the country like wars which have persisted in Northern Uganda and political riots in most urban areas disrupt tax collectors
13. Hostility of tax payers especially in case of un fair direct taxes may make the exercise dangerous leading to death of some tax collectors in the struggle to collect taxes
14. Language barrier since Uganda is composed of many ethic groups with different languages leading to time wastage in the process of tax assessment and collection
15. There are many illegal activities which are not known to the fiscal authority yet yield income for example prostitution

THE INCIDENCE OF A TAX

When a tax is imposed on a commodity, it increases the cost of production and producers react by reducing the amount supplied and increasing prices to shift the burden to consumers. That is why the supply curve moves inwards from S1 to S2 and price increases from P1 to P2 as seen below

Explain the incidence of a tax or effect of a tax when supply is of unitary elasticity and demand is elastic





The total tax is represented by line AC=P2P0 which results in a shift in the supply curve from S1 to S2

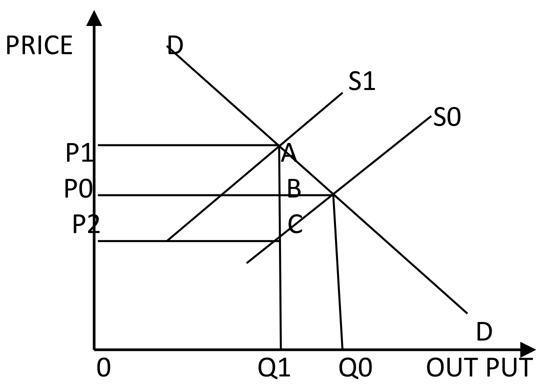
Out of this total tax P2P0, the buyer pays tax AB which is the same as P2P1. This means that the buyer bears a smaller tax burden

The seller or producer pays tax BC which is the same as P1P0 which is a bigger tax burden

Explain the incidence of a tax when both demand and supply are of unitary elasticity

When a tax is imposed on a commodity, it increases the cost of production and producers react by reducing the out put so as to increase the price in order to shift the burden of the tax to the consumer. That is why the supply curve moves inwards from S0 to S1 and price increase from P0 to P1

Incidence of a tax when both demand and supply are unitary



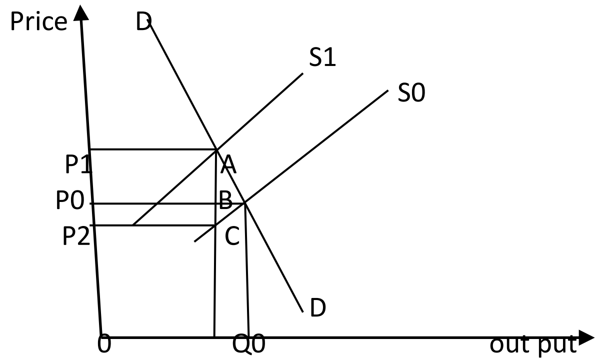
The total tax= AC which is the same as P1P2 and this result into a shift in the supply from S0 to S1

Both the seller and buyers share the tax burden equally with the buyers paying tax equal to AB which is the same as P0P1 and the seller pays equal tax BC= P0P2

Explain the incidence of a tax when the supply is of unitary elasticity and demand is inelastic

When a tax is imposed on a commodity, it increases the cost of production and producers react by reducing the out put so as to increase the price in order to shift the burden of the tax to the consumer. That is why the supply curve moves inwards from S0 to S1 and price increase from P0 to P1

Incidence of a tax when supply is of unitary elasticity and demand is inelastic

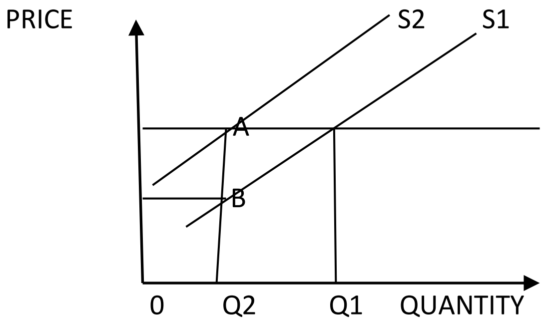


The total tax per unit is = AC which is the same as P1P2 leads to a shift in supply from S0 to S1 and quantity supplied from Q0 to Q1. Out of the total tax per unit the buyer bears a heavier tax of AB which is the same as P0P1 while a producer or a seller bears a smaller tax burden of line BC which is the same as P0P2

Explain the incidence of a tax when the demand is perfectly elastic and supply is of unitary

When a tax is imposed on a commodity, it increases the cost of production and producers react by reducing the out put so as to increase the price in order to shift the burden of the tax to the consumer. That is why the supply curve moves inwards from S1 to S2 and price increase from P1 to P2

Incidence of a tax when demand is perfectly elastic and supply is of unitary elasticity



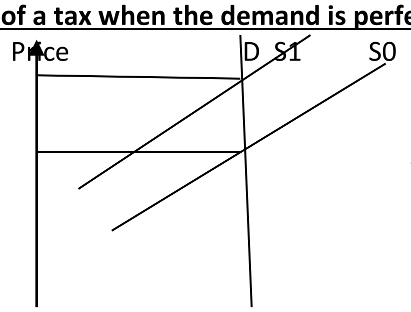
The total tax per unit is AB which is the same as P0Pt. this resulted in an up ward shift in the supply curve from S1 to S2

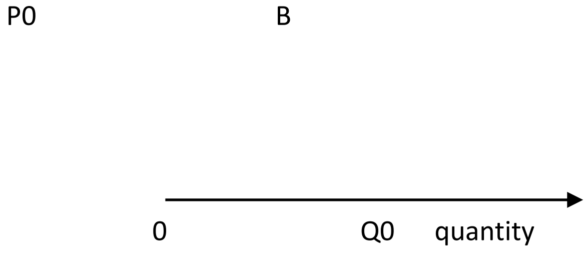
Explain the incidence of a tax when the demand is perfectly inelastic and supply is of unitary elasticity

When a tax is imposed on a commodity, it increases the cost of production and producers react by reducing the out put so as to increase the price in order to shift the burden of the tax to the consumer. That is why the supply curve moves inwards from S0 to S1 and price increase from P0 to P1

Incidence of a tax when the demand is perfectly inelastic and supply is of unitary elasticity

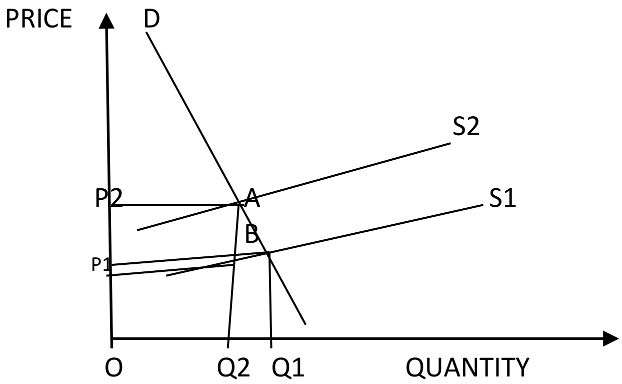
A





The total tax per unit is equal to line AB which is the same as P0Pt that results in a movement of the supply curve upwards from S1 to S2. In this case the buyer/consumer pays all the tax (P0Pt) inform of increased price of the commodity. The seller does not bear any tax burden

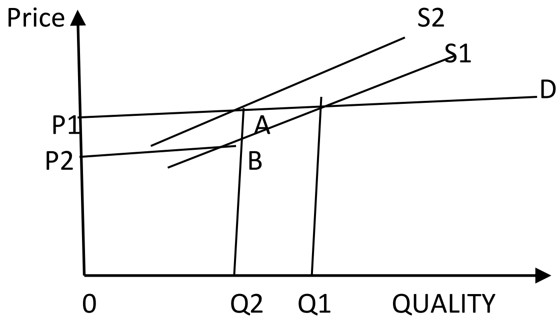
<u>Incidence of a tax when supply is elastic and demand is inelastic</u>



The total tax is equal to AC per unit which is the same as P1P2 this results into a shift in supply from S1 to S2. Out of this total tax per unit the buyer bears a heavier tax burden of AB which is the same as P0P2

While the producer bears a smaller tax burden of line BC which is the same as P0P1

<u>Incidence of a tax when supply is elastic and demand is perfectly elastic</u>



Explanation.

The total tax per unit is AB which is the same as P0Pt. this resulted in an upward shift in supply curve from S1 to S2.

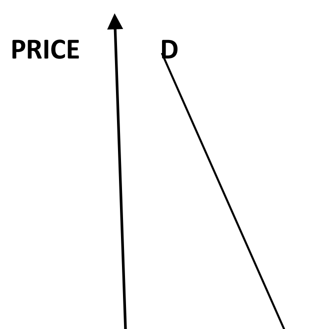
In this case the seller pays all the tax and the buyer pays no tax

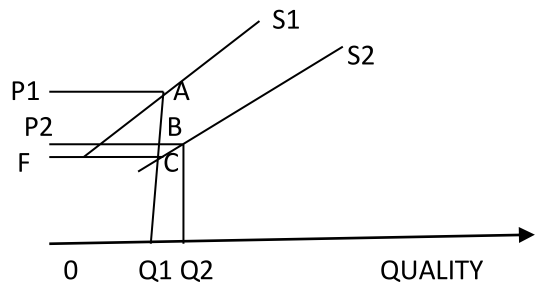
Summary about the incidence of a tax

The more elastic the demand curve the bigger the size of the tax paid by the seller compared to the consumer

The more inelastic the demand curve the bigger the tax paid by the buyer compared to the tax paid by the seller
When both demand and supply are of unitary elasticity, then both the seller and the buyer pay the same amount of tax
When demand is perfectly inelastic the buyer pays all the tax
When demand is perfectly elastic the seller pays all the tax
Revision question
Explain the incidence of a tax when supply is elastic and demand is i) inelastic ii) perfectly elastic
What factors influence/ determine the incidence of a tax/ give the factors upon which incidence of a tax is dependant
Relative elasticity of demand, when demand is more elastic the seller bears a bigger part of the tax than the consumer while when the supply is elastic, the seller or producer can pass much of the to the consumer
The market structure, the monopolistic market has a greater ability to pass much of the tax to the consumer due to inelastic demand while under a perfect market structure the seller is the price taker and hence bears much of the tax burden due to difficult to pass it to the consumer
Type of a tax, for direct taxes the incidence of a tax is born by the person or firm on whose income or property the tax is imposed while for indirect taxes the incidence of a tax may be shifted by the producers or seller to the consumers depending on the elasticity of demand and supply
Time interval, in the short run producers tend to bear a big proportion of the tax burden due to inability to alter production while in the long run producers can not adjust their level of production and shift part of the tax to the consumer
Price, a tax can only be shifted if it brings a change in the price of a commodity. When a tax causes no change in the price of the commodity for example for perfectly elastic demand producers bear the entire tax incidence yet if there is an increase in the price after a tax then the producer and consumer may share the tax in a given proportion
Extent of the tax base, the narrower the tax base the more difficult it is for the seller to shift the tax burden because the consumer will move away from consuming the taxed commodities to non taxed commodities
Subsidy, a subsidy is money payment or any form of assistance granted by the government to producers of essential goods and services

Effects/purpose of a subsidy
Decreased prices or fall in price, a subsidy will bring a bout a fall in prices of essential commodities due to reduced cost of production
Increase in demand (consumption), a subsidy given to a producer can reduce the final prices and thus increase its consumption
Explain the effect of a subsidy on demand
Approach
Talk of:
Perfectly elastic demand
Perfectly inelastic
Unitary demand
Elastic demand
Inelastic demand
Explain the effect of a subsidy on inelastic demand
<u>Illustration of the effect of a subsidy on inelastic demand</u>





The total subsidy is AC which is the same as P1F. Out of this total subsidy the consumer benefits more by proportion = AB which is P1P2 due to increase in supply from S1 to S2. The producer benefits from a smaller proportion equal to BC which is P2F. The equilibrium out put is also increased from 0Q1 to 0Q2

NB. Explain the remaining effect on different elasticity of demand

GOVERNMENT/PUBLIC EXPENDITURE

Public expenditure refers to the way the government spends the revenue it has collected from the various sources. Government/public expenditure includes expenditure on goods and services, administration, maintaining the security of the country, expenditure on social services etc

TYPES OF GOVERNMENT EXPENDITURE

Recurrent expenditure. This is the government expenditure on the day to day running of the state for example defense, health, education, salaries of civil servants etc

Development expenditure. This is the expenditure on medium term and long term projects for example pensions, buildings which can lead to development of the country

HOW GOVERNMENT SPENDS PUBLIC REVENUE

Government spends government revenue on the following;

i. Economic policy and this includes ministry of planning, agriculture, marketing etc
ii. Social policies like health, education, information etc
iii. Defense, this includes the army and other military equipments
iv. Maintenance of law and order (police force)
v. Government administrative services
vi. Other expenditures like public debts

REASONS FOR INCREASE IN GOVERNMENT EXPENDITURE/CAUSES OF HIGH GOVERNMENT EXPENDITURE

The level of government expenditure in LDCs is increasing Uganda in particular and this can be explained due to the following:

1. Debt servicing by government. This is the paying back the debt together with interest
2. Increased expenditure on the purchase of fire arms as a result of political instability and riots. For example the newly purchased jet fighters of sh 1.7 trillion to enforce stability
3. Increase in the wages/salaries of government workers has led to increase in government expenditure for example 30% rise for primary teachers in the 2010/2011 budget
4. Increased provision of social services for example roads, hospitals etc has led to increase in government expenditure. In the 2010/2011 government allocate3d sh 260b to improve maternal and reproductive health and sh 50b for maintenance of 10000km national roads
5. Natural calamities for example floods in Bulambuli and Ntoroko districts, earth quakes have led to increase in government expenditure. Because the government has to spend

money to provide people with shelter for instance land slides in Buduuda and jiggers in Bosoga
6. The employment of expatriates means paying them in foreign currency, government therefore spends more in paying such people
7. Rapid increase in the country's population means that government has to spend more money providing facilities for the increasing population
8. Wasteful government spending on state functions, trips, allowances and buying expensive cars for government ministers which amount to 76 ministers for example the sh3.6b for swearing in function by the president
9. Expansion in administration services for example new districts implying increased number of members of parliament, District Residence Commissioners etc, new ministries. For example the newly added three ministries i.e. ministry in charge of Teso, Bunyoro ect
10. A lot of money is spent by the government on subsidization of parastals offering credit schemes to foreign investors

IMPACT OF INCREASED GOVERNMENT EXPENDITURE
1. It creates an increase in demand for goods and services
2. It may increase employment and standards of living of the citizens
3. It leads to increase in economic and social infrastructures of a country and this increases labour productivity
4. It may lead to inflation where increase in money supply is not followed by increased in production
5. Government revenue from taxation on income increases
6. It widens consumer's choice
7. It may lead to BOP deficits due to increased expenditure on imports

METHODS OF CONTROLLING GOVERNMENT EXPENDITURE
1. Appeal to international bodies to write off debts to reduce debt servicing
2. The government should encourage cost sharing so as to reduce on the costs incurred on education, health service
3. Reduction on the size of civil servants especially those without qualifications
4. Government should resort to borrowing soft loans which lower rates of interest and long payment period which reduces the burden of debt servicing
5. Adoption of population control measures
6. Reduction of cabinet through integration of some ministries for example ministry of education and sports
7. Restoring peace and security in the country through democratic governance and equitable distribution of income to reduce expenditure on defense
8. Training local man power to avoid relying on foreign labour which is too expenditure
9. Privatizing non performing state enterprises to reduce expenditure on them

PUBLIC DEBT

Public debt is the total amount of money borrowed by the central government, local government and public corporations from both internal and external sources. However, national debts are debts borrowed by the central government from both internal and external sources

CLASSIFICATION/TYPES OF PUBLIC DEBTS

Classification according to source of borrowing

Internal debt/domestic debt: This is the total amount of money owed by the central government to domestic entities in form of bonds and treasury bills for example from central banks, individuals etc

External debts: this refers to the amount of money owed by the central government to foreign governments and international agencies like African Development Bank, IMF, World Bank etc

Or

These are debts constituted by the amount of money the government acquires from outside countries through borrowing. For example from IMF, World Bank, foreign governments etc

Classification according to how the debt is used

i. **A reproductive debt**: This is a debt (internal or external) that has been contracted to purchase real assets or productive assets which contribute to the internal growth and development of the country i.e. Can be used to produce goods and services whose gains can be used a gain to repay the debts for example debts to build schools, dams, industries etc
ii. **A dead weight debt**: this is a debt that is contracted to finance un productive activities for example purchase of firearms, organizing ceremonies or to finance current consumption there is no expected gains

NB. **A dead weight tax (prohibitive tax)** is the tax when imposed makes consumers to abandon consuming the taxes good

Classification of debts a according to the method of debt repayment

A funded debt: This is the debt with no specified period of repayment at the time of borrowing. It's a debt contracted by the government by buying bonds whose redeemable dates are not specified by the government but it keeps on paying the annual interest on the principle. It is normally a long term debt

Unfunded debts (floating debt). This is the short term debt whose date or time for repayment is specified at the time of securing it

Sources of public debts

i. The government can sale treasury bills and treasury bonds through open market operations
ii. Sale of government stocks and shares in public companies
iii. Funds obtained from compulsory social saving schemes e.g. NSSF
iv. Ways and means (short term borrowing)

Advantages of internal borrowing

i. It helps to preserve foreign exchange
ii. It encourages the nationals to contribute willingly to the development programs in the country
iii. It reduces the problem of external dependence by the country
iv. It can be used for creation of employment opportunities if it invested in productive ventures like industries
v. It may reduce income inequality since internal borrowing mostly affects the rich people
vi. It controls inflation by reducing money supply in the circulation

The burden of internal public debt

i. The burden of the internal debt is indirect and comes about in form of costs of taxation to finance the debt
ii. The repayment of the debt by taxation may reduce the work effort
iii. The debt is likely to affect so much the young generation since they will repay the debt in future without having enjoyed its benefits
iv. It discourages private capital formation which is required for investment
v. It may be inflationary if it is to finance unproductive ventures

vi. It favors the rich who use services like electricity etc frequently yet the poor are taxed to pay the debt incurred in constructing such

Arguments for an external debt

i. It increases the country's' forex
ii. It increases investments by reducing the saving-investment gap
iii. It create employment opportunities especially if the borrowed money is used to carry out investments like establishment of industries

Burdens of an external public debt

i. It deprives the country of foreign exchange which is used to pay the debt with the rate of interest
ii. Repaying the debt might mean that the government has to cut down expenditure on public goods leading to low standards of living
iii. Some times external debts are tied with strings i.e. in some cases external loans are available for non productive projects
iv. Long term loans are a burden to future generations who have to pay back future loans
v. If it is a dead weight debt, the future generation would have to suffer paying the debt whose benefit they do not realize
vi. It leads to over dependency of the borrowing country to other countries and its disadvantages
vii. It leads to balance of payment problem/deficit due to high expenditures incurred in clearing external debt

ROLE OF PUBLIC DEBT IN ECONOMIC DEVELOPMENT

The roles of a public debt are both positive and negatives

POSITIVE ROLES/MERITS

1. Debt finances the burden of high taxation which would reduce peoples' disposable income and savings. Here the government can get the money to finance public utilities without over taking the public
2. Borrowing is a source of government for spending in financing infrastructures and investments plus other activities
3. Debt financing fills the saving - investment gap between the available saving and funds required for investments. This promotes investments in the country
4. External debt increases forex in the short run to finance foreign government expenditures like purchasing capital goods like machines used in the production process
5. Borrowed funds can be used to pay back loans borrowed earlier for example through debt conversion
6. Public debt is used to finance deficit budget since increases on the amount of money supplied. Many countries finance a deficit budget through borrowing
7. It helps the country that has suffered calamities like drought, wars, floods, famine; land slides etc. this country after suffering calamities will use the borrowed fund to finance such disasters
8. Debt financing in the short run helps the government to finance its budget without over taxing the people. This reduces the burden of over taxation
9. Public debt can be used to import man power thus filling the man power gap in developing countries. This is especially with external borrowing which enables a country to get forex that can be used to import man power
10. Internal borrowing encourages borrowing from the private sector and this enable the private sectors to earn interest after the maturity period
11. Internal borrowing through sale of securities (treasury bills) reduce money supply and inflation

12. Public debt can be use by the government to fund the private sectors to boost them up. This increases investment levels thus creating more jobs
13. Public debt promotes international trade between the borrowers and their lenders. This is because the borrowing countries will always be interested in trading with the lender countries.
14. Borrowing supplements on the narrow tax base and low taxable capacity that is common in LDCs due to poverty and low investments. There fore debt financing is necessary to meet government expenditures since little revenue is collected from taxation

NEGATIVE ROLES/ DISADVANTAGES

1. The burden of the public debt is always shifted onto the future generation yet the borrowed funds only benefited the people at that time but not the future generation
2. When a hard loan is secured, it increase government expenditure in clearing debts
3. Failure to repay an internal debt makes the government to become un popular and its political opponents take the advantage of the governments' inability to pay the loan and causes political instability
4. Public debt may be inflationary especially if the borrowed fund is put in the hands of the few people. This increase aggregate demand beyond aggregate supply hence causing demand pull inflation
5. Continuous debt servicing worsens the balance of payment problem. It makes the total government expenditure a broad to exceed the total government revenue got from abroad hence the balance of payment problem
6. Payment of the broad funds via taxation may decrease private consumption, investments and worsens peoples' standards of living
7. Borrowing makes the borrowing countries to be dependants hence denying them chance of self reliance. This is more so with external debts
8. Failure to get the promised loans makes the implementations of the country's plans difficult thus debt financing is one reason for plan failures in LDCs
9. National debt creates vicious cycle of debt. This is because LDCS can not depend on their own to raise funds to clear the previous debts. They there fore resort to borrowing from other countries in order to pay the existing debt
10. Servicing the external debt deprives the country of its scarce forex which is required for improving productive capital. There fore debt servicing leads to forex shortage
11. Debt financing/borrowing encourages laziness and wastage of the borrowed funds especially if such funds are mistaken to be free. This is because people become expectants and participate less in economic activities

DEBT REDEMPTION

This refers to the repayment of the debt both the principle and interest on it

WAYS OF DEBT REDEMPTION/METHODS OF CLEARING PUBLIC DEBTS

Internal debts

1. Sinking fund, it refers to the fund set aside by the government for the future debt redemption. Here a fixed sum/ amount of money is set aside by the government for repaying back the debt
2. Debt conversion, this involves borrowing from cheaper sources and secure a soft loan to clear a hard loan
3. Disinvestment, here the government use money secured from different investments to clear the debt other than investing that capital
4. The government can also sell its liquid assets such as gold kept by the central bank and raise fund for debt redemption

5. Selling of government securities such as treasury bills as a way to raise revenue which can be used to pay internal and external debts
6. Use of the surplus budget, in this case a government gets a surplus during a particular financial affair that surplus can be used to pay back the debt
7. Seeking pardon, the debtor country may plead with its creditors to have the whole debt waved off. Some times debts are waved off
8. **Capital levy**, it is a special tax imposed on the rich people by the government to cover any of its expenditure
9. **Debt repudiation**, it's when a debtor country fail to have the money to pay the debt and it deliberately refuse to repay the debt
10. **Debt rescheduling**, this involves negotiating with the creditor to post pond the period of repaying the debt
11. **Taxation,** here the government can tax the people and raise money to pay back the debt
12. Through privatization and this enables the government to fund for debt redemption
13. By way of ordering the central bank to print more money to clear the lenders
14. Government may also lower its expenditure so as to remain with enough to pay off its creditors
15. Grants, the government can get a grant which can be used to settle debts

External debts

1. Use of foreign exchange reserves
2. Debt conversion
3. Embarking on export promotion so as to clear off the debts as foreign exchange tends to increase
4. Import substitution can be encouraged so as to save foreign exchange to clear debts
5. Sell of foreign investments by the government to settle debts
6. Writing off debts by donor countries
7. Encourage borrowing from low interest sources to pay high interest loans
8. Improvement of the domestic market so as to create a self sustaining economy

NB. All points on internal debts can also apply on external debts but not those of external debts applying on internal debts

Revision questions

Describe the various ways your country can employ to reduce the debt burden

Explains the methods can be employed by your country to reduce public debts

DEBT MANAGEMENT

This means the ways how the public debts (internal and external) are administered i.e. how are obtained, controlled, solved and later a lone repaid or retired. It involves all conditions involved in borrowing till the debt is paid back

There are three main objectives of debt management

i. To regulate the liquidity of the economy as a situation measure i.e. to control the amount of money in the economy
ii. To ensure proper channeling and timing of funds in the stated projects thus making proper use of funds in the right channels fin a proper period of time
iii. To minimize the costs of government consumption expenditure by influencing private market demand and consumption goods

- **Debt conversion**: This refers to a situation where the government can convert a short term loan into a long term loan or vise versa. The conversion of long term loan internal loans to short term internal loans increases liquidity and conversion of internal short term loans into long term loans reduces liquidity in the economy

TERMINOLOGIES USED IN DEBT MANAGEMENT

Debt contraction. This is the obtainance of a loan/debt from a lender. It is equally so formal in getting an external debt between the lender and the borrower who must both sign the debt agreement after agreeing on terms and conditions they have stated
Years of grace: This is the period between debt contraction and the time when debt servicing commences i.e. when the debt has retired
Debt servicing: This is the payment of the interest on a debt and some times plus a proportion of the principle which is due (keep paying interest on the debt and some times part of the principle amount which is due. This begins after the years of grace have expired
Debt retirement: This is the time when the contracted debt must be repaid to the creditor or the lender. This takes place after the debt servicing or during debt servicing
Debt rescheduling: When the debt retirement is due but the borrowing country finds its self unable to repay the debt it can through negotiations request the lender to give it another period of time after which a new date should be stated for retiring the debt. This means that a country may continue servicing the debt for the stated new period until retirement is made
Interest free loans: these are loans given to a borrowing country carrying no or having no interest on the principle. These are some times called loans
Concessional bilateral debts: these are debts from countries for which a very low rate of interest is paid and repayment of the principle takes a long date say 20 years or more
Non concessional debts: these are given by either the government or international financial institutions basically on commercial forms. They carry a very high interest rate and the lenders of such loans are purely business driven
Debt trap: This is the acquisition of a new loan to pay the old loan
Debt consol: This is the debt whose principle is never paid but the lender continues to earn interest on the borrowed fund
Recurrent expenditure: this is the government expenditure on the day to day running of the state. For example paying salaries of civil servants
Development expenditure: This is government expenditure on medium and long term projects for example road construction, industrialization etc

WAYS OF DEBT MANAGEMENT

i. Borrowing from low interest sources
ii. Grants
iii. Sale of government securities
iv. Use of profits from enterprises for the debentures incurred
v. Monetary policy printing
vi. Operation of sinking fund
vii. Debt rescheduling
viii. Debt repudiation
ix. Operation of surplus budget
x. Draws from the central bank reserves
xi. Negotiation of development trade offs
xii. Export promotion
xiii. Privatization/denationalization

TAXATION FINANCING

This is an economic situation where the government’s planned recurrent and development expenditure is financed by revenue from taxes

ADVANTAGES OF TAXATION FINANCING

1. It improves on income redistribution where by this is possible especially when the progressive taxation policy is used i.e. the rich are taxed highly so as to subsidize the poor/proving services to the poor
2. Taxation promotes civic responsibility and demand for the government on the use of the revenue raised i.e. the government will become more diplomatic
3. It promotes self reliance and reduces the burden of dependency on foreign assistance which has adverse effects
4. Taxation financing protects the country from inflationary tendencies which characterize deficit financing/ borrowing and printing of more money
5. Taxation financing on imports can be used to protect home infant industries a against competition and dumping
6. Recover of wealth (commodity wealth) which others tend to obtain from or as a result of death i.e. others tend to obtain from or as a result of death i.e. others peoples' efforts against inheritance tax, death and estates duties
7. To restrict consumption of certain commodities considered harmful to a minimum level for example spirits, cigarettes etc
8. Taxation is a method through which society changes those whose use its facilities like roads, police, bridge to become rich
9. Taxes are flexible for they can be increased any time those in need in order to increase tax revenue for capital levy- specific tax imposed on the rich people to repay the debt

DISADVANTAGES OF TAXATION FINANCING

1. Financing development by taxing citizens is a mere transfer of resources from one section of the community to another with in the country hence not adding peoples' purchasing powers
2. High taxes may be a disincentive to the producers and workers and so their efforts of work may be reduced
3. In LDCs taxes can not raise enough revenue because of low incomes, low taxable base and capacity
4. Taxes take high costs in collection and it takes time to raise the required revenue so borrowing is cheaper
5. It may cause political and economic instabilities especially when the tax burden is very much felt
6. It may promote tax evasion and avoidance which creates a short fall in projected tax revenue so some projects may not be done

DEFICIT FINANCING

This refers to the raising of revenue for public expenditure through borrowing both internally and externally. This happens when tax revenue falls short of the projected government expenditure

ADVANTAGES OF DEFICIT FINANCING OVER TAXATION FINANCING

1. It may lead to an increase in GDP where by this results from investments made from the monetary borrowed funds into productive activities
2. Loans help a country to avoid the disincentives of taxes which normally retard the economic growth and development
3. Incase of dated loans/floating/unfunded debts, the government can repay the loan by borrowing from other sources without imposing a burden on tax payers
4. Incase of funded debts, the grace period is long and debts can be rescheduled. This therefore does not put pressure on the government to repay
5. Loans from other countries can be used to supplement on loan revenue sources in order to bring about development

6. Borrowing unlike taxation is not deflationary because it brings about increased money supply and keeps prices high and attractive
7. More economies of scale can be generated as more borrowed funds come in lump sum which helps the receiver projects to take on large scale and to take off easily
8. It reduces political resistance to high taxation and this increases the popularity of the government and hence stability
9. Reproductive debts increase government revenue and this brings about high rates of capital accumulation for example roads, factories
10. It's a quick and more reliable form of government revenue as the donors and other multi-national corporations tend to keep their pledges. This is because these industries and institutions are attracted by high interest paid
11. It encourages friendship with outsiders hence helping the country to become an open economy. This even creates market for its goods and so encourages more domestic and foreign investment leading to faster development
12. Borrowing for financing wars reduces political instabilities/insecurity in the country which promotes investments thus creating more employment opportunities which improve the standards of living of people

DISADVANTAGES OF DEFICIT FINACING

1. There tends to be a reduction in the value of imports as much foreign exchange is to flow out to service debts thus this consequently reduces the standards of living
2. National debts increase money supply. This creates inflationary tendencies and may create difficulties in the attempts by the government to create economic stabilization
3. If debts are not kept to a minimum, the cost of administering a debt may be considerable so as to avoid such a problem, with internal debts governments issue long term bonds
4. Interest costs on loans are considerably high especially if borrowing takes place during the time of high interest rates. This consequently place a big burden on a country's resources when repaying debts
5. Some external debts are tied with strings (conditions) for example in some cases loans are available for non profit/ productive projects like immunization, relief food and arms
6. If it is a dead weight, the future generation will have to suffer in paying the debt whose benefit they did not realize
7. The burden of the internal public is indirect and it manifests its self in the cost taxes to finance the debt
8. The repaying of the debt through taxes may discourage workers and investment as well which retards development
9. It favors the rich who put in place investments by the borrowed funds for example tertiary education, electricity and the poor are taxed to finance such services

CAUSES OF PUBLIC DEBTS IN LDCs

1. Rising energy prices, ever since 1973 when oil prices started rising, LDCs because of over reliance on oil imports are suffering BOP deficits and contracting massive debts to finance the oil imports for example price of fuel increased by 9.1%
2. Increased interest rates: sharp increases in real interest rates lead to increased pressure of debt serving forcing LDCs to borrow from other countries to pay the loans. For example the interest rate increased to *12%* according to 2010/2011 financial year
3. Wasteful government expenditure and consumption: LDCs borrow heavily to finance their wasteful expenditure by politicians and diplomatic missions a broad for example the government used *sh3.6billion* on swearing in ceremony for presidency, *1.7 trillions* for buying jet fighters

4. World recession: The severe global recession which began in 1981, reduced the aggregate demand for the exports of many LDCs since they are semi manufactured and raw goods. The recent credit crunch is also reducing demand for exports from exports leading to low foreign exchange thus force many LDCs to resort to deficit financing
5. Limited revenue from taxation: LDCs fail to realize enough revenue from taxation to meet the desired government expenditure. As a result, they are forced to borrow in order to finance projects for example in the financial year 2011/2012 *sh6,330b* are expected from taxation and *sh29,00b* from donations which some are loans
6. Need to fill savings investment gap: Because of the vicious circle of poverty leading to low savings and investments, LDCs borrow to supplement these low savings and investments in the economies
7. Need to fill the foreign exchange gap: due to low earnings of foreign exchange from exports, LDCs are forced to borrow in order to finance their BOP deficit
8. Unfavorable terms of trade: the un favorable TOT against LDCs due to poor quality output, limited market etc means that they are unable to finance their imports by export revenue. This forces LDCs to borrow to enable them, import essential commodities
9. Inflation in LDCs: inflation in LDCs makes exports expensive and LDCs fail to export such that they are forced to borrow in order to in order to meet certain obligations for example the inflation rate in Uganda the general price level of all items increased by *16.1%* per annum in *may 2011* which is one of the highest in the world
10. Emergency expenditures: LDCs borrow money to finance calamities or emergency expenditures which may initially not have been budgeted for. For example the recent land slides in Buduuda and epidemics in Busoga region (jiggers)
11. Need to fill the man power gap also causes debts in LDCs. This is due to inadequate skilled labour force to work in industries and other technical fields such countries are forced to borrow money in order to import skilled man power from abroad
12. Ambitious development plans: Most developing countries have ambitious development plans which they can not finance using locally available resources as a result they resort to borrowing to finance such projects
13. Need to avoid adverse effects of taxation like low aggregate demand, killing initiative to work hard etc which slows down economic activities thus resorting to borrowing to finance their programs
14. LDCs find it convenient to borrow because payment of the debt contracted can be rescheduled and it is also quick in raising needed revenue
15. Monetary policy tool: government uses borrowing as a monetary policy tool to draw money away from the population for example through the treasury bills during inflationary periods

Account for increased public debts in your country
Distinguish between deficit financing and taxation financing
Explain the implications of deficit financing over taxation financing in your country

Debt burden: This refers to the cost of borrowing to the present and future generations. A public debt to an economist can be expressed in different ways i.e.
As a proportion (a percentage of a given variable say % of GNP)=
(Total public debt/GNP x 100). And this shows the percentage of GNP committed to loan payment

- For example As a percentage of exports i.e. (Total public debt/exports x 100) which means that the amount of exports required to meet a debt
- As a percentage of number of tax payers i.e. (TPD/total no. of tax payers x 100) which implies debt per tax payer
- As a percentage of labour employed i.e. (TPD/Labour x 100)

- Can be expressed as a short term, medium and long term debts
- As a percentage of the total population i.e. (TPD/ Total popn x 100) this means the debt per capita

GOVERNMENT BUDGET

The word budget has been derived from the French word "bougetts" which means a small bag. It emphasizes a bag containing the annual financial plans of the government there fore
A national budget is a financial statement of a country which shows estimated or anticipated/ planned revenue and estimated expenditure (planned expenditure) in a given financial year. It is usually prepared on an annual basis and presented by the minister of finance before the parliament for a approval

ELEMENTS (COMPONENTS OF A NATIONAL BUDGET)

1.It must have objectives:

- Reduction of unemployment
- It aims at raising the rate of economic growth
- Controlling inflation
- It aims at raising the rate of economic growth
- It should be there to improve on the balance of payment position
- Raising revenue for provision of social services for example medical care, education and other infrastructures
- Reduction in income inequality
- Protection of infant industries
- Discouragement of consumption of harmful goods
- To stimulate investments by increasing government revenue and reducing taxes on productive ventures
- To control government expenditure

2. It must show the income expected
3. It should show how the income expected is going to be spent
4. It gives a summary of the performance of an economy during the previous financial year
5. It indicates the current economic growth rate and the desired rates in the near future
6. It shows the contribution to national economy per sector i.e. a agriculture, industry, mining, forestry etc
7. It shows the balance of payment position of the country
8. The monetary and fiscal strategies for the year

Explain the objectives of drawing national budgets in LDCs

TYPES OF BUDGET

There are basically two types of budget namely:

Balanced budget: This is a budget where the government planned expenditure equal to the government planned revenue in the financial year

Unbalanced budget: This occurs when government expenditure is either greater or less than the expected revenue from taxation. There are two types of un balanced budget

A surplus budget: this is a budget in which the planned revenue is greater than planned government expenditure. It usually operates during high levels of inflation or economic boom. It **is undertaken because of the following:**

i. To regulate a boom i.e. periods of much economic activities

ii. To reduce inflation by withdrawing money from circulation i.e. closing the inflationary gap through taxation
iii. To finance development projects/ investments
iv. Government policy of accumulating reserves for future needs by reducing consumption
v. For paying public debts
vi. To reduce aggregate demand for goods and services. This may help to maintain favorable balance of payment problems
vii. To raise money to pay public debts

Explain the advantages of a surplus budget. Refer to the above being presented in the present tense

DISADVANTAGES

It may lead to heavy taxation burden in an attempt to raise revenue

i. Reduced aggregate demand from taxation may reduce economic growth
ii. It may reduce savings and investments due to heavy taxation
iii. Reduced industrial activities due to low aggregate demand may lead to un employment
iv. Deficit budget: This is a budget in which the planned government expenditure is greater than the projected government revenue for a given financial year

CAUSES OF DEFICIT BUDGET

1. Narrow tax base due to few economic activities and low taxable capacity in LDCs. This makes it difficult to raise enough revenue to cater for the planned expenditures
2. Tax avoidance and evasion which leads to less revenue from taxes for government expenditures
3. A reduction of the real value of money during inflation causes a deficit budget
4. LDCs are characterized by economic instabilities such as inflation which increases expenditure hence leading to a deficit budget
5. Unfavorable terms of trade due to low quality of exports and high value of imports which are highly priced. This reduces earning from exports and increase expenditure on imports thus leading to a deficit budget
6. Balance of payment deficit, most of the country's' expenditure on imports always exceed the revenue from exports. This high expenditure on imports leads to a deficit budget
7. Corruption and embezzlement of funds, this reduces revenue realized from the various sources to cater for the planned expenditure
8. High population growth rate which increases government expenditure on social services and other public utilities above its expected revenue
9. The existence of a large informal and subsistence sector which do not generate export revenue to the government yet the government has to import and at the same time provide social services hence leading to deficit budget
10. Continuous debt servicing, this forces the government to spend much of its revenue abroad such that it becomes difficult too difficult for the government to meet other expenditures leading to a deficit budget
11. High administrative costs like salaries of civil of civil servants and political leaders. This increases government expenditure above its planned revenue causing a deficit budget. For example the high government expenditure on ministers, RDCs, members of parliament etc
12. Increased expenditure on the increased number of districts and increased expansion of main roads, hospitals, schools etc. these increase government expenditure above its planned revenue leading to a deficit budget

13. Occurrence of natural calamities for example floods, famine drought, landslides, epidemics like jiggers in Busoga region etc have increased government expenditure above the planned revenue causing a deficit budget
14. There is misallocation of funds in LDCs especially through unproductive activities like organizing expensive state functions, military equipments. This increases government expenditure beyond the expected level leading to deficit budget

HOW DOES THE GOVERNMENT FINANCES A DEFICIT BUDGET

1. Through borrowing from the central bank i.e. printing of more money
2. Borrowing from external sources i.e. getting loans from a broad
3. Through donations or getting grants
4. Sale of government securities or borrowing from the public
5. Use of foreign reserves for example gold kept by the central bank
6. Sell of government enterprises through privatization increase government revenue and finance the deficit budget
7. Use of profits from government commercial ventures like parastatal organizations
8. Levying special taxes for example capital levy on the very rich people

WAYS OF REDUCING A DEFICIT BUDGET

1. Increase in the tax base to increase tax revenue to cater for the planned expenditure
2. Checking on high population growth through family planning to minimize government on social services
3. Reducing inflation through price controls, use of fiscal policy.etc This reduces high government and increase the real value of money
4. Improving the terms of trade (TOT) i.e. through quality improvement of the exports to bring more income
5. Fight corruption and embezzlement through introduction of anti- corruption policies and punishing the culprits
6. Privatization to reduce government expenditure on the inefficient sectors
7. Through cost sharing in health and educational institutional. This reduces government revenues
8. Reducing the size of the civic servants i.e. through retrenchment. This will reduce government expenditures
9. Diversification of the economy. This will increase government earnings and stabilize the economy
10. Ensuring political stability to reduce defense expenditures
11. Trade promotion through liberalization of the economy
12. Monetization of the subsistence sector

THE ROLE OF A NATIONAL BUDGET

1. It is in the budget that the government gives accountability to the people through the parliament how it gets revenue and spends in the various financial years. This is because before presenting a new budget, review is made about the previous budget. This creates contentment among the people leading to political stability
2. Budget stimulates the rate of economic growth. This is done through allocation of expenditure in the productive sector and projects for example road construction
3. The budget helps to maintain a favorable balance of payment and this is done by imposing taxes on certain imports to discourage demand for them. This reduces expenditure on imports hence reducing the balance of payment problem

4. Budget is helpful in reducing income inequality. The budget can be used to achieve equitable distribution by imposing progressive tax and spending on programs that can benefit the poor
5. The budget is an instrument in controlling inflation. This is done by reducing government expenditure, increase taxes to reduce the disposable income and the purchasing power of the people hence controlling demand pull inflation
6. The budget stimulates the economy. The budget can be used as an instrument for uplifting the economy from recession especially through deficit budgeting
7. The government can use the budget to get grants or aid from other counties through a deficit budget. It is also used as a condition by international lending institutions like IMF and World Bank to give loans to developing countries
8. The budget is used to maintain high levels of employment through promoting investments and provision of subsidize all of which are done in the budget. This increases employment opportunities in the country
9. The budget is used to motivate the government employees for example through increase of their salaries. For example in the financial year 2010/2011 teachers' salaries were increased by 30%
10. The budget is used to encourage private sectors through lending, purchase of shares and setting up joint investments between the government and private sectors. For example there may be introduction o0f micro finances from which the private sectors borrow money
11. Budget stimulates investments by increasing government expenditures and reducing taxes on productive ventures. This increases the GPD of the country thus realizing faster economic growth
12. The budget can be used in balancing national development by spending on the development of backward area
13. The budget is used in stabilizing and maintains public goods like roads, security, hospitals etc this is because through the budget the government revenue from the various sources outlined in the budget
14. The budget can be used in protecting the domestic infant industries. This is done through increasing import duties and subsidizing the local industries. To do this a balance or a surplus budget
15. Budget is used as a much of stimulating mass support to the government and to encourage hard work among the nationals. This is through presenting a statement that shows a good past performance with better strategies by the government for the future

HOW CAN THE GOVERNMENT USE FISCAL POLICY TO A CHIEVE ECONOMIC DEVELOPMENT

Fiscal policy: Refers to the use of government borrowing. Taxation and spending to regulate the level of economic activities in the country OR

: is the use of public finance operations (especially taxation, government expenditure and public debt management) to a achieve development and full employment this can be done in the following ways

1. Fiscal policy can be used to increase production and create employment for example giving subsidies to farmers, attracting foreign investors by taxing them less and protecting their industries using import taxes
2. The government can spend on employment generating sectors like public works, agriculture and industry

3. Progressive taxation can be used to distribute incomes and reduce income inequalities. This increases the number of people participating in investment, production and job creation
4. The government can spend on infrastructure like roads, hospitals, schools etc, it can also participate in production through parastatals
5. Both internal and external borrowings are ways of getting revenue to finance projects
6. The government can check on population growth by reducing child allowances and taxing those with many children
7. The government can finance training and orientation facilities to increase skills of labour and reduce unemployment
8. The government can give unemployment benefits to those who are un employed. It can also give assistance to people with disabilities who cannot be employed
9. The government can assist job seekers to get distant jobs by giving them transport and moving allowances
10. The government can reduce taxes on industries, which use labour intensive technology and increase taxes on industries' which use capital intensive technologies. This encourages employment creation

NB**. Tools of fiscal policy include**

- Government borrowing
- Taxation
- Expenditure

REVISION QUESTIONS
UNEB 2004 P1
What is meant by a public debt?
Suggest three ways in which an external public debt may be cleared
What is fiscal policy?
State any two source of government
Distinguish between debt financing and taxation financing
Present the advantages debt financing over taxation financing
UNEB 2003P1
Explain the incidence of a tax when supply is elastic and demand is:
Inelastic
Perfectly elastic
What are the advantages of levying indirect taxes?
UNEB 2003 P2
Distinguish between a balanced budget and a deficit budget
State any two ways of financing a deficit budget
Differentiate between a progressive tax and a regressive tax
Mention any two effects of a progressive tax system in your country
UNEB 2005 P1
Distinguish between incidence of a tax and impact of a tax
Give any two demerits of a regressive tax
Differentiate between a budget surplus and a budget deficit
Explain the significance of a national budget in an economy
UNEB 2005 P2
Distinguish between fiscal policy and monetary policy in your country
State ant two instruments of fiscal policy in your country
UNEB 2006 P1
Differentiate between a proportional tax and a progressive tax

State any two merits of progressive taxes
Assess the role of taxation in your country
How can the current taxation system in your country be improved

UNEB 2006 P2

Distinguish between capital gains tax and corporate tax
Give any two demerits of corporate tax in your country
Why do countries incur debts?
Explain the methods used to reduce the burden of public debts in your country

UNEB 2007 P1

Differentiate between direct and indirect tax0
Assess the impact of taxation in an economy
Define the term government budget
Mention any three objectives of a government budget
Distinguish between a progressive tax and a proportion tax
Give any two advantages of a progressive tax over the proportion tax

UNEB 2007 P2

Differentiate between impact and the incidence of a tax
Mention two effects of taxation in your country

UNEB 2008 P1

Distinguish between a national debt and a public debt
State two reasons why countries incur public debts

UNEB 2008 P2

Explain the principles of taxation
Examine the problems faced by tax authorities in Uganda

UNEB 2009 P1

Distinguish between direct taxes and indirect taxes
Explain the impact of direct taxes on an economy

UNEB 2010 P2

Define public debt management
State any three objectives of pubic debt management in your country
Differentiate between tax evasion and tax avoidance
Assess the impact of indirect taxes on the economy of your county
NB You are advised to do all those questions and bring for marking at a zero price

INTERNATIONAL TRADE

It refers to the exchange of goods and services between countries. It a trade across boarders or territory boundaries of a countries.

Or

Is the exchange of goods and services among residents of different countries or between two or more countries

International trade is divided into the following

I. **Bilateral trade**. This is the exchange of goods and services between two countries for example between Uganda and Tanzania
II. **Multilateral trade.** This refers to the exchange of goods and services among more than two countries for example Uganda, Rwanda and German, between Kenya, Burundi and USA
III. **Entre-pot trade**. This is the exchange of goods and services between countries across territorial boundaries of another country
IV. **Intra-trade** This is the buying of goods by a country from another country and reselling them to another country

International trade involves both imports and exports

Import trade. This is the purchase of commodities from another country. It involves goods and services entering into the country. It is divided into

Visible import trade. This is the trade in goods or tangible items bought by a country from other countries. In Uganda they include drugs, vehicles, spare parts, military hard ware etc

Invisible import trade. This is a trade in intangible items bought by a country from other countries. Such items in Uganda include Tel-communication services, banking, and technical services in form of expatriates

Export trade. This is the selling of commodities to another country. It involves both goods and services. It includes:

Visible export trade. This is trade in tangible items sold by a country to other countries like coffee, tea maize, fish etc in case of Uganda

Invisible export trade. This is trade in intangible items sold by a country to other countries. In Uganda they include tourism, electricity, transport etc

REASONS FOR INTERNATIONAL TRADE (why countries participate in international trade?)

1. To enable countries get what they can not produce. Countries engage in international trade to import products that they can not produce due to inadequacy of technology, manpower and other resources
2. To create employment opportunities. Export trade is carried out to increase production thus generating more employment opportunities by increasing the use of variable factors of production like labour.
3. To widen the tax base and raise tax revenue. Countries engage in international trade to generate revenue in form of import and export duties. This is because increase in the volume of exports increases the export duties and imports increases import duties
4. To dispose/sell off surplus out put. Countries participate in international trade to get market for the domestic output that can not be consumed locally and this encourages countries to exploit their resources
5. To promote international co-operation between countries. International trade is undertaken to improve the international relationship between countries and its advantages like getting foreign aid in times of catastrophes like floods, landslide etc and achieving political stability
6. To promote international specialization. International trade is undertaken to enable countries concentrate on production of commodities where they incur least opportunity cost. This increases the level of out put and of good quality
7. Due to **"vent for surplus theory"** which states that developing countries should increase their primary product exports in order to attain rapid economic growth. International trade encourages the exploitation of idle resources to produce surplus products, which can be exchanged for other products
8. To enhance technological development through technology transfer. International trade enables countries to exchange technical man power hence filling the technology gaps in LDCs
9. To supplement domestic out put, it is done to reduce domestic shortage of particular commodities by importing from other countries to top up. This helps to reduce demand pull inflation in the economy
10. To increase efficiency through international competition. International trade eliminates domestic monopoly through imports which compete with monopolists products leading to improved quality of domestic out put
11. To widen consumers' choice. International trade encourages importation of a variety of commodities from others countries which enables consumers to make choice thus improving their standards of living
12. To stimulate efforts, international trade is undertaken to encourage hard work amongst the citizens by exposing them to superior foreign products. This induces them to work very hard to compete favorably

IMPORTANCE OF INTERNATIONAL TRADE (WIDER GAINS FROM INTERNATIONAL TRADE/POSTIVE ROLES)

1. It provides a country with a variety of consumer goods which widens consumers' choice thus leading to improved standards of living of people. This is because international trade encourages a variety of imports from other countries which are of high quality
2. It enables countries to dispose off their surplus out put which enables their resources fully leading to economic growth and development due to increased out put produced
3. It encourages international specialization which leads to greater output and lower prices. This also enables countries to earn high foreign exchange due to production of high quality out put which can compete favorably on the world market
4. It creates employment opportunities in export promotion industries, shipping and transportation of exports and imports which increase the income of the people employed in such fields. This increases their standards of living hence development
5. It promotes international competition which results into better quality output and low prices. This also reduces domestic monopolists with their adverse effects like exploitation of consumers, poor quality products, use of wrong measures etc
6. It facilitates technological transfer especially from developed countries to developing countries which results into production of high quality goods thus improving people's standards. Technological transfer includes better machines, spare parts, and technical experts
7. It enables countries to cover domestic shortages during period of natural disasters for example draught, landslides, floods etc by importing goods from other countries
8. It increases foreign exchange earnings from exports which improves on the BOP position of the country since earnings from exports are greater than expenditure on imports
9. It encourages invention and innovations as well as exchange of knowledge and ideas an international level. This increases investment in countries participating in this trade, variety of export commodities and of good quality
10. It leads to mutual understanding and co-operation among trading patterns and this can lead to world peace since such countries can not go into a war
11. It generates government revenue in form of custom duties which it uses to extend social services to people in form roads, water supply, hospitals, power supply etc thus improving on their standards of living

DISADVANTAGES OF INTERNATIONAL TRADE

1. International trade creates BOP problem resulting from spending more on imports and earning less from exports. This is common with LDCs whose exports are from the agriculture sector which are substituted by synthetic fibres.
2. It promotes dependence syndrome. This is through trade dependence with its adverse effects like shortages in case of misunderstanding
3. It exposes a country to consumption of harmful products, importation of demerit goods like cigarettes, cocaine, alcohol, firearms etc which reduces the general socio-economic welfare
4. It promotes imported inflation. This results from importing from countries prone to inflation leading to high prices of imports which reduces the disposable incomes leading to poor standards of living

5. It encourages dumping. International trade enable countries to sell their products to foreign markets at prices lower than the home prices thus subjecting the nationals to inferior goods leading to poor standards of living
6. ***NB Dumping is the selling of goods and services to foreign markets at prices lower than the home market. It has effects like***
   - It leads to BOP deficits
   - Deteriorating terms of trade
   - Retarded growth of domestic industries
   - Reduces foreign exchange earning
7. International trade is associated with deteriorating terms of trade because most developing countries deal in primary products which fetch lower prices while developed countries deal in manufactured products whose prices are very high. This leads to un favorable TOT due to high Marginal Propensity to Import in LDCs
8. It retards growth of domestic industries; the local industries are out competed by the foreign manufactured goods of high quality and low prices thus worsening the un employment problem due to under utilization of resources
9. It leads to over exploitation of few existing resources as countries are aiming at producing a surplus for export. This leads to quick depletion of such resources making the future generation vulnerable to scarcity of resources
10. It promotes economic dominance by strong trading partners which limits the political sovereignty of some countries as they are under control over others
11. It creates international demonstration effect. Developing countries are exposed to consumption and moral behaviors of MDCs for example luxurious consumption, poor dressing etc this leads to loss of saving culture and moral values in LDCs
12. Technology transfer from international trade leads to technological unemployment as many local labourers are replaced by machines like robots, tractors, computers etc thus leading to poor standards of living

LIMITATIONS TO INTERNATIONAL TRADE

a) Differences in languages, this limits the level of communication amongst traders from different countries since they use different languages
b) Limited connections of transport and communication between countries. This limits accessibility to some countries thus obstructing international trade especially land locked countries fore example tourists prefer to go to Kenya than Uganda
c) Most countries produce homogeneous goods. This limits the level of exchange of such goods amongst such countries. This is common in LDCs who export mainly similar agricultural products
d) Protections amongst countries. This limits the chances of producing exports because exportation is not free due to tariff and non tariff barriers
e) High operational costs. These include transport costs, ware housing, insurance and clearing such costs reduces profits hence a limitation to international trade

f) Poor quality of goods produced by LDCs, these goods can not compete favorable on the world market hence reducing such countries to fully participate and benefit in international trade
g) Production of synthetic fibers by MDCs. This limits export trade of many LDCs in commodities such as cotton, sisal rubber
h) Differences in weights and measure, different countries have different weights and measures this creates difficulty in exchange hence limiting international trade
i) Forex shortages. This limit the scale of import trade especially in low developing countries
j) Trade integration like Preferential Trade Area and others limit the participation in trade with non member countries thus reducing the volume of international trade
k) Ignorance of existence of markets in particular countries limits the level of exports of some countries in need of such markets
l) Sanctions from developed countries to developing countries like Libya, Zimbabwe limit such countries to participate in international trade. Some times they are not allowed to trade with any country
m) Differences in ideologies i.e. there is always no free trade between socialists and capitalist blocks which limit the volume of international trade
n) Differences in religions and culture also limits international trade for example the Muslim religion does not allow the importation of pock and hard drinks like beer in Muslim countries

THEORIES OF INTERNATIONAL TRADE

They are mainly two theories of international trade

THE ABSOLUTE ADVANTAGE THEORY

This was put forward by Adam smith and it states that "if given the same amount of resources a country produces more of a given commodity at less input costs than others". Absolute advantage is a situation where given the same amount of resources a country produces more of a given commodity at less input cost than others

Take a case where there are two countries namely Uganda and Rwanda both producing maize and tea as shown below

Country	Maize ('000')	Tea ('000')
Uganda	5	10
Rwanda	1	5

Using one unit of labour Uganda can produce either 50,000 tones of maize or 10,000 metre of tea while Rwanda can produce 1000 tones of maize or 5000 metres of tea

There fore Uganda can produce both maize and tea more efficiently than Rwanda. This implies that Uganda has an absolute advantage over Rwanda in the production of both

THE COMPARATIVE COST ADVANTAGE THEORY

It states that "a country should specialize in the production of a commodity where it incurs the lowest or the least opportunity cost". The country exchanges this commodity to obtain commodities where it has a high opportunity cost. This can be illustrated using the above table

Country	Maize ('000')	Tea ('000')
Uganda	5	10
Rwanda	1	5

Opportunity cost = Alternative fore gone/ Alternative chosen

Opportunity cost of Uganda for **maize** 10/5 = **2** for **tea** 5/10 = **0.5**

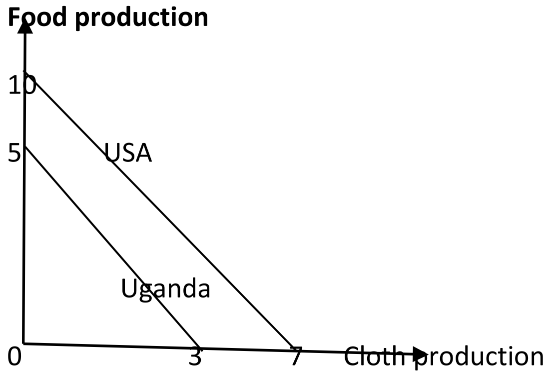
Opportunity cost of Rwanda for **maize** 5/1 = =**5** for **tea** 1/5 = **0.2**

From the above calculations Uganda has the least opportunity cost in producing maize which is **2** than Rwanda which has high opportunity of producing maize which is **5**. There fore Uganda should specialize in producing maize

Rwanda has the least opportunity cost in producing tea which is **0.2** than Uganda which has a high opportunity cost of **0.5** in producing tea. There fore Rwanda should specialize in producing tea

If Uganda specialize in maize and Rwanda in tea exchange would develop between the countries resulting into internal trade

Example two



a) Which country has the absolute advantage in production of both commodities?
b) Which country has the comparative cost advantage in production of cloth?
c) Which country has the comparative cost advantage in production of food?
d) Which commodity should Uganda specialize in and why?

Solutions

Opportunity cost **= Alternative for gone/ Alternative chosen**

Opportunity cost of USA for **food** 7/10 = **0.7** for c**loth** 10/7 = **1.4**

Opportunity cost of Uganda for **food** 3/5 = **0.6** for **cloth** 5/3 = **1.66**

a) It is USA with absolute Advantage of producing both commodities because she produces more units in both than Uganda
b) It is USA with comparative Advantage in the production of cloth because she incurs the least opportunity cost of **1.4** compared to Uganda with a high opportunity cost of **1.66**
c) It is Uganda with comparative advantage in the production of food because she incurs the least opportunity of **0.6** compared to USA with high opportunity cost of **0.7**
d) Uganda should specialize in the production of food because it is where she has the least opportunity cost of **0.6** compared to cloth with a high opportunity of **1.66**

Exercise: study the below and answer questions that follow

Country	generators	Coffee
X	400	600
Y	100	300

From the table above

1. Which country has the Absolute Advantage in both commodities?
2. Which country has the comparative Advantage in production of generators?
3. Which country has the comparative Advantage in production of generators?
4. Stare the commodity each country should specialize in and give reasons

ASSUMPTIONS OF COMPARATIVE ADVANTAGE THEORY

1. It assumes existence of only two countries and production of two commodities
2. It assumes free trade i.e. no barrier to international trade
3. It assumes constant technology
4. It assumes constant costs of production
5. It assumes that labour is homogeneous i.e. labour is equal in terms of productivity
6. It assumes perfect knowledge in the product and factor markets
7. There exists free mobility of FOP
8. There is no currency restriction
9. It assumes similar tastes and preferences
10. It assumes barter exchange/barter trade
11. It assumes no transport costs
12. It assumes that countries reach full employment level and all resource have been employed

APPLICABILITY OF COPMARATIVE COST THEORY TO LDCS

1. Developing countries have tended to specialize in agriculture where they have lowest comparative cost hence making the theory applicable. For example Uganda and Brazil specialize in exporting coffee, Ghana cocoa, Nigeria palm oil etc
2. There are barter trade arrangements in LDCs i.e. countries exchange goods for goods hence making the theory applicable to LDCs
3. There is rise of labour intensive techniques which is abundant in LDCs hence making the theory relevant because it assumes labour as the only variable factor of production
4. There is some degree of mobility of factors of production with in individual countries, labourers have been found moving from one country to another thus the theory is applicable to developing countries
5. Developing countries import manufactured goods where they have lesser comparative advantage for example Uganda imports machines and spare parts from Japan, cars from German etc. Thus making the theory applicable

INAPPLICABILITY OF COMPARATIVE COST THEORY (CRITICISM/LIMITATIONS)

1. The existence of multi-lateral trade limits the theory. Many countries are participating in trade with more than two countries for example Uganda is trading with Kenya, Sudan, USA, chain etc. yet the theory assumed only two countries in trade thus inapplicable
2. Existence of more than two commodities produced limits the theory because it assumes only two commodities produced. Many countries produce different commodities which they export to other countries thus making the theory inapplicable to many countries
3. Existence of trade barriers i.e. tariff and non tariff barriers like foreign exchange control, quotas, total ban, custom duties etc make the theory inapplicable. This is because it assumes free trade which is un realistic since countries use tariffs and non-tariff barriers to control the volume of international trade hence the theory is inapplicable
4. It ignores transports costs which may cause differences in costs. This limits the theory since it assumes no transport costs which is unrealistic because goods have to be transported to markets which are far thus increasing costs and making the theory irrelevant
5. It ignores the possibility of absolute cost advantage yet many LDCs have it in some commodities most especially in agricultural commodities thus making the theory inapplicable in LDCs
6. It ignores the need for self reliance by countries and assumes that a country should specialize in one commodity with the least opportunity cost and import others with high opportunity cost from others countries. Yet most countries strive to achieve self reliance by producing all commodities needed in the domestic economy thus making the theory inapplicable in such countries
7. The existence of high unemployment and under employment levels in LDCs limits the operation of the theory. The theory wrongly assumes the possibility of full employment of all factors of production yet in LDCs there exist unemployed resource thus making the theory inapplicable
8. It ignores the fact that demand for agricultural products is inelastic and assumes elastic demand which is not true. This is because even if countries produce agricultural products at the least cost implying that they will be sold at a reduced price such products have inelastic demand their demand will not increase a lot. Hence the theory is inapplicable

9. It ignores the fact that factors of production have different abilities and skills for example some labour is skilled, semi skilled or unskilled and their productivity is different. This limits the theory because it assumes homogeneity of factors of production which is not true
10. It ignores the existence of diminishing returns and possibility of soil fertility getting exhausted leading to reduced out put as more and more factors are applied on a fixed factor. This limits the theory because diminishing returns operates on land and labour yet the theory assumes that increase in factors of production leads to increase in out put at a reduced cost
11. Poor nations would become poorer due to poor terms of trade because the theory encourages them to production of only primary products which are faced with poor terms of trade thus a limitation to developing countries
12. Existence of monetary exchange limits theory because it assumes only barter trade yet in most developing countries there is use of as a medium of exchange not only goods for goods. This is explained by the existence of many commercial banks in such countries thus the theory is inapplicable
13. It ignores international immobility of factors of production especially labour due to high level specialization and social ties and assumes perfect mobility of factors of production which is un realistic thus making the theory inapplicable
14. It ignores the possibility of change in comparative advantage where by a country may incur high opportunity cost in the commodity it has been incurring the least opportunity may be due to variable costs which increase with the costs of production, industrial break down etc and it assumes that a country has only comparative advantage thus making it inapplicable
15. It ignores the change in technology and only assumes constant technology yet if there is improvement in technology this can change the comparative advantage from one commodity to another. Hence the theory is inapplicable
16. It ignores the existence of different currencies used. Different countries use different currencies and it does not tell us which currency is to be used in international trade thus making it inapplicable

DISTRIBUTION OF BENEFITS FROM INTERNATIONAL TRADE BETWEEN LOW DEVELOPING COUNTRIES AND LDCs

Why have LDCs not benefited from international trade as much as DCs?

The benefits from international trade have not been evenly distributed. This is due to the following

1. LDCs face unfavorable terms of trade as they are exporters of mainly primary products whose prices are low on the world market due to low value addition
2. Developing countries tend to put tariffs and quotas on imported goods from LDCs, hence reducing their foreign earnings from exports due to protection policies
3. LDCs are importers of highly priced manufactured goods from MDCs leading to unfavorable Balance of Payment Position thus benefiting less from their primary products
4. LDCs have weak bargaining power in commodity markets and hence fail to bargain for higher prices for their exports for example coffee leading to low foreign exchange earnings

5. LDCs produce similar products which limits economic integration among LDCs to widen exports markets hence making them benefit less from international trade due to low foreign exchange earnings
6. Technological progress in DCs such as increased use of synthetic fibre and adoption of raw-material saving technology has significantly reduced the demand for primary products and raw materials from LDCs
7. Low developing countries have a narrow export base and hence limited foreign exchange earnings from exports thus making them benefit less from international trade
8. Limited market for LDCs' exports as markets are flooded by producers from other primary producers leading to less befits from international trade
9. LDCs have a higher marginal propensity to import yet developed countries have a higher marginal propensity to export leading to high foreign exchange earnings to MDCs
10. International trade has not stimulated manufacturing industries in low developing countries as they are subjected to importing manufactured goods from MDCs leading to consumption of the scarce foreign exchange
11. Rapid population growth rate in LDCs requiring increased importation of highly priced manufactured goods from MDCs instead of expanding the export sector leading to low foreign exchange earnings
12. The exports from LDCs have elastic demand and imports have inelastic demand. This implies that prices of imports can rise without reduction in demand for them especially capital goods

IMPROVING THE POSITION OF LDCs IN INTERNATIONAL TRADE

a) Export diversification i.e. widening LDCs' export base by introducing new crop varieties, growing flowers, rearing animals of good quality breeds and setting up processing industries to increase foreign exchange earnings
b) Import substitution industries should be set up to reduce foreign expenditure on imports thus stabilizing BOP position in LDCs
c) Encouraging trade among low developing countries through economic integration such as Preferential Trade Area (PTA), East African Common Market (EACM), COMESA etc
d) Negotiating for removal of trade barriers in Developed countries and opening up of their market to LDCs exports through World Trade Organization (WTO) as well as taking advantage of AGOA (African Growth Opportunities Act) to penetrate the USA market
e) Industrialization strategy so as to reduce dependence on Developed Countries for industrial imports thus stabilizing BOP position in LDCs
f) Adding value to exports to fetch higher prices for example instead of exporting coffee, beans. LDCs should process and export instant coffee
g) Controlling output on the world market so as to raise export prices for example the coffee retention scheme to ensure that such countries are supplying only what is demanded
h) Looking for alternative markets elsewhere for example in Chain, Middle East etc to realize greater earnings in exports

i) Commodity agreements aimed at establishing and increasing the earnings of raw materials exporters e.g. Oil Producing and Export Countries (OPEC), International coffee Organization and Tea agreements etc

COMMERCIAL POLICY

This is a policy adopted by a country government towards international trade. It is divided into free trade and protectionism

FREE TRADE Vs PROTECTUION TRADE POLICY

FREE TRADE

Free trade policy is the policy of non- interference by government in foreign trade i.e. the government neither helps nor hinders the movement of goods and services between the countries. It is the trade which does not involve tariff and non tariff barriers to restrict international trade

CASE FOR FREE TRADE (ADVANTAGES)

1. Low prices of goods. Free from import duty lowers the prices of imported goods or prevents increase in the prices hence enabling people to buy variety of goods from international trade thus improving their standards of living
2. It discourages monopoly tendencies in the economy. Under free trade, each country specializes in a few branches and under its role of competition. This leads to production of good quality products
3. It leads to improvement in the quality of goods due to stiff competition between local producers and imports from other countries. This enhances peoples' standards of living
4. It leads to easy mobilization of resources because it encourages inflow of resources for example technology
5. Free trade widens the market for goods produced most especially the surplus out put. Because countries will be able to dispose off their surplus to other countries
6. The consumers are provided with a variety of goods which widens their choice thus improving their standards of living. This is due to inflow of imports from other countries
7. It creates more employment opportunities to the people engaged in the production this increases their earnings and improves their standards of living
8. It leads to increased foreign exchange earning to a particular country due to increased exportation. This stabilizes a country's BOP position
9. It encourages specialization. Each country specializes in the production of particular goods which promotes efficiency leading to increased out put thus accelerating economic growth and development

10. It promotes international co-operation and mutual understanding among the countries involved in free trade. This fosters political stability in the countries involved in free trade
11. It encourages maximum exploitation of the domestic resources because it requires high production. This leads to increased national income countries participating in free trade
12. It stimulates effort and hard work due to exposure of people to superior imports from developed countries. This also encourages creativity
13. It encourages faster expansion of infant firms due to managerial skills acquired from developed countries

CASE AGAINST FREE TRADE

1. The local industries are out-competed by the well developed industries leading to un employment and it also kills creativity and initiative among local producers
2. It encourages dumping of goods in the recipient country thus exposing inferior commodities to the population. This leads to poor standards of living of the people
3. It results into increased external economic dependence on other countries with its associated effects like shortages in times of misunderstandings and undermining political independence of the dependant
4. It may result into imported inflation when goods are coming from an inflationary country with its adverse effects like loss of value of local currency, making the ruling government unpopular
5. It results into low tax revenue to the countries involved in free trade since there no tariffs charged. This retards the process of economic growth and development
6. It worsens the Balance of Payments problems due to excessive free importation followed by limited exportation resulting in high foreign expenditure compared to receipts from exports
7. It leads to low level of exploitation of local resources due to dependence on imports and demonstration effect in most LDCs thus leading to persistence unemployment in such countries
8. It may lead to importation of undesirable goods with adverse effects on nationals like expired computers, second hand vehicles which all are pollutants to the environment and human beings
9. It may worsen a country's Terms of Trade due to high import prices and low export prices
10. It may lead to political dominance by MDCs to LDCs. This affects planning in LDCs because of the influence of foreign ideologies and strategies which may be inappropriate in these countries

TRADE PROTECTION POLICY

Protectionism refers to the use of tariffs and non tariff barriers to restrict the international trade. **Trade protection policy** is a policy of government interference in foreign, the government may put up some measures that restrict the movement of goods and services between countries

FORMS OF PROTECTION (TOOLS)

1) **Tariff barriers**. These are trade restrictions fin form of taxes imposed don goods entering the country (import duty) or living the country (export duty). This makes imports expensive thus discouraging their consumption
2) **Non tariff barriers**. These are trade restrictions without the element of taxation for example quotas, total ban etc they include the following:
3) **Administrative controls**. This involves having restrictions such as tight bureaucratic procedures in obtaining import or export licenses. This depends on government's objectives. If the government wants to reduce imports, it makes procedures very tight
4) **Total ban (trade embargo**). This is a legal prohibition of importation into the country of specified goods and services for example drugs, animal products from countries affected by animal diseases etc
5) **Foreign exchange control** (manipulation of exchange rates). The government restricts or limits the amount of foreign exchange allocated for some imports or operates a dual exchange rate with a higher exchange rate for imports of luxury goods and a lower exchange rate for essential commodities
6) **Subsidies to local industries**. Provision of subsidies to domestic producers reduces their costs of production and prices, and make locally produced goods cheaper than imported goods there by discouraging imports
7) **Quotas**. This is the maximum limit on goods to be imported into the country (import quotas) or goods to be exported out of the country (export quota) within a specified period of time
8) **Devaluation.** This is the official lowering of the value of country's currency in terms of other currencies. This makes imports relatively more expensive there by reducing their domestic demand in favor of locally produced goods
9) **Deflationary policy.** This involves liquidity squeeze to reduce domestic import demand thus restricting their inflow. This involves restrictive monetary policy
10) **Interest rate policy.** Government takes the responsibility of making arrangements to provide the domestic manufactures with loans at a slightly lower interest rate. This helps in reducing the cost of production
11) **Preferential treatment**. Imports from regional economic integration member countries are charged less duty than the non-member countries
12) **Transport discrimination**. It involves charging higher transport costs to the imported goods and low transport costs to the exports. This discourages importation. This is so possible when the transport system is controlled by the government
13) **Special deposits**. This involves forcing the importers to make special deposits before importing. This increases costs of importing thus discouraging importers

CASE FOR (MERITS/ADVANTAGES/POSITIVE EFFECTS) FOR TRADE PROTECTION POLICY

1. It protects domestic infant industries from unfair foreign competition firms with low cost foreign products which results in increased out put thus accelerating economic growth and development
2. It corrects the Balance of Payment position by reducing foreign exchange expenditure on imports. Thus achieving economic growth and development
3. It creates employment opportunities at home by reducing imports and stimulating domestic demand for local products. This increases the earnings of people thus improved standards of living
4. It generates government revenue in form of import and export duties. This enables the government to extend social services to its people in form good health facilities, education, power supply etc
5. It reduces external economic dependence on other countries and promotes self reliance due to promotion of local production and exportation
6. It prevents the importation of undesirable goods which are bad to human health like cocaine, cigarettes etc through charging high import duties on such commodities
7. It discourages dumping of cheap and substandard or expired goods into the country which may discourage local production and lead to poor standards of living of the people
8. It checks on imported inflation by prohibiting imports from countries suffering from hyper inflation. This leads to economic stability and attracts more investors in the country
9. It improves on the country's TOT through control of exports for example the coffee retention scheme. This enables a country to supply on the world market only what is demanded
10. It strengthens political ties through preferential duties with the promotion of regional integration. This leads to political stability among the member country
11. It encourages use of local resources and hence efficient utilization of the idle resources which increases economic growth

CASE AGAINST TRADE PROTECTION POLICY

The nationals are subjected to consumption of poor quality goods produced by local firms. This due to lack of competition in the domestic economy due protection

The nationals are subjected to consumption of highly priced goods produced locally. This reduces their disposable income leading to poor standards of living

It encourages monopoly tendencies in the economy by protecting domestic producers from foreign competition leading to exploitation of nationals inform wrong measures and high prices after restricting out put

It limits variety of goods provided to the consumers for consumption this limits consumers' choice leading to poor standards of living thus underdevelopment

It results into reduced government revenue in case of non-tariff barriers for example quotas and total ban of some imports leading to under provision of social services like hospitals, improved roads, free education etc. thus leading to economic growth and development

It reduces the market for exports due to reduced volume of international trade resulting in low export earnings thus worsening the BOP position

It increases government expenditure to implement the policy for example enforcing total ban of some imports instead of developing other sectors of strategic importance like agriculture

It encourages trade malpractices for example smuggling in cases of high tariffs which results into loss of government revenue

The protected firms have a tendency of remaining infant in order to be protected. This leads to underutilization of resources leading to underdevelopment

It may frustrate inflow of foreign resources which results into reduced investment prospects. This leads to persistence unemployment in most developing economies

It discourages specialization with its advantages like efficient utilization of resources, good quality products produced, increased out put thus retarding the process of economic growth and development

It leads to disappearance of cheap foreign commodities on the local market. This also leads to exploitation of consumers by the local producers

REVISION QUESTION

- Distinguish between Free Trade and Protection Trade Policy
- Why do some countries adopt protectionism on international trade policy?
- It is protectionism rather than free trade should be adopted if countries are to benefit from international trade discuss

BALANCE OF TRADE

This is the difference between the value of a country's visible exports and visible imports

TERMS OF TRADE

This refers to the quantity of domestic goods that a country exports in exchange for one unit of imported goods. It is the ratio of price index of exports (P_X) to the price index of imports (P_m)

I.e. T.O.T $= \frac{P_X}{P_M}$

TYPES OF TERMS OF TRADE

There are two types of terms of trade

Barter terms of trade of trade (Commodity T.O.T)

This is the ratio of the price index of exports to the price index of imports i.e. it shows the amount of exports required to purchase a unit of imports

$$\text{Barter T.O.T} = \frac{PX}{PM} \times 100$$

If the ratio is greater than **1,** it means that **1** unit of export buys more than **1** unit of imports. (More favorable T.O.T). If the situation increases year after year then the country has **improving T.O.T**

If the ratio is less than **1**, it means that **1** unit of export buys less than **1** unit of imports. (Unfavorable T.O.T). If the situation increases year after year the country has **deteriorating T.O.T**

Income terms of trade

It refers to the export purchasing power of a country's import or it refers to the capacity of a country to import out of her export earnings. In other wise income terms of trade = Barter TOT times the quantity of exports

$$\textbf{Income T.O.T} = \frac{P_X}{P_M} \times Q_X$$

Therefore income TOT may improve due to:

- Increase in exports
- Increase in price of exports
- Decrease in price of imports

DESCRIPTION OF TERMS OF TRADE

Favorable TOT. This is when the prices of exports are higher than the prices of imports

Unfavorable TOT. This is where the price index of a country's imports is higher than export prices

Deteriorating TOT. This is when export prices are falling and import prices are rising

Improving TOT. This is when the import prices are falling and the export prices are rising

MEASUREMENTS OF TERMS OF TRADE

The most commonly used concept is the barter TOT. There fore Terms of Trade **(T)** will be the index of export price **(P_x)** divided by the index of import price (**P_m)** and expressed as a percentage

I.e. **T =** $\left(\frac{P_x}{P_m} \times 100\right)\%$

- **If T = 100% it is favorable**
- **If T = > 100% it is more favorable**
- **If T = < 100% it is unfavorable**

Example 1: Suppose that with 2001 was a base year (100) that by the end of 2008 export price would have risen by 5%, then the import price index now may be 97. Then the TOT has improved by:

$\left(\frac{105}{97} \times 100\right)\% =$ 108.25% hence favorable TOT

NB the higher the TOT above 100, the greater the improvement in TOT and vice versa

Example 2: given 95 as a country's export unit value index and 110 as its import unit value index

a) Calculate the terms of trade of such a country

$T = \left(\frac{P_X}{P_M} \times 100\right)\% = \left(\frac{95}{110} \times 100\right)\% = 86.4\%$

b) Comment of such a country's state of terms of trade

It has unfavorable terms of trade

Example 3: study the table below showing the TOT for country X (2007-2011)

Year	Export price index	Import price index	Terms of Trade
2007	100	100	
2008	142	108	
2009	120	114	
2010	154	173	
2011	128	132	

Calculate the terms of trade for the years 2008-2011

Terms of trade = $\frac{P_X}{P_m} \times 100$

TOT in 2008 = $\frac{142}{108} \times 100 = 131\%$

TOT in 2009 = $\frac{120}{} \times 100 = 105\%$

114

TOT in 2010 = $\frac{154}{173} \times 100 = 89\%$

TOT in 2011 = $\frac{128}{132} \times 100 = 97\%$

Did country X experience favorable or unfavorable terms of trade in 2010? Give reason. Country X experience unfavorable TOT in 2010 because import index were greater than export price index

Exercise

Study the table below and answer the questions that follow

Year	**Export price index**	**Import price Index**	**Terms of trade**
2000	150	150	
2001	140	125	
2002	132	170	
2003	143	130	
2004	120	150	

Calculate the terms of trade for the years and comment its state

TERMS OF TRADE IN LDCs

Why have terms of trade tended to move against developing countries?

1. Falling prices of exports. LDCs are exporters of low priced primary products mainly determined by the consuming countries which are stronger in trade negotiations leading to low export earnings
2. LDCs are importers of expensive manufactured capital and consumer goods whose prices are high leading to unfavorable terms of trade
3. Weak bargaining power of LDCs in commodity markets. Their marketing agencies are weak and can not bargain for higher prices leading to deteriorating terms of trade
4. Increasing substitution or competition of exports with synthetics produced by MDCs. These have reduced the demand for agricultural raw materials and hence lower prices compared to high prices of imports
5. Low income elasticity of demand for exports especially agricultural food-stuffs from LDCs. This leads to low earnings from such exports leading to unfavorable terms of trade
6. Invention of raw material saving technology by developed countries which has further reduced the demand for raw-materials from LDCs. This results in low export earnings leading to unfavorable terms of trade
7. Protectionist policies by MDCs in form of imports restrictions to improve on their terms of trade. This worsens terms of trade in developing countries due to low earnings from exports

8. LDCs export low quality products which have low value added in general for example exporting coffee beans instead of processed instant coffee. Hence low prices on the world market
9. Market flooding of raw agricultural products. This results from competition among producers of similar products in commodity markets which leads to fall in export prices
10. Unfavorable exchange rates partly as a result of commercial policies like devaluation which involves lowering value of a country's currency in terms of another country. This also leads to unfavorable terms of trade in LDCs
11. Rising price of imports. This arises due to rapid population growth rates in LDCs leading to increased demand for imports which involves use of scarce foreign exchange earnings

BALANCE OF PAYMENTS

BALANCE OF PAYMENTs is a systematic record of all economic transactions between the exporting country and foreign countries for a given period of time usually one year

STRUCTURE OF BOP ACCOUNT

CURRENT ACCOUNT

This refers to records of all the transactions involving physical movement of goods and services and transfers. It is further subdivided into the following subsections

a) **Visible trade account.** This refers to a sub-section which keeps a record of all the receipts from the export of tangible goods and all the expenditures abroad on the imports of goods

NB Trade balance (Visible balance) is the difference between receipts from goods exported and expenditures on goods imported in a given period of time. When there is a surplus on this account, a country is said to have **favorable trade balance** and when there is a deficit, the country would have **unfavorable (adverse) trade balance**

b) **The Invisible Trade Account/invisible transactions:** This refers to a sub-section which records all transactions arising from provision of services .they include transport, insurance, tourism, travel etc. it records all the expenditures on services rendered by non-nationals to the economy and receipts from provision of services by nationals a broad

NB

- The difference between foreign exchange received and foreign exchange spent on these transactions is called **invisible balance**
- The difference between all the expenditures abroad (both visible and invisible) and all the receipts from abroad arising from both the visible and invisible trade account is known as **balance of payments on current account**

c) **Transfers:** these include donations i.e. official grants and private transfers which also involve foreign exchange expenditure **and receipts**

CAPITAL ACCOUNT

This records all transactions arising from capital movements into and out of the country (both private and government) in a given period of time usually one year

Capital inflow may include things like investments by foreigners in the country, purchase of local currency by foreign residents, buying of treasury bills sold by local banks to foreigners etc. these items constitute credit entries on the BOP account

Capital outflow include things like investments by nationals in other countries, purchase of treasury bills by nationals in foreign countries etc. these items constitute debit entries on the BOP account

CASH/MONETARY ACCOUNT

This is also known as the **balancing item or official settlement or financing account**. This section records all the transactions related to changes in the country's foreign exchange reserves and It is a summary of the net differences between the inflows and out flows from current and capital accounts

It shows the surplus or deficit in BOP accounts and how the imbalance can be run down or financed to balance the account

An increase in the foreign exchange reserves in both current and capital accounts leads to **a surplus** on the monetary account.

Causes of BOP surplus

- ❖ Appreciation in TOT of the country i.e. increase in the prices of exports in relation to price of imports
- ❖ Increased capital inflow into the country e.g. increase in the number of foreign investments in the country
- ❖ Reduction in import expenditure i.e. when a country reduces its expenditure on imports either through protectionism or import substitution
- ❖ Increase/improvement in the quality of products
- ❖ Reduction in military expenditure as a result of improved political stability

It **can be disposed off to attain BOP equilibrium e.g**.

- ❖ Buying of gold,
- ❖ Lending to other countries
- ❖ Investing abroad
- ❖ Purchase of IMF facilities (SDR)

A reduction in the foreign exchange reserves in both current and capital accounts leads to a deficit on the monetary account.

Causes of a deficit BOP account

- ✓ Low volume of exports, this reduces export earnings

- ✓ Low quality products which reduce competition in the export market
- ✓ High value of imports because of imported inflation resulting in excess expenditure
- ✓ Fluctuations in the prices of agricultural products which reduce the incomes of the country
- ✓ High marginal propensity to import in LDCs
- ✓ Huge debt repayment obligations by LDCs
- ✓ High military expenditures because of political instability
- ✓ High miscellaneous expenditures arising from many government trips abroad
- ✓ Inelastic demand for exports of LDCs
- ✓ Effects of domestic inflation

A deficit can be financed by:

- ✓ Using previous foreign exchange reserves,
- ✓ Selling of gold reserves of the country
- ✓ Borrowing from friendly countries,
- ✓ Borrowing from IMF,
- ✓ Selling securities abroad (e.g. bonds)
- ✓ External debt rescheduling/conversion/cancellation
- ✓ Disinvestments at home e.g. privatization

A country's reserves may be kept at various levels which may include the following

- ❖ Commercial banks in the country may hold balance for foreign exchange with foreign commercial banks
- ❖ The central bank may hold balance with other central bank in other countries
- ❖ The central bank may keep gold and special drawing rights (SDR) with IMF
- ❖ The central bank may keep gold at home
- ❖ The central bank may keep foreign exchange by itself

Revision questions

- ✓ **Distinguish between surplus BOP and deficit BOP**
- ✓ **Outline any three ways of off setting a surplus BOP**
- ✓ **Explain the causes of a deficit BOP in your country**
- ✓ **What attempts could be done to off set a deficit BOP account**

ERROR AND OMISSION ACCOUNT:

This section acts as the balancing item of the BOP account of a country. If all the records of the BOP accounts are complete, both the credit and the debit sides of the BOP account statement must be equal or balance. If there is any imbalance in the BOP accounts, it can be added or subtracted for balancing purposes

BOP PROBLEMS IN LDCS

BOP problem refers to persistent shortage of foreign exchange for several years after year and the sources of financing it are exhausted. This is a persistent deficit BOP. A persistent surplus also implies that there is disequilibrium; however this is not a national economic problem

Balance of Payment Problems are caused by factors that reduce exports and increase imports or those that increase capital outflow and decrease capital inflow

CAUSES OF BOP PROBLEMS IN LDCs

1. Exportation of primary products with low value added/low quality for example semi-processed agricultural and mineral products which fetch low prices on the world market
2. Importing high volumes of expensive manufactured consumer goods or high marginal propensity to import. This results in increased foreign expenditure yet the revenue collected is low leading to persistent BOP problem in LDCs
3. High inflation in developing countries discourages exports by making them expensive to outside countries and encourages imports because many countries are willing to sell in a country where prices are high
4. Narrow export base i.e. low volume and limited variety of exports resulting into less foreign exchange earnings thus causing persistent BOP problem in developing countries
5. Unfavorable natural factors such as drought, floods, frost. This leads to agriculture failure (low output) which is exported
6. Protectionism and discriminatory policies in developed countries in form of tariffs and non-tariff barriers limit the rate at which LDCs can accumulate foreign exchange earnings from their exports
7. Limited market as all low developing countries sell in the same external markets which results into flooding of the markets hence lowering prices leading to reduced foreign exchange earnings
8. High military expenditure on importation of military equipments because of rampant political instabilities and unrest in many developing countries. This account for BOP problems in developing countries. Further still, political instabilities reduces the productive capacity of LDCs
9. Excessive government expenditure on bureaucrats, foreign travels, diplomatic missions abroad, maintaining of embassies abroad etc
10. High rate of capital outflow mainly inform of profit repatriation and income repatriation by foreign investors and expatriates respectively. This is due to weak government policies leading to persistent BOP problem
11. Importation of expensive capital goods for investment also drains a lot of LDCs foreign exchange reserve thus leading to BOP problems in LDCs
12. Over reliance on expatriate man power. This is caused by low skill development in LDCs and forces such countries to import skilled labour from other countries at high costs
13. Debt servicing due to constant borrowing leading to high capital out flow from LDCs to DCs hence reducing the scarce foreign exchange reserve leading to persistent BOP problems in LDCs

14. High exchange rate When the value of the currency in terms of other currencies is very high or over valued, outsiders find i.e. expensive to buy the over valued currency so as to buy the commodities from that country. This reduces exports
15. Decline in world demand due to instability in markets, reduction in population, increased competition from synthetic fiber, and fall in incomes leading to low export earnings
16. Poor performance of the service industry leading to limited attraction of tourism thus persistent BOP problems in developing countries

MEASURES TO CORRECT BOP PROBLEM

1. Instituting trade restriction such as tariffs, import quotas, administrative controls etc to discourage imports thus reducing demand for foreign exchange
2. Export promotion to increase the volume of exports and the quality of export goods. This increases foreign exchange earnings leading to stable BOP position. This can be done through giving subsidies to producers, increase in producer prices etc
3. Diversification of export markets through regional economic integration for example the East African Common market, Preferential Trade Area (PTA), COMESA etc to increase export earnings
4. Devaluation of the domestic currencies to encourage exports and discourage imports. This involves making the local currency cheaper in relation to currencies of other countries. It makes exports cheap and imports expensive hence reducing the demand for foreign exchange
5. Import substitution strategy can be undertaken to encourage consumption of locally produced goods and conserve scarce foreign exchange available. It involves producing locally which were formerly imported
6. Man power planning training and development to reduce the huge expenditure on expatriates. This can be done by equipping training institutions with necessary learning facilities that can enhance vocational and technical knowledge
7. Reducing expenditure on foreign missions and diplomatic travels can help to reduce BOP problems
8. Creating a conducive political atmosphere to limit military expenditure on buying military equipment and attract foreign investment
9. Liberalization of the economies to encourage domestic production and increase output for the export market. This involves removing barriers to trade in the domestic economy to enable all potential investors to take part in the economic activities
10. Strengthening commodity agreements of which developing countries are signatories e.g. European Economic Community, International Coffee Agreement, international Wheat Agreement etc
11. Encourage barter trade arrangements in order to minimize use of scarce foreign exchange available. This can also reduce BOP problems
12. Debt conversion, rescheduling and debt relief can be undertaken
13. Use of accumulated foreign reserves to over come BOP problems

14. Export diversification to widen the export base and to reduce the effects of natural factors and price fluctuations
15. Putting some restrictions on profit repatriation i.e. the amount of money to be repatriated and that ploughed back in business restrictive fiscal policy. This reduces the disposable income and discourages expenditures on foreign. Besides, it increases revenue through taxation while reducing government expenditure there by conserving foreign exchange
16. Reducing population growth rate to reduce demand for imports and reduce foreign exchange expenditure
17. External borrowings should be done. The government can borrow externally from the donor institutions and other governments

DEVALUATION POLICY

Devaluation is the legal reduction of the value of the country's currency in terms of other currencies for example given that the exchange rate is 1 Us$ = 1000 Ug. Shs. Calculate the new exchange rate after devaluation of the shilling by 20%

New exchange rate = 1000 + (20/100 x 1000)

=1000+200

=1200Ug shs

$\Rightarrow$ 1Us$=1200Ugshs

Therefore exchange rate is 1US$ = 1200Ugshs

Exercise: given that the exchange rate is 1US$ = 2500 Ugshs. Calculate the new exchange rate after devaluation of the shilling by 40%

The aim of devaluation is to maximize foreign exchange earnings by encouraging exports and discouraging imports since it makes imports expensive and exports become cheaper for foreigners. However it is used when there is a fixed exchange rate.

TERMS RELATED TO DEVALUATION

Competitive Devaluation: is a situation where several countries devalue their currencies in an attempt to gain a competitive advantage over another

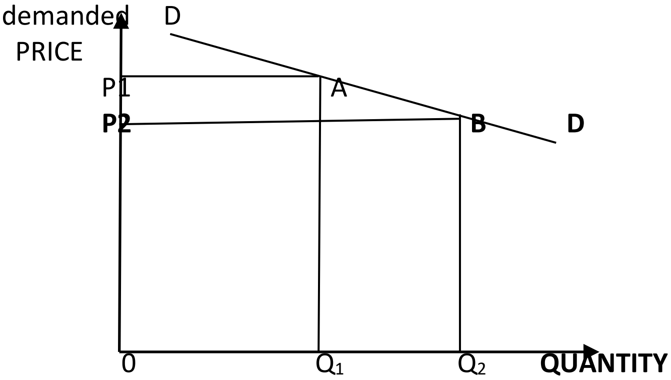
Over- Valuation is the legal increase in the value of the country's currency relative to other foreign currencies

Under valued currency: this refers to the currency whose exchange rate (price) is fixed below its free market level. This makes exports very cheap and imports very expensive

Revaluation is the official rising of the value of a country's currency relative to other foreign currency

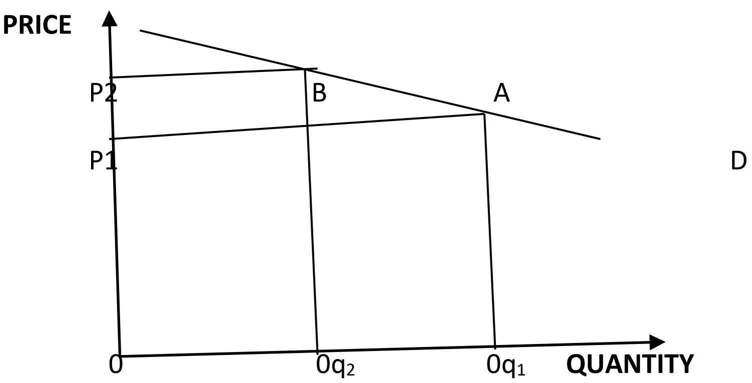
CONDITIONS NECESSARY FOR THE SUCCESS OF DEVALUATION IN SOLVING A COUNTRY'S BOP

The **foreign demand for a country's export in foreign market must be price elastic** so that a small price reduction in export resulting from devaluation should lead to a proportionately large quantity demanded



Before devaluation a country was exporting $0q_1$ at price $0p_1$ and earning foreign exchange $0q_1Bp_1$. After devaluation export prices reduce to $0p_2$ increasing the quantity purchased from $0q_1$ to $0q_2$ and foreign exchange earning $0q_2Ap_2$

1) The **domestic demand for imports must be elastic** i.e. a small increase in import prices should result into a bigger decrease in their demand and hence a fall in foreign exchange expenditure



Before devaluation, a country was importing $0q_1$ at price $0p_1$ and incurring foreign expenditure $0q_1Ap_1$. After devaluation import prices rise to $0p_2$ reducing the foreign expenditure to $0q_2Bp_2$

2) The **supply of exports must be price elastic** so that as demand for a country's exports abroad increase, supply should also increase. In other words the economy should not be at full employment
3) **There must be no competitive devaluation** i.e. competing countries must not also devaluate at the same rate or higher as there would be no competitive advantage gained by devaluation and no preference for the country's exports
4) **Inflation must not exist in the devaluating country**, as this would erode the competitive advantage gained from devaluation

5) **There must be no import controls** or restrictions on a country's exports in form of tariffs and non-tariff barriers such as quotas, total ban etc
6) **There must be no parallel foreign exchange markets**
7) **The authorities should be able to resist the trade union pressures for the rise in wages** in protection against the raised cost of living caused by a rise in import prices
8) **The government should not correct the structural imbalances** or wrongs of the economy unless this is done after devaluation for example by replacing outdated machinery, devaluation may not succeed in improving a country's BOP

CIRCUMSTANCES UNDER WHICH DEVALUATION MAY FAIL TO SOLVE THE BOP PROBLEM

1. When imports have inelastic demand such that rise in their prices does not reduce their demand. I.e. where there is urgent need to import essential commodities, which a country can not do without for example intermediate imports, machinery, spare parts, petroleum products, raw materials etc
2. When the demand for a country's exports in foreign markets is inelastic, such that the quantity purchased remains almost the same even at lower prices
3. When other competitive countries retaliate by devaluing their currencies by the same rate or higher as there would be no advantage gained by devaluation
4. When other countries protect their domestic producers by use of tariffs and non-tariff barriers such as quotas, subsidies etc. this makes devaluation to fail because there would be no room for exportation or exports will become expensive in such countries
5. If the supply of exports is inelastic for example due to structural bottlenecks, long gestation etc leading to failure to increase supply if demand for exports has increased hence no gain is realized as a result of devaluation or when the economy has attained full employment
6. When the country is experiencing inflation as this erodes away the competitive advantage secured by devaluation i.e. the prices of her exports will be high and this leads to less demand for them
7. When there is a decline in world demand for a country's exports for example because of competition from synthetic fibres, adopting of raw materials saving technology etc. it makes devaluation to fail
8. When there is illegal exchange market for example the former Kibanda market where importers can obtain foreign exchange at un official rates
9. When the country is experiencing political instability as this discourages domestic production and supply of exports thus making devaluation to fail to achieve its objectives
10. When there is mismanagement of the policy it will fail. This is because devaluation requires proper management however with no doubt that with high level of corruption and inadequate management in developing countries, the policy of devaluation may no succeed

CONSEQUENCES OF DEVALUATION

NEGATIVE CONSEQUENSES

- ❖ It worsens the BOP problems especially if the demand for imports is inelastic because most of the are essential and the supply is inelastic the foreign exchange expenditure remains higher and the earnings reduce despite devaluation
- ❖ Devaluation leads to smuggling as nationals try to earn high value currencies through smuggling leading to resource out flow
- ❖ Devaluation worsens domestic inflation as it raises the price if imports leading to low standards of living of the people
- ❖ Devaluation leads to high capital outflow as nationals prefer to invest outside the country so as to earn profits from high valued currencies
- ❖ It discourages investments as it leads to an increase in the cost of raw materials and capital goods which retards the process of economic growth and development
- ❖ Continuous devaluation creates uncertainty in foreign exchange market and discourages foreign investors
- ❖ It leads to persistent budgetary deficits because of the government expenditure on imports tends to increase as a result of devaluation
- ❖ Devaluation results in speculation as people begin to hoard foreign currencies in anticipation of higher profits when devaluation occurs in future
- ❖ It affects the low income and fixed income earners whose earnings are eroded by inflation

POSITIVE CONSEQUENSES

- ❖ Reduction of foreign exchange expenditure by increasing the price of foreign exchange
- ❖ Increased export earnings as a result of making exports cheap in other countries
- ❖ It is a tool of correcting BOP deficits in a fixed exchange rate regime
- ❖ It protects local producers by reducing imports this promotes self sufficiency
- ❖ It reduces imported inflation by reducing the inflow of imports
- ❖ It checks on dumping by making dumped imports expensive

EXCHANGE RATE SYSTEM

An exchange rate is the rate or price at which one currency can be exchanged foe another. It is the value of a currency in relation to a another currency in the foreign exchange market eg 1Us$ = shs 1860, 1£ = shs 3250, etc

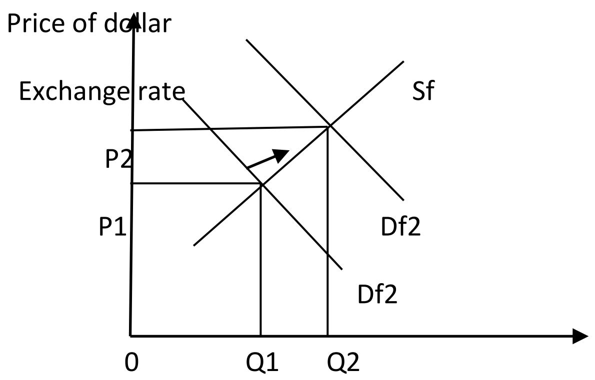
Foreign exchange market is the market where foreign currencies are exchanged at a price which is expressed by the exchange rate

Since rate of exchange is a price like all other prices, it is determined by market forces of demand and supply. The demand for and supply of foreign exchange are composite demand and supply. The demand for foreign exchange is derived from the demand for foreign goods and services

CHANGE IN EXCHANGE RATE

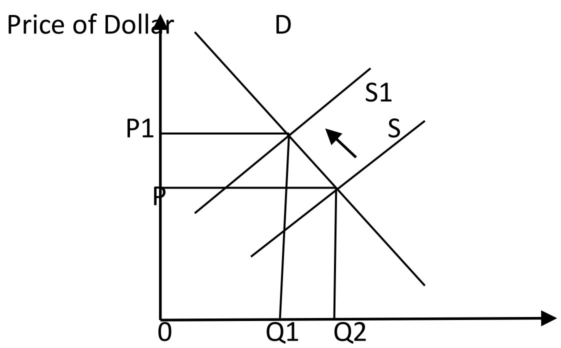
The exchange rate, determined by the market forces, exchanges (increase or decrease) due to changes in the factors which determine the demand for foreign exchange

1) A rise in the domestic prices and cost of production (foreign prices and costs remaining the same) results in increase in the demand for foreign goods and services hence increase in demand for foreign exchange. Consequently demand curves shifts upwards causing a rise in the exchange rate



Quantity of forex (Dollars demanded per time unit)

On the other hand, fall in the export causes left-ward shift in the supply of national currency



Quantity of forex (Dollars demanded per time unit)

The ultimate result of the shifts in demand and supply curves is change in the exchange rate

2) A rise in the real income of a country other factors remaining the same, causes increase in imports which are income elastic. Increase in imports causes increase in demand for foreign exchange currency causing a rise in the exchange rate. The reverse will be true if real income of a country decreases
3) Domestic real income remaining the same, arise in the real income abroad would tend to increase the domestic exports and simultaneously the foreign demand for domestic currency leading to rise in exchange rate

4) If the interest rate in the domestic economy increases in relation to interest rates in the foreign countries, the capital inflow increase and out flow decreases. Consequently, foreign demand for domestic currency increases in relation to domestic demand for foreign currency. This increases the rate of exchange. A fall in the domestic rate of interest will have a reverse impact on the exchange
5) The speculative purchases and sales of foreign exchange in the exchange market also affect the demand for and supply of foreign exchange, resulting in change in exchange rate. The change in exchange rate depends on the effect of speculations behavior on the supply and demand conditions in foreign exchange market

TYPES OF EXCHANGE RATE

a) **FIXED (PEGGED) EXCHANGE RATE**:

A fixed exchange rate system is where the central authority fixes the exchange rate of a currency in relation to other currencies in the foreign exchange market at a specific value or it is where the exchange rate system is where the exchange rate is maintained at a given level by the government. It is not allowed to change in the face of either BOP surplus or deficit. There fore the government has the obligation to buy and sell foreign exchange whenever there is excess supply and demand for foreign exchanges

ADVANTAGES OF FIXED EXCHANGE RATE

I. It provides stability in the foreign exchange rate. Exchange stability encourages international trade thus achieving high economic growth rate
II. It creates conditions for smooth flow of international capital. This is because it ensures a certain return on the foreign investment
III. It eliminates the possibility of speculation, whereby it removes the dangers of speculation activities in foreign market
IV. The fixed rate system reduces the possibility of competitive devaluation of currencies. The possibility has been strengthened by the IMF rules for the member nations
V. It enables people to gain confidence in the strength and value of the domestic currency as there are no likely depreciations and appreciations

DISADVANTAGE OF FIXED EXCHANGE RATE

I. It can lead to misallocation of the scarce foreign resources. This imposes a heavy burden on the financial/monetary authorities in the control of foreign exchange resources and reserves
II. Shortages in international liquidity may result, as monetary authorities Endeavour to minimize fluctuations beyond reasonable limits

III. It can lead to inflation and high social costs. This is because the system could temper with prevailing stable situations of full employment
IV. It requires a lot of foreign reserves in order for it to operate successfully. This could consequently lead to a BOP problem

It may result into either over valuation or undervaluation of the country's domestic currency i.e. over valuation is the official fixing of the exchange rate above its free market rate while undervaluation is the official fixing of the Value of the currency of below its free market rate (equilibrium

TYPES OF FIXED EXCHANGE RATE

- **The gold standards**

This is when a country's unit of currency is valued at specific amount of gold. There are several types of gold standards which include

I. **The gold bullion standard**: this is the exchange mechanism where gold in bullion (bar) form is convertible into paper money for foreign trade only
II. **The gold exchange standard**: This is the exchange rate mechanism which occurs when a country fixes the value of the currency which is in gold standard
III. **Full gold standard**: This is an exchange mechanism where gold coins freely circulate in the economy and paper money is fully convertible into gold

b) **The pegged exchange rate**: this is when the price of a particular domestic currency is fixed in relation to a given foreign currency for example the Ug shs being pegged to the Us dollar and the price of other foreign currencies are determined according to dollar shilling relationship or **This is** is the exchange rate mechanism when a country sets a fixed rate of exchange then guarantees to buy or sell any amount of the foreign currency at this rate or price
- **The adjusted pegged system**: this is a mechanism when the guaranteed exchange rate is fixed but not allowed to vary with in a certain limit i.e. it is not allowed to appreciate with in a certain limit and the government undertakes to buy and sell foreign currencies with in the range
- **The dual exchange rate**: This is when there are two exchange rates fixed with one set for the essential or priority sectors and the other for non- priority sectors or the existence of two official exchange rates in the economy of Window 1 and Window 11

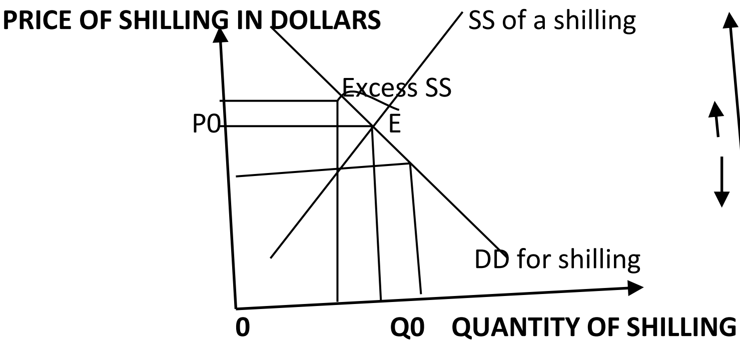
Reasons for dual exchange rate

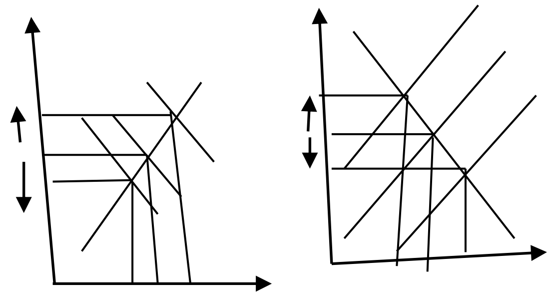
- ***To encourage importation of priority goods***
- ***To discourage importation of luxuries***
- ***To make foreign exchange readily available to all categories of importers***
- **Dirty float/managed flexibility**: this is the exchange rate mechanism when the government allows the forces of demand and supply to determine the exchange rate but still comes in to manipulate the exchange rate

- ❖ **Purchasing power party exchange rate**: this is the mechanism when the exchange rate between two currencies is equated to their purchasing powers

c) Flexible/Free/Floating/Fluctuating Exchange Rate

This is the exchange rate determined by the market forces of demand and supply of foreign currencies without any intervention by monetary authorities





↑ **stands for currency Appreciation**

E is the equilibrium

↓ **stands for currency Depreciation**

The changes in demand and supply conditions can bring about the following:

Appreciation of currency: This is the increase in the value of a currency in relation to other currencies in the foreign exchange market and this is caused by either increase in demand or decrease in supply

Depreciation of the currency: this is the loss of value of a currency in relation to other currencies in the foreign exchange market and it is caused by either the decrease in the demand for the currency or increase in the supply of the currency

MERITS OF FLOATING EXCHANGE RATE

1. It provides large degree of autonomy in respect of domestic economic policies
2. It is self-adjusting and therefore, it does not involve government to maintain on adequate foreign exchange reserve
3. The price of the domestic currency against the foreign currency is free and fair since it is determined by forces of demand and supply thus eliminating inflationary pressure
4. The flexibility exchange program indicates the strength of the domestic currency
5. As compared to the fixed exchange system, it does not require a lot of foreign exchange reserves to be kept by the central bank to defend the currency and the exchange rate
6. There are no rigidities in acquiring foreign exchange
7. It works well under a liberalized economy. The forex bureau supply foreign exchange to meet the private demand
8. It discourages the emergence of parallel or illegal foreign exchange market

DISADVANTAGES OF FLUCTUATING EXCHANGE RATE

1. Floating the currency can permit the transfer of inflation due to highly priced goods and services
2. It encourages speculation among traders, investors and consumers
3. It may increase smuggling of foreign currency, as foreign exchange is sold in un official markets, when the speculators purchase it cheaply and sell them expensively
4. It require closer supervision and monitoring by the authority in order to avoid cartel arrangements
5. It may subject domestic economy to price fluctuations. This makes employment and production difficult as it will lead to uncertainties in international trade, which may discourage trade among nations, capital and financial resource movement
6. It depends on market mechanism and yet this has several defects that may lead to misallocation of resources

d) Multiple exchange rate

This is the exchange rate purchased at different rates/ prices by local currency. This depends on the purpose for which foreign currency is required e.g. the exchange rate would be lower for importers of medicine and higher for importers of luxuries

CAUSES OF FOREIGN EXCHANGE SHORTAGES

a) The prevalent heavy debt burden. There is no doubt that debt repayment has caused foreign exchange scarcity in most of the developing countries
b) Producing of agricultural products for export in raw form, has resulted into low foreign exchange earnings leading to shortage of foreign exchange
c) High capital outflow in form of foreign exchange by foreign investors in LDCs leads to foreign exchange shortages. This is because most of the investors are foreigners and they repatriate all profits earned to their home countries
d) Inadequacy of investments abroad contributes to foreign exchange shortages in Uganda. Most of the developing countries have limited investments in other countries hence when domestic foreign reserves are finished they experience shortages
e) High population growth rates. As population increases, most of the foreign capital resources are usually diverted to sustain the ever increasing population leading to increased expenditure thus causing foreign exchange shortages
f) Existence of large subsistence sector which hardly generate foreign currency because production is meant for home consumption not for sale
g) Political instabilities in developing which limit their foreign exchange earnings because it scares away foreign investors leading to foreign exchange shortage
h) High marginal propensity to import in LDCs leads to excessive foreign exchange expenditure. This is mainly caused by the demonstration effect in these countries where by people prefer imported goods at the expense of locally produced goods

i) Rampant corruption, mismanagement and misallocation of the external resources have further led to foreign exchange shortages. Because even the scarce foreign exchange is being misallocated
j) Protectionism from DCs. DCs tend to restrict goods from LDCs, this limits the demand for Uganda's exports for example, thereby, minimizing her foreign exchange potential
k) Low levels of industrialization in developing nations leads to foreign exchange shortages. This is due to low value added to exports as most them are semi processed resulting in low foreign exchange earnings

HOW TO MINIMISE FOREIGN EXCHANGE SHORTAGES IN LDCS (UGANDA)

1. Embark on export diversification to increase her foreign exchange earnings, to minimize the shortage.
2. Foreign exchange control should be stressed so reduce the out flow of foreign exchange.
3. Where possible, the country should engage in barter trade to minimize the shortage.
4. Investments abroad should be increased to enable the country the necessary foreign currency.
5. Skill development should be emphasized to increase productivity for the export markets, so as to increase foreign exchange earnings.
6. Conducive political atmosphere and incentives should be put in place to encourage foreign investments so as to increase capital in flow in terms of foreign exchange.
7. Import substitutions, Establishment of home industries for goods formerly imported, to reduce imports and maximize foreign exchange expenditure.
8. Improvement on the quality and value of her exports to enable it fetch enough foreign exchange revenue.
9. Developing countries are encouraged to expand on their export promotion industries in abide to sell more export s and earn more foreign exchange.
10. The subsistence sector should be reduced to increase out put for market which could raise the export potential hence acquires adequate foreign exchange.
11. Concerned government should wage war against corruption and embezzlement.
12. Though LDCs have often remained dependent of foreign capital, they should strive to attain self-reliance in order to minimize foreign exchange earnings.

HOW TO MINIMISE FOREIGN EXCHANGE SHORTAGES IN LDCs. (UGANDA)

1. Embark on export diversification to increase her foreign exchange earnings to minimize the shortage. This involves creating a number of economic activities with in the sector i.e. exporting primary and processed products from agriculture, industrial, service sector etc

2. Foreign exchange control should be stressed so as to reduce the outflow of foreign exchange. This is where the government puts regulations to control the foreign exchange like fixing official exchange rates, controlling inflows and outflows of foreign exchange
3. Where possible the country should be engaged in barter trade to minimize the shortages
4. Investments abroad should be increased to enable the country obtain the necessary foreign currency.
5. Skill developments should be emphasized to increase productivity for the export markets so as to increase foreign earnings
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12. Through LDCs have often remained dependent of foreign capital, they should strive to attain self- reliance in order to minimize foreign exchange expenditure

FOREIGN EXCHANGE CONTROL

Exchange control is where the government puts regulations to control the foreign exchange market. Controls may include fixing official exchange rates, controlling inflows and outflows of foreign exchange and prioritization in allocation of foreign exchange

ADVANTAGES OF EXCHANGE CONTROL

1. It establishes the exchange rate and the prices of imports
2. It checks on rampant outflow of foreign exchange
3. It enables the government to allocate foreign exchange to priority areas like fuel, drugs, inputs and security
4. It is used to reduce imports to protect infant industries and reduce balance of payment deficit
5. It reduces importation of un desirable goods and luxuries by allocating them less foreign exchange
6. It maintains the stability of exchange rate by controlling demand and supply of foreign currencies
7. It can be used to control inflation by allocating foreign to importation of scarce commodities
8. It controls money laundering i.e. the inflow of money earned from illegal activities

DISADVANTANGES OF EXCHANGE CONTROL

1. It is costly to administer i.e. many people have to be employed to implement controls
2. It encourages corruption in foreign exchange departments
3. It delays business transactions. Decision making on prioritization of allocation of foreign takes a lot of time
4. It discourages foreign investors who would not be sure they will be allowed to repatriate their earnings
5. It interferes with freedom of choice of residents. People are not free to prioritize the imports, which they need
6. It encourages black market in the foreign exchange market if the controls are not in line with market forces buyers should violate control laws
7. It is difficult to control demand and supply of currencies from different countries
8. The control of foreign exchange inflow limits and delays donor funding of projects and reduces capital inflow from foreign investors

LIBERALISATION OF THE FOREIGN EXCHANGE MARKET

This is where the exchange rate is determined by forces of demand and supply in a competitive market

ADVANTAGES OF EXCHANGE RATE LIBERALISATION

1. Importers can buy foreign exchange freely from forex bureaus
2. Exporters can sell the foreign exchange (which they get from exports) to forex bureau. The gain in turn flows to the farmers who get high prices from their commodities
3. It reduces corruption in foreign exchange allocations
4. Tourism is encouraged because tourists can get the local currency for the use while they are in the country
5. Foreign exchange flows in the country even from goods which are smuggled to other countries
6. It encourages foreign exchange since investors can easily get foreign exchange for importing raw materials and for taking back home
7. It creates many employment opportunities since its forex bureaus employ many skilled Ugandans
8. It reduces the rate of inflation through reducing money supply by the central bank by buying the local currency from banks and forex bureaus
9. It provides government revenue by taxing profits of forex which revenue can be used to provide social services like hospitals, roads and developing other sectors
10. It saves the government from wasting resources to cut down illegal buying and selling of foreign currencies

DISADVANTAGES OF EXCHANGE RATE LIBERALISATION

1. It may lead to underdevelopment of priority sectors like importation of raw materials and drugs due to the competition existing between them and non priority areas like importation of luxuries for foreign exchange
2. It results in profit repatriation where foreign investors take back to their hone countries a big fraction of the profits they make
3. It is difficult to transform the economy since foreign exchange is difficult to direct to vital sectors like agriculture

ECONOMIC INTERGRATION

Economic in tegration is the coming together of countries in a given region so as to promote trade and enjoy economic benefit by working collectively e.g. EAC, European Union, PTA, COMESA etc or economic integration refers to cooperation of several countries for the sake of enjoying economic benefits

FEATURES OF ECONOMIC INTERGRATION

- Free trade among member states
- Common external tariff structure on goods from non-member states
- Free movement of factor services i.e. capital, labour and other resources
- Common policies and ideologies
- So0me times use of a single currency and common budget
- Common geographical boundaries
- Common services run jointly e.g. railways, airways post and telecommunication

OBJECTIVES OF ECONOMIC INTERGRATION

- To promote trade liberalization or free trade amongst member countries
- To increase specialization among the countries and benefits arising from it
- To improve on the welfare or standard of living of the nationals of the countries involved
- To raise the efficiency of the member states
- To attain full employment situation or full capacity utilization of the resources
- To enlarge the market for the products of the member states
- To increase employment opportunities due to free mobility of factors of production in member countries
- To promote close employment ties between member states

FORMS (TYPES/STAGES) OF ECONOMIC INTEGRATION

PREFERENTIAL TRADE AREA: This is the first stage of economic integration where countries give preferential treatment in form of reduced tariffs on selected commodities from member states for example PTA of Eastern and Southern Africa

FREE TRADE AREA: this is where there is free trade among member countries (states) but external tariffs against non-member countries differ among member countries. There is no common tariffs policy on trading with other countries each country is free to set its own tariff rates in trading with non member countries

CUSTOMS UNION: This is a form economic integration where there is free trade among members with a common tariff structure on goods from non member states

COMMON MARKET: This is where there is free trade among member states with a common external tariff structure on goods from non-member countries and also free movement of factor services(with in the region FOP)

ECONOMIC UNION: this is an advanced stage of integration with free trade among member states, with a common external tariff structure on goods from non-member states, free factor flows (movement), harmonized economic and political policies as wells as sharing and running of common services jointly e.g. European Union

Summary of features

- Free movement of goods and services between the member states
- Common tariffs on goods coming from non member countries free movement of FOP among member countries
- Joint economic institutions
- Joint economic planning by member states
- Provision of jointly operated common services such as railways, airlines poster and telecommunications
- Member countries may also use common currency

ECONOMIC FEDERELATION: this is the most advanced stage of economic integration where there is perfect free movement of goods and factors among member countries, there is joint ownership of common services and in addition the member countries operate the same monetary and fiscal policies. The countries in this group are run as one, economically and politically like USA

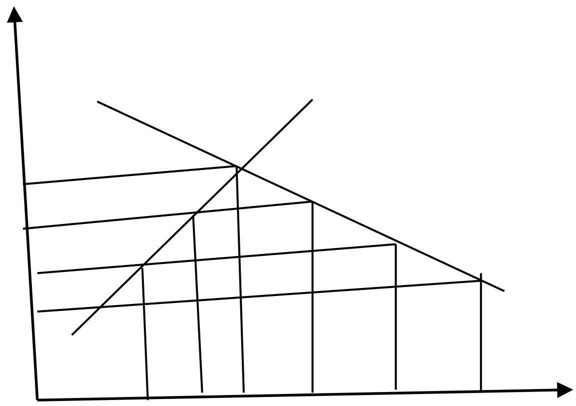
CONDITIONS NECESSARY FOR THE SUCCESS OF ECONOMIC INTEGRATION

1. Geographical proximity of member countries i.e. countries should be geographically close to each other e.g. Uganda, Kenya, Burundi, Rwanda and Tanzania
2. Countries should be at the same (equal) stages of development if they are to enjoy benefits equally

3. Existence of good infrastructure such as roads, railways and tel-communication networks linking member countries
4. Existence of political stability and good investment climate in all member countries
5. Political will and commitment on the part of the political leaders and their citizens
6. Common ideology by members in the region for example free enterprise economies (capitalization) by all member countries
7. Member countries should preferably be of the same size
8. Have common language in the region mainly English and Kiswahili
9. Existence of common currency among the member countries

GAINS/BENEFITS/ADVANTAGES/MERITS FROM ECONOMIC INTEGRATION

1. It promotes trade creation. This is where trade shifts from a high cost non-member trading partner to a low cost member state. As a result of integration there is a shift in the source of imports from a high cost member country to a low cost member country



Before integration, a country like Uganda may be importing a commodity from another country like Sudan which is a low cost producer at price pst (price inclusive of tariffs). A similar commodity can be obtained from Kenya at price pkt inclusive of tariffs. With co-operation between Uganda and Kenya it is possible to obtain the commodity from Kenya at a lower price PF that does not include tariffs. Therefore, we say that integration has led to trade creation

2. It result in expansion of market for a country's goods and services which encourage optimum utilization of resources thus achieving full employment
3. It increases the bargaining power of member countries in the international and commodity markets leading to favorable TOT
4. It promotes political co-operation among member states e.g. in European Union. This leads to political stability in such countries thus achieving faster rate of economic growth and development

5. Sharing and running common services such as railways, airways, poster and tele-communication etc reduces operational costs and leads to economies of scale
6. It enables industries in the region to compete and improve on the quality of output i.e. produces in each nation must become efficient to meet completion of other produces within the regional integration
7. More employment opportunities are created in the region as a result of wider markets which stimulate investment. This increases the earnings of people thus improving their welfare
8. It enables consumers in the region to enjoy a wide variety of goods and services from member states cheaply as a result of abolition of tariffs. This widens their choice and improves on the standards of living
9. It encourages co-ordinated planning, the removal of trade barriers opens up the possibility of the member countries undertaking rational and co-ordinated planning of their industrial decisions i.e. who should produce what and in what quantity. This reduces duplication of industries
10. Administration savings from the elimination of customs officer, border patrols etc for trade among member nations as a result of removing barriers. This reduces government expenditure on administrations
11. Regional economic integration promotes joint research which improves on the quality of produce in member countries
12. It increases access to foreign aid among member countries because at times it is used by donors as a pre-liquisite in order to give assistance to developing countries
13. It increases the availability of commodities and reduces inflation especially during bad seasons when production is poor in some areas
14. Economic integration eases trade due to use of one currency hence there will be no complications in converting currencies thus making trade to smoothly move on

DISADVANTAGES/DEMERITS OF ECONOMIC INTEGRATION

1. It may result into trade diversion i.e. where there is a shift from importing goods from low cost non-member state to a high cost member state when economic integration takes place

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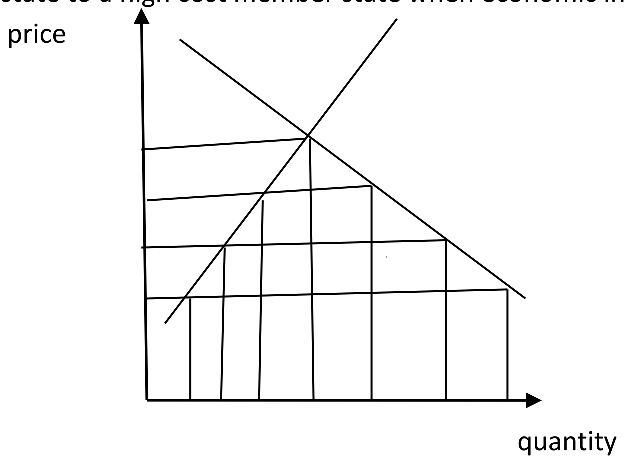

Before integration a country may obtain commodities at price P_n from a lower cost producer, however, as a result of economic integration by removing barriers on goods and imposing common external tariffs the price of the commodity from non member country may rise to P_{tm}. The country is now forced to buy from a member of the union at price p_m which is higher than p_n.

2. Loss of customs revenue: economic integration makes countries to loss customs revenue which would be realized if there is no integration. This is due to removal of tariff barriers among member countries
3. It leads to development of growth poles i.e. movement of goods may de in one direction e.g. one stronger country may dominate the export trade whereas the weaker ones are turned into recipient countries and are impoverished
4. Countries are compelled to buy poor quality goods from member countries instead of importing better quality products from non-member states. This leads to poor standards of living
5. Economic integration result in surpluses of similar products arising from member countries producing the same type of goods which limits trade and results in wastage of resources
6. Economic integration may lead to uneven distribution leading to regional imbalances in development. For example during EAC, many industries were located in Kenya because of transport viability and good infrastructure. There fore Uganda and Tanzania were not benefiting from the integration
7. Free movement of factors of production would lead to competition and un employment in some countries most especially countries with inadequate skilled manpower
8. Less developed countries still have shortage of funds to finance the integration, which leads to reliance on donors who are not always reliable
9. Economic integration may result in loss of political sovereignty where by some strong member countries may end up dominating affairs of other countries
10. Regional integration leads to sacrifice of national interests in favor of the interests of all especially where some countries are at low levels of development

LIMITATIONS OF ECONOMIC INTEGRATION (WEAKENESSES/PROBLEMS/WHY ECONOMIC GROWTH MAY FAIL

1. Trade diversion may make some of the member countries to quit the co-operation
2. Production of similar goods and services by regional member states limit regional specialization. Hence many countries see no value to form or remain in economic integration
3. Differences in the level of development among member countries in the region e.g. Kenya is relatively more developed than Uganda and Tanzania
4. Poor transport and communication net work linking countries in the region e.g. roads, railways etc
5. Political instability within the region e.g. in Uganda, Sudan, DRC, Rwanda etc these civil wars and other conflicts hamper the total co-operation of integration

6. Limited political will to participate in economic integration. Although numerous agreements are made they are not actually implemented at national level
7. Problem of being member to many regional association and organization such as PTA, COMESA, EAC etc. most states are members of not just one but several organizations. These overlaps lead to squandering of resources, conflicts, and inconsistencies etc
8. Economic dependence of many developing countries on the industrialization countries especially the former colonial powers, conflict with idea of regional integration
9. Lack of a common regional currency
10. Fear of unequal distribution of benefits among member states
11. Differences in languages used and this is mainly due to different historical background some use French, others English hence harmonization becomes difficult
12. Differences in ideologies i.e. some believe in capitalism others in socialism

NB outline any four disadvantages of trade diversion

- High prices for the goods
- Low quality goods are offered to the population
- Encourages smuggling in of cheaper commodities from non-member countries
- Discourages unity of member countries
- Low consumption levels
- Loss of government revenue
- Limited variety of commodities

REVISION QUESTIONS

- ❖ Distinguish between trade diversion and trade creation
- ❖ Distinguish between absolute advantage and comparative advantage
- ❖ To what extent is the theory of comparative advantage applicable to developing countries?
- ❖ What are features of an economic union?
- ❖ Under what circumstances may economic integration succeed?
- ❖ Account for increasing need of East African Federation among East African countries
- ❖ How does a common market differ from a customs union?
- ❖ What are the advantages and disadvantages of a common market as a form of economic integration?
- ❖ Assess the role of economic integration in the development of your country
- ❖ Distinguish between economic union and economic federation
- ❖ Explain the objectives of economic integration

UNEB 2004 p1

- Distinguish between floating exchange rate and pegged exchange rate
- State two disadvantages of floating exchange rate
- Distinguish between Free trade area and a custom union
- Examine the merits and demerits of regional cooperation

2004 p2

- Distinguish between trade diversion and trade creation
- Mention two disadvantages of trade diversions

2006 p1

- Distinguish between a custom union and a common market
- Explain the factors which limit economic integration in LDCs

2007 p2

- Distinguish between managed exchange rate and floating exchange rate
- State two advantages of adopting a floating exchange rate
- Explain the reasons for unfavorable TOT in your country
- Suggest measures that should be taken to improve TOT in your country

2008 p1

- Mention any four effects of balance of payments deficit

2008 p2

- Distinguish between currency revaluation and currency undervaluation
- State two effects of currency y undervaluation
- Differentiate between A floating exchange rate and a fixed exchange rate system
- Explain the merits and demerits of foreign exchange control in an economy

2009 p1

- Distinguish between comparative advantage principle and absolute advantage principle
- State any two assumptions of comparative principle

2010

- Differentiate between balance of trade and terms of trade
- State two ways of improving TOT in your country
- State the Vent for surplus theory as used in international trade
- Assess the role of international trade to the development of your country

ECONOMIC PLANNING OR DEVELOPMENT PLANNING

ECONOMIC PLANNING is the deliberate conscious and continuous effort by the government to influence the major economic variables such as savings, exports and imports, consumption etc of a given country to achieve specific objectives over a given period of time.
NB economic development planning is also known as economic planning or development planning
A development plan refers to a written document prepared by the planning authority or government planning agency showing the social and economic goals like improving education and the strategies for achieving those goals within a stated period of time
Economic plan refers to a written document containing government policy decisions on how resources shall be allocated among different uses in order to achieve a specific or targeted rate of economic growth over a given period of time

TYPES OF PLANNING AND PLANS
PERSPECTIVE PLAN/LONG TERM PLAN: this is a plan which covers a long period of time say 10 or more years. An example of such a plan in Uganda is vision 2025

ADVANTAGES OF PERSPECTIVE PLAN/PLANNING

i. It widens employment opportunities in the economy most especially if it catering for all sectors of the economy by setting up various investments
ii. It encourages the development of social and economic infrastructure like constructing roads and rehabilitating them, extending power in different parts of the country etc. This improves on the welfare of people
iii. It may lead to increased level of out put hence promoting economic growth. This is achieved through encouraging savings and investment in the economy
iv. Perspective planning reduces income inequality and its adverse effects like social tension created between marginalized areas and well off areas most especially if it catering for all regions in the country
v. It may improve on the countries level of skills through allocating resources to human capital development in form of educating people, organizing workshops and seminars, providing on job training like in-service education
vi. It results into increased foreign exchange earnings if planning involves export promotion
vii. It ensures proper and better utilization of resources like labour, natural resources etc because of the adequate time provided

PROBLEMS FACED IN FORMULATING A PERSPECTIVE PLAN

i. **I**nadequate data to guide in proper decision making this is caused by poor record keeping in the country. Hence the data given about population growth rate, consumption, savings and government expenditure in inaccurate
ii. Political instabilities or frequent changes in governments. This cal lead to failure of perspective plans since new government may come with new plans yet the already formulated plans are still in the implementation stage
iii. Inadequate trained manpower like planners, implementers, evaluators, and inspectors etc to carry out the plan formulation
iv. Unforeseen economic disturbances like price changes. These affect perspective plans because inflationary tendencies lead to under estimation of costs for plan formulation and implementation
v. Unfavorable natural factors like heavy rains, epidemics like nodding disease, chorella, jiggers etc, landslides. Such catastrophes tend to divert the would resources for perspective plans
vi. Dependence on external influence or resources and such resources are not reliable because at times they come rate, sometimes they do not come at all
vii. Limited government commitment in formulating plans for example inadequate close supervision and monitoring of formulated perspective plans

CLASSIFICATION OF PLANS ACCORDING TO COVERAGE

A partial plan. This is a plan that covers part or section of the economy. It is also known as micro plan or micro planning. Examples include, regional plans, sectoral plans etc

MERITS OF PARTIAL PLANS/PLANNING

i. It expands employment opportunities if resources are allocated to major economic variables like investments, economic infrastructures like power supply etc
ii. It may improve the labour skills in the parts covered most especially in human capital development (education)
iii. It is easy to implement since it requires less finances and resources than a comprehensive plan
iv. It promotes research, innovation and invention in the sector it covers

DEMERITS

i. It may worsen income or wealth inequality since it covers one or few sectors of the economy
ii. It creates political tensions especially when some parts are not included in the plan
iii. It may lead to rural urban migration if it covers only urban areas
iv. It may lead to quicker exhaustion of resources in the parts covered

Comprehensive plan or comprehensive planning. This is a plan that covers all the sectors of the economy. It is also known as macro planning

MERITS

i. It creates more employment in the economy since it is covering all sectors
ii. It widens the tax base because of increased level of economic activities from all sectors catered for by the plan
iii. It ensures efficient utilization of resources and thus increased level of out put
iv. It promotes intersectoral linkages and its advantages for example increased market and balanced growth
v. It reduces income inequality and regional imbalances in development since it caters for all parts of the country

DEMERITS

i. It is not appropriate where the country is large
ii. It is costly to under take since it requires large amounts of funds to cater for the whole economy
iii. It may not efficiently utilize the local resources in different places
iv. It may result in huge losses when some plans fail

Sectoral planning. This is a plan that covers one or few sectors of the economy like education sector. Its merits and demerits are the same as for partial plan

Regional planning. This is planning that covers a particular part or region of the economy with the strategies in the plan suiting the requirements of that region for example Northern Uganda Reconstruction program (NURP), the Karamoja Development Agency (KDA)
Project planning. This is planning aimed at a specific project. Examples include individual projects, rural electrification, dam construction and road contraction

CLASSIFICATION ACCORDING TO TIME PERIOD

Short term plan. This is a plan that covers a short period of time ranging from one to three years. An example is an annual plan, which covers a period of ten or more years

Medium term plan. Is a plan that covers a period of five to ten years
Long-term plan or perspective plan. This is a plan which covers a long period of time for example covering a period of ten or more years

CLASSIFICATION ACCORDING TO SOCIAL ECONOMIC SYSTEMS

a)Indicative planning/capitalist planning. This is planning that involves the government identifying priority areas for resource allocation and provides incentives and conducive atmosphere to the private sector but without directing their decisions

b) Imperative planning or directive or authoritarian planning or socialist planning. This is planning which involves the central authority identifying the available resources and people's needs and prepares or formulates plan to be implemented

Under this we have centralized planning or top to bottom planning and decentralized planning or bottom to top planning

i. **Centralized planning (top-to- bottom planning).** This is planning where the state or central authority determines resource allocation. This is done by determining the prices to be charged and allocation of factors of production among different activities in the economy
ii. **Decentralized planning or bottom-to-top planning.** This is planning at a lower administrative level such as a region, district, country and others. The people in a given area identify their priorities, draw their plans and implement them with assistance from the central authority where necessary

c) Democratic planning: this is planning where the government involves the people at every stage of planning right from the formulation up to the implementation of the plan incorporating ideas of both private sector and government agencies

MERITS OF CENTRALISED PLANNING

1. The central government can easily mobilize foreign resources or foreign aid from donors compared to private individuals. This helps the government to supplement domestic resources thus accelerating the process of economic growth and development
2. It favours or promotes national interests and priorities like improving people's standards of living in the country by creating more employment opportunities
3. It reduces wastage of scarce resources due to their proper planned use. This is because all the resources used are planned by the central planning unit
4. Centralized planning helps to ensure equitable re-distribution of resources or income. This reduces social tensions arising from regional imbalance created by partial planning because the government plans for the whole country
5. It encourages proper coordination in the development of different sectors of the whole economy thus eliminating dualistic tendencies
6. Centralized planning helps to bring economic stability in the country where proper planning influences variables like inflation, employment, and investment. This attracts foreign investors in the country
7. Centralized planning solves the problem inadequate man power at local levels to formulate and implement the plans since it uses the available skilled labour from the parts of the country
8. It brings oneness or forges unity or public participation in the development of the whole economy. This leads to successful implementation of plans since all people support them
9. Centralized planning widens the tax base through promoting economic activities in all parts of the economy. This enables the government to extent social services to people in form of infrastructural development
10. Centralized planning is appropriate where the country is small
11. It ensures consistence of plans leading to their successful implementation

DEMERITS OF CENTRALISED PLANNING

1. It is inappropriate where the country is large due to inadequate resources and under utilization of resources due to wide coverage
2. It may lead to rural urban migration if rural areas are not well catered for in the centralized planning. This can results into high crime rate in urban areas, poor performance of agriculture etc
3. Centralized planning results into delays since it is characterized by red tapes and bureaucracy. This can lead to plan failures
4. Centralized plans do not normally respond to rapid structural changes for example rapid increase ion the demand due to population explosion. This is because such plans tend to be rigid
5. Centralized planning does not adequately cater for the local interests and priorities in the different areas. This can lead to failure of national plans in such areas
6. It is costly to under take since it requires large amounts of funds to cater for the whole country. This can expose the country to huge debts to support such plans
7. It may lead to imbalances in resource allocation where more successful areas or sectors are favoured. This can lead to political instability in the long run
8. Centralized planning reduces participation or commitment of the local people in the implementation of the plans since such plans may not address the needs of local people
9. Centralized planning reduces government revenue since most local tax collectors are not sure of the size of benefit their areas will have from the taxes

10. It may not efficiently utilize the local resources in the different places

MERITS OF DECENTRALISED PLANNING

1. It favours the local interests and priorities of the people thus promoting regional development
2. It promotes the use of the local resources in the area thus saving the scarce foreign exchange
3. It results in more tax revenue since it ensures efficient tax collection as local tax collectors are aware of the benefits they will get
4. Decentralized planning increases employment opportunities in the different areas/regions. This result from the many economic activities catered for by decentralized planning
5. It is appropriate where the country is large since different areas have different needs and priorities
6. It promotes division of labour between the central and local governments or promotes specialization by region. This results in implementation of plan successfully
7. Decentralized planning avoids bureaucratic tendencies associated with centralized planning which can lead to plan failure
8. It reduces rural urban migration and its associated disadvantages to the country like high crime rate, open urban unemployment etc. this is because decentralized planning promotes the development of rural areas
9. Due to limited capital to cater for all regions, there is need for decentralized planning
10. It promotes regional development and competition thus accelerating the process of economic growth and development

DEMERITS OF DECENTRALISED PLANNING

1. Decentralized planning may worsen the problem of income or wealth inequalities or regional imbalances in development. This is because plans may succeed in some areas with skilled manpower and fail in other areas with inadequate or no skilled labour
2. It destroys the power of nationalism (unity) since each region addresses its own problems. This can reduce unity among people and hence some regions may end up suffering in case of disasters like prolonged drought, land slides, epidemics etc
3. Decentralized planning may result into labour migrations from areas with poor development plans to areas with better levels of development to get employed there
4. Decentralized planning leads to loss of government tax revenue to corruption of the local leaders if not monitored
5. It may lead to resource wastage and faster depletion. This is due to over utilization of local resources from one region
6. It reduces the influence of the government in effectively controlling the activities of the economy. This can retard the process of economic growth and development
7. Decentralized planning creates political unrest where unsuccessful regions blame the ruling government for their poor standards of living
8. It may result in delays in plan implementation due to shortage of capital
9. Decentralized planning results in poor quality goods and services in some areas due to shortage of skilled manpower

OBJECTIVES OF PLANNING/RATIONALE FOR PLANNING/THE NEED FOR DEVELOPMENT PLANNING

Why is there need for development planning in an economy or country?

1. To influence the allocation of resources in the most productive activities. Planning helps the government to direct efforts, to gather resources and allocate them appropriately
2. To solicit for foreign aid. Economic plans are used by the government to make convince donors that their money or whatever out put will be put to economic use according to the plans drown
3. To collect the BOP problem. Plans are drawn to correct the BOP problem through enhancing resource utilization for exports and allocating resources to import substitution industries so as to correct the balance of payment deficit
4. To create a balance between the public and private sector. Without planning it becomes difficult to balance the public and private sectors activities meant for development in LDCs. Planning helps to identify public and private responsibilities in achieving development
5. To ensure equitable distribution of resources through creation of employment opportunities in all parts of the country. This can be achieved through comprehensive and centralized planning by investing in sectors that create more employment
6. To mobile support from the public. Plans may reveal future economic opportunities like creating jobs, improving people's welfare which can convince the people to give support to the government. This is common with perspective planning
7. To reduce unemployment problem in the economy. Plans help the government to reduce unemployment specially disguised unemployment caused by poor man power planning which supply labour not demanded in the job market. The government uses plans to influence institutions to produce skills that are only demanded in the job market
8. To reduce wasteful competition thus limiting duplication of goods and services in the economy. This is because what ever is produced is planned
9. To identify investment opportunities. Plans are used to identify areas which are suitable for private and public investment and in Uganda this is done by Uganda investment authority
10. To compare present trends and targets to the future so as to ensure consistence in growth and development. This enables the government to predict the expected growth rate in future
11. To reduce the level of economic dependence or to ensure self reliance in the economy. Through planning the government can formulate targets and strategies of achieving self reliance for example human capital development plans like UPE, USE etc, science education to reduce dependence on foreign expatriates
12. To ensure price stability in the country by availing goods and services to reduce demand pull inflation. The government can also formulate plans intended to reduce or increase on prices of goods and services through price controls
13. To determine and accelerate the rate of economic growth through directing resources to sectors with several linkages

ROLES OF DEVELOPMENT PLANNING IN LDCs
POSITIVE ROLES

1. Development planning helps in the allocation of resources in the most productive activities. Planning helps the government to direct efforts, to gather resources and allocate them appropriately
2. It helps the government to solicit for foreign aid. Economic plans are used by the government to convince donors that their money or whatever out put will be put to economic use according to the plans drawn. Economic plans are also used as a condition by lending institutions like IMF and world bank

3. Economic planning helps the country to collect the BOP problem. Plans are drawn to correct the BOP problem through enhancing resource utilization for exports and allocating resources to import substitution industries so as to correct the balance of payment deficit
4. Economic planning strikes a balance between the public and private sector. Without planning it becomes difficult to balance the public and private sectors activities meant for development in LDCs. Planning helps to identify public and private responsibilities in achieving development
5. It promotes equitable distribution of resources through creation of employment opportunities in all parts of the country. This can be achieved through comprehensive and centralized planning by investing in sectors that create more employment
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12. It ensures price stability in the country by availing goods and services to reduce demand pull inflation. The government can also formulate plans intended to reduce or increase on prices of goods and services through price controls and adequate foreign exchange
13. Development planning accelerates the rate of economic growth through directing resources to sectors with several linkages

NEGATIVE ROLES

1. It destroys an individual or private initiative most especially in case of centralized planning which does not involve individuals in plan formulation, implementation and evaluation. This discourages investments in the economy
2. It promotes inefficiency in production in some parts of the economy for example decentralized planning which can be practiced by some areas with inadequate skilled man power to implement such plans. This can lead to under or production of poor quality goods and services in such areas
3. It promotes political dictatorship that is to say incase of centralized planning which does not involve local people in plan formulation and implementation. This can lead to political instabilities in the country and resentment
4. Planning in form of centralized planning encourages bureaucracy and red tape causing delays and failures of some plans. The many procedures involved in centralized planning can cause unnecessary delays which can lead to failure of such plans

5. It results in wastage of resources if some plans fail yet some resources are already committed to such plans for example the poverty eradication action plan which failed
6. Corruption becomes rampant most especially in decentralized planning by local readers when some companies are competing for tenders
7. It results in poor quality products due to low competition most especially in centralized planning and partial plans
8. It is costly since it involves incurring costs of plan formulation, implementation and evaluation. This can expose the country to external debts

PRINCIPLES OF PLANNING/ELEMENTS OF A GOOD PLAN/QUALITIES OF A GOOD PLAN

i. It should be **comprehensive**, that is should cover all the sectors, regions of the economy
ii. It should be **politically acceptable** by all the people at all levels. This will enable people to participate in its implementation and monitoring
iii. It should be achievable or **economically feasible** that is based on the available resources and prevailing economic situation
iv. It should obey the **principle of optimality**, which requires that a plan should ensure optimum use or allocation of the available resources to meet set targets
v. It should obey the **principle of compatibility**, which emphasizes that planned projects should be able to co-exist or have linkages so that the existence of one project does not hinder the existence of another for example the existence of agriculture modernization should not hinder the plan for environment conservation
vi. A good plan should obey the **principle of sequencing**, which requires that plans should be made such that they follow a specific or definite order with proper timing of the different projects
vii. Consistency. A good plan should be **consistent** i.e. harmonize all sectors of the economy and be well coordinated
viii. A good plan should be **socially desirable** or relevant by directly meeting the needs or demands of the people
ix. **Proportionality**. A good development plan should allocate or apportion available resources to the different projects or sectors according to priority or the most pressing needs
x. A good plan should be **internationally relevant** by taking into consideration the global situations like demands/ requirements of the donors, international market requirements such as quality standards etc
xi. A good development plan should be **easy to understand or interpret and implement** by implementers, monitors and evaluators
xii. It should be **cost effective** that is, the expected benefit should be greater than estimated cost of implementation

REASONS FOR PLAN FAILURES

Account for plan failures in most developing countries (Uganda)

1. The over ambitious plans. LDCs come up with very many big plans which are not attainable, measurable and specific yet the resources for formulating; implementing and evaluating such plans are inadequate thus leading to plan failure
2. Many LDCs lack sufficient capital needed in formulating, implementing and evaluating plans i.e. buying the resources to be used, paying the salary of implementers and inspectors etc
3. The weak political will and support of the population. Most governments in LDCs like Uganda formulate plans and a lot of resources are committed to the formulation state rather than implementation and follow up stages. In addition to that, there is also lack of follow up and participation of the population in formulating and implementing such plans leading to their failure

4. Inadequate skilled man power for plan /weak planning machinery for plan formulation, implementation and evaluation. Most LDCs face the problem of inadequate planners, inspectors, implementers and this is mainly due to high illiteracy rate in these economies
5. The poor state of infrastructure in developing countries like power supply, impassable roads hindering the mobility of implementers, inspectors etc, poor banking system that can mobilize resources. All these account for plan failure
6. The persistent economic instability in most LDCs like inflation and foreign exchange shortages. These affect the implementation, monitoring and evaluation of plans due to under estimation of costs involved most especially in perspective planning which covers a long period. This is because when prices of materials needed in plan formulation, implementation and evaluation increase; it leads to under estimation of costs
7. Hostile climatic conditions like heavy rains, thunderstorm, floods, earthquakes, land slides etc also lead to plan failures in LDCs. This is because they affect some plans like plan for modernization of agriculture, they force such countries to divert the would be resources to such disasters
8. Political instabilities in most LDCs for example in Somalia, Libya, and Sudan etc these affect plan formulation, implementation and evaluation as planners; inspectors are scared by such insurgencies
9. The inaccurate data in most LDCs makes plan implementation and evaluation to fail for example data about population growth rate, quality of labour force, and age and sex composition of the population. This leads to under estimation of costs
10. The external influence or interference from MDCs or international lending institutions like IMF and World Bank. Such lending institutions or developed countries have policies that are contradicting with development plans of LDCs for example retrenchment policy contradicts with the plan of achieving full employment, privatization against centralized planning etc thus making the failure of such plans
11. Failure of external sources of funds also makes some of the plans in LDCs to fail. This is because most of the resources used come from developed countries, they some times come late, and at times MDCs cut off resources without informing these countries while other expected resources do not come at all
12. The high rate of corruption and embezzlement of funds meant for plan formulation, implementation and evaluation. This is a common disease in most LDCs where top government officials misappropriate funds meant for plans to serve their personal interests
13. Presence of a large private sector in LDCs makes it difficult for centralized planning to succeed because most of the plans are opposed by private individuals for example a minimum wage legislation by employers, price controls etc
14. The high population growth rate in most developing countries also makes some plans to fail. This is because the resources which would have been used for plan implementation and formulation are diverted to supporting the ever increasing population
15. Ignorance of people/conservatism in LDCs also makes many plans to fail. This is due to high illiteracy rate and negligence of the government to involve people in plan formulation and implementation

Explain the problems faced in plan formulation

FACTORS INFLUENCING THE EFFECTIVENESS OF ECONOMIC DEVELOPMENT PLANNING OF A COUNTRY

The points must be explained on both sides

The following are the factors influencing the effectiveness of economic development planning:

i. Availability of statistical information or data

ii. The political atmosphere
iii. The political will and support of the population
iv. The economic climate or level of economic stability
v. The degree of corruption/accountability
vi. The level of infrastructural development
vii. Availability of trained manpower
viii. Natural factors like rain fall
ix. Strength of the planning machinery
x. The degree of external influence
xi. The level of population growth rate

Revision questions
Examine the factors that limit effectiveness of economic development planning in LDCs
Why are economic plans more successful in MDCs than in LDCs?
Explain the factors that can lead to successful implementation of plans in an economy

THE PLANNING PROCESS

Planning is supposed to be a continuous process which involves the following major stages

1. Identification of goals and objectives of planning. This involves defining what is to be achieved and when to achieve it
2. Plan formulation. This refers to the setting up of plans where ways of attaining objectives are formulated, taking into account interdependence and conflicts between/among the various activities, programs and projects
3. Plan implementation. This refers to transforming the plan into actual work. It is the practical part of planning where programs and projects are started and evaluated at all stages to make sure that they ate in line with the attainment of the indented objectives
4. Plan evaluation. This is an attempt to find out whether the plan is fulfilling the intended objectives. It takes place at all stages of planning

Plan strategy: this refers to a policy guideline set by the planning authority or central government to formulate and implement economic policies for development purpose
A plan strategy indicates:

i. Formulation of objectives/set objectives
ii. Specific targets
iii. Methods of mobilization of financial resources
iv. The body or personnel responsible for monitoring and evaluation of the plan
v. The implementers

Economic policy: refers to statement of objectives and methods of achieving these objectives by the government, business institutions etc