ECONOMICS PAPER 3 JUNE 2006

1. (a). Explain the characteristics of a free market economy

Detailed explanation of the following characteristics of the free market economy: private individual own the means of production; Freedom of enterprise and choice exist. Self interest; competition among buyers and sellers is a controlling mechanism; market forces and price mechanism:
a) a system of economic organization in which individual persons, singly or in groups, privately own the factors of production and possesses the right to use and dispose those economic resources generally in whatever matter they choose
b) Economic activities will be conducted by managers of firms instead of entrepreneurs freedom of enterprise
c) Requirements :
i) Competition ii) Unlimited use of Wants ; iii) Non-economic institutions have significant bearing in capitalism in its development ; iv) There should be some economic institutions in free market economy - private property - freedom of enterprise and choice ; v) Private Property - right of individual to control property and the right to enjoy the economic rewards that result - government protects owners claims - functions: (1) does not refer to only tangible things (intellectual rights), (2) encourage accumulation of private property - encourages the private savings of private and corporate income (3) inheritance - generational transfer of wealth - separate from but attached to private property - not based on merit
d) Economic Institutions
e) Conditions of Capitalism (perfect competition)
f) political power parallels concentration of economic power
g) competitive system achieves equilibrium prices and quantities in every market by Pareto?

(b) Free market are often viewed as efficient in allocating scarce resources

Why then and with what implications on efficiency, are governments often intervening in economic activities?

Discussion should be bases on role of government in the market economy such as production and distribution of public & merit goods; regulation or control of externalities as way of insuring efficiency in production and consumption
Market Economy: Efficient system making use of the price mechanism; Price changes signals surpluses and shortages; Shortages can cause windfall profits; Gluts incur losses; Reallocation of resource takes place with firms entering profit-making markets and exit loss-making markets
Economic efficiency is attained

- Productive efficiency achieved when goods are produces at lowest achievable cost (Any point on the PPC)
- Allocative efficiency achieved when no one can be made better off without someone being worse off (requires perfect competition and absence of externalities)
- Socially efficient allocation when Social Marginal Benefit = Social Marginal Cost, welfare maximised

Market Failure in Market Economy: Occurs when free markets, operating without any government intervention, fail to deliver a socially efficient allocation of resources to produce goods and services
Sources:
1. Externalities (Either negative or positive)

2. Underproduction of Merit Goods (Goods/services that have been deemed socially desirable and under-consumed through the political process, usually because of external benefits)
3. Overproduction of Demerit Goods (Goods/services that have been deemed socially undesirable and over-consumed through the political process, usually because of external costs)
4. Failure to provide Public Goods (Total Market Failure)
5. Imperfect competition
6. Imperfect Information
7. Immobility of Factors of Production

Correction of Market Failure

Public provision: Public goods; May be extended to merit goods (e.g. education, vaccination)

Market Solutions

1. Taxes
2. Marketable permits
3. Subsidies
4. Identifying Property Rights
5. Regulation
6. Total Ban
7. Nationalisation

2. The manager of a firm selling chocolate and cigattes reads of a government tax review raising indirect taxes across the board. He approaches you seeking advice on the tax implications on the business. With 'sales' and 'tax incidence' in mind, advise the manager on the impact of the tax review on his business.

Discussion should be based on the elasticity implication of the indirect tax on the two goods { chocolate as a luxury and cigarette as an addictive goods} candidates required to explain the definitions of indirect taxes (sales tax) and tax incidence(division of the tax between producers and consumers) on the firm. Demand for chocolate is elastic; the business is likely to bear the burden of the tax while the demand for cigarettes is inelastic and consumers will likely bear the burden.
The firm's view of the tax is that it adds to the cost of production by raising the equilibrium price and reducing quantity demanded of the good.
An evaluated discussion should covered the effects of the tax on revenue and costs of the firms

3. (a) Faced with rising costs, when should a firm close down (i) in the short run (ii) in the long run?

Explanation of the effects of rising cost and the shutdown positions including the definitions of the short-run and long-run. Diagrammatic illustration of the shut-down must be clearly shown for both short run(where price is equal to average variable costs) and long run (where price =average total costs)
When a firm is making a loss, it will have to decide whether to continue production or not. This decision will, in fact, depend on the different total costs levels and whether the firm is operating in the short run or in the long-run. If the firm is in the short run, and is making a loss whereby;

- -Total Costs (TC) is greater than Total Revenue (TR),
- And Total Revenue is greater or equal to Total Variable Cost (TVC),

It is advisable for the firm to continue production. If it fails to achieve these conditions, it is advised to close down so that the only costs the firm will have to pay will be the Fixed Costs (FC). Even if the firm stops producing, it will have to continue to meet the level of Fixed Costs (FC). Since whether the firm produces or not, it will have to pay fixed costs, it is better for it to continue production in an attempt to decrease total cost and increase total revenue, thus making profit. This can be done by;

- ***Increasing Productivity:-*** The most obvious methods involve automation and computerization which minimize the tasks that must be performed by employees. All else constant, it benefits a business to improve productivity, which over time lowers cost and (hopefully) improves ability to compete and make profit.
- ***Adopting new methods of production like just in time or lean manufacturing:-*** In an attempt to reduce costs and wastages.

In the long run, the condition to continue producing requires the price (P) to be higher than Average Cost (AC) i.e. the line representing market price should be above the minimum point of Average Cost (AC) curve. If price (P) is equal to Average Cost (AC), the firm is indifferent between shutting down and continuing to produce. This case is different from the short run shut down case because in the long run, there is no longer a fixed cost (everything is variable).

(b) Discuss the benefit to society of a large firm.

Discussion should focus on the benefit of large scale operation in market structures such as oligopoly, duopoly or monopoly. These may include:

- Economies of scale
- Employment
- Lower costs
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4. Schweppes (Central Africa) and Coca Cola entered into agreement whereby Schweppes (Central Africa) stopped production of carbonated soft drinks ceded this to Coca Cola, while the later ceded to Schweppes (Central Africa) the right to produce fruit juice. This was to remove wasteful competition.

(a) Explain the feature of the market structure in the case above

Explanation of the features of an oligopolistic or duopolistic market structure for the above case. These may include:

- Interdependence
- Indeterminateness of the demand curve
- Conflicting attitude of firms
- Elements of monopoly and competition price rigidity
- Aggressive or defensive marketing methods
- Small number of large firms
- Existence of kinked demand curve
- Lack of uniformity and constant struggle

(b) Discuss the actual advantages and disadvantages to society arising from an agreement between Schweppes (Central Africa) and Coca Cola in the case above.

Discussion should focus on the real advantages and disadvantages to society of such collusion or cooperation as shown by the two firms. These may include for advantages:

- Oligopoly develops the innovations that advance the level of technology, promote economic growth, and leads to higher standards of living.
- The firms are able to take advantage of economies of scale that reduce production costs and prices

  Disadvantages:
  - Inefficiency in resource allocation
  - Concentration of wealth and income

Evaluation should clearly show the merit and demerits of price collusion to society

Collusive Oligopoly

- Firms agree to act together to restrict competition on:
  - price

    - location allocation
- Price is likely to be higher than the market clearing price meaning output/sales are likely to be lower than they might otherwise be
- May not maximise profits, in order to create a more secure environment
- Most efficient firms will be tempted to break ranks by cutting prices, leading to increased market share
- Inherently unstable
- Illegal

5. (a) How does the economic theory explain differences in wages within and across occupations?

Explanation should focus on how economic theory is used to determine wage rates. The MRP theory and the classical theory of supply and demand should be used to explain the difference in wages within and cross occupations.

The MRP theory states that, under conditions of perfect competition, every worker of the same skill and efficiency in a given category will receive a wage equal to the value of the marginal product of that type of labour (ceteris paribus: MP of labour in the industry is the amount by which the output would be increased if a unit of labour was increase). Marginal cost of labour is equal to the wage rate.

Supply and demand theory states that the wages rate is determined interaction of demand and supply of labour at equilibrium.

(b) Discuss how useful economic theory explaining wage differentials in your country

Discussion should focus on how economic theory is useful in explaining wage differential applied to Zimbabwe. Focus could be on the underlining principles on which wages are determined such as:

- Difference in efficiency
- Existence of non-competing groups
- Difficulty of learning the trade
- Collective bargaining
- Future prospects

As compared to the basic economic theories or extent to which economic theory is relevant in the Zimbabwe's wage determination.

Evaluation may include the mention of types of markets, government legislation and institutional factors of critique based on assumptions

6. (a) How is the level of economic activity measured?

Explanation of the three methods or ways of measuring the economic activity.

These are:

Expenditure Approach: This approach looks at the final uses of the output for private consumption, government consumption, capital formation and net of imports & exports. According this approach, GDP is the sum of following four major components: GDP = C+I+G+(X-M)

- Personal consumption expenditure on goods and services,
- Gross private domestic investment,
- Government expenditure on goods and services, and
- Net export to the rest of the world.

- *Income approach.* Add up the *flow of income* received in the same year by everybody involved in the production of these goods and services.

  Income approach

- Determining GDP by adding up all the components of income that arises from the production of that output.
    - Compensation of employees + rents + interests + proprietors' income + corporate profits + taxes on production and imports would equal the National Income.

❖ *The output approach:* Adding-up of all of the contributions to domestic output made by each producing unit in the country (after allowing for stock depreciation). => Sum up the 'value added' by each industry producing a good or service in our economy.

(b) How useful are the measures of gross domestic product and gross national product in indicating living standards in a country?

Discussion should be based use of GDP and GNP as a measurement of standards of living. These include GNP per capita which indicate the overall standard of living of a countries; to measure economic growth; to calculate rate direction in which national income is growing; indicate distribution of factor incomes among wage earners and property owners; assist in formulating domestic policies and assist international economic planning.

Analysis should include limitation of GDP and GNP

Nonmarket transactions:

- Some productive activities don't take place in the market, and as the GDP only measures the market value of output, these activities don't show up in the GDP.
- Thus, GDP understates a nation's total output

Leisure: GDP only takes the market value of output, therefore, LEISURE (paid vacation, holidays, leave time), which shows increase of well-being, satisfaction, and 'psychic income' is excluded in the GDP.

Improved product quality: GDP is a quantitative measure, and thus does not capture the value of improvements in product quality

The Underground Economy ("black market"): Embedded in the economy is a flourishing and productive underground sector

- o Include gamblers, smugglers, drug dealers, etc.
- o However most participants engage in perfectly legal activities, but choose illegally not to report their full incomes and therefore is not counted in the GDP

Understates GDP: GDP and the environment

- The growth of GDP is inevitably accompanied by "gross domestic by-products" (i.e. dirty air, polluted water, toxic waste, congestion, and noise)
- the social cost of the negative by-products reduce our economic well-being.
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7. (a) Explain how a significant investment by a firm leads to a rise in national income

Investment

The influences include:

- *Changes in real disposable income.* If real disposable income is increasing, demand for consumer goods and services is also likely to be rising. This may encourage firms to expand their capacity.

- *Expectations.* Firms are much more likely to invest if they fell optimistic about the future.

- *Capacity utilization* (the extent to which firms are using their capital goods). Firms are more likely to infest if they are currently operating at full capacity.

- *Current profit levels.* High profit levels can encourage investment in two ways. They provide the finance to invest, and they are likely to contribute to firms` optimism about the future.

- *Corporation tax* (a tax on firms` profits). Cuts in tax increase the profit and might increase investment, since more money is left to spend.

- *The rate of interest.* A rise in the rate of interest would be likely to reduce investment for four main reasons. First, it will increase the opportunity cost of investment because the return at the bank is getting higher. Second, higher interest will make it more expensive to borrow. Third, as well as affecting the cost of investment it will also affect the expected return on the investment. Finally, it reduces the demand for shares. This will reduce their price level and so decrease the funds that firms can raise for investment.

- *Advance in technology.* New technology may cause lower **unit cost**, which is the average cost per unit of output.

- *Price of capital equipment.* A reduction in the price of capital equipment may also increase investment. It will become affordable for more firms to buy new machinery.

(b) Discuss the economic factors determining investment in Zimbabwe.
Discussion should focus on the factors influencing investment applied to Zimbabwe

1. *Marginal Efficiency of Capital (MEC) or expected rate of profit:* MEC or expected rate of profit the most important factor affecting private investment. If the business expectations are good or if the MEC is high, more investment will be made. On the contrary, if there is an economic depression in the country or there are bleak prospects of profits, investment will be discouraged. Thus, the fluctuations in investment are mainly caused by the fluctuations in the MEC.
2. *Rate of interest:* The second important factor affecting investment is rate of interest. The rate of interest does not quickly change; it is more or less sticky or constant. Hence, the inducement to invest, by and large, depends on the MEC. For a suitable investment condition, the rate of return or profit must at least equal to rate of interest. So long as the expected rate of return exceeds the rate of interest, investment will continue to be made. In other words, the MEC must never fall below the current rate of interest, if investment is to be worthwhile.
3. *Excess capacity:* There are some other factors that affect investment. Excess capacity is one of them. If a firm has already ‘excess capacity’ and can easily handle increased future demand, it will not go in for further investment in capital equipment.
4. *Technological progress:* Technological progress also affects current level of investment. For instance, a new invention may render the present capital stock of a firm obsolete and adversely affect its ability to compete. In this case, further investment will be called for.
5. *Political and security conditions:* This factor has become one of the major important factors that affect the investment, esp. with reference to under-developed countries including Zimbabwe. Political instability, poor security arrangements and society’s negative attitude towards investment companies can badly damage the investment environment, and the country can be

suffered from poverty and unemployment due to lack of investment. Countries like Kenya, Zimbabwe, Sudan, etc. are the worst victims.

8. **(a) Show how Comparative Advantage Theory justifies trade between countries [10]**

Detailed explanation of how comparative advantage theory determines trade between countries with illustrative examples with PPC diagrams

Nations engage in trade for the same reason that individuals engage in trade—they can both gain from it (e.g., lower prices, more goods and services, more consumer choices, greater competition). A country has a comparative advantage in producing a good if the opportunity cost of producing the good (in terms of other goods it could produce) is less than another country's. This latter concept is the basis for international trade, or the exchange of goods and services between countries. If each country specializes (concentrates its efforts) in the production and export of those goods and services in which it has a comparative advantage and imports from other countries those goods and services in which it does not have a comparative advantage, more can be produced with the world's scarce resources and all countries can benefit from this increased production.

(b) Should your country purse trade on the basis of Comparative Advantage Theory.

Discussion should be centered on comparative advantage theory as basis of trade in Zimbabwe. Candidates are expected take position and may use absolute advantage to justify trade in their country.

Critics of free trade argue that wealthier countries take advantage of low labor costs or low environmental standards in developing countries and merely exploit workers and degrade the environment. Further, specialization, which leads to greater dependence on trade, may leave some countries vulnerable to natural Limitations:

- Due to the law of increasing opportunity cost, a country will lose her CA with increasing specialisation, making complete specialisation not possible in the real world
- Difficult to realise the benefits of specialisation and trade due to factor immobility
- International transport costs can be very high, making it cheaper to produce in the home country than import
- Countries might produce goods without CA due to protectionism
- Sufficient differentiation of similar goods may make the products competitive worldwide disasters or swings in world prices.

9. **Assess the benefits of growth to a developing country such as Zimbabwe**

Assessment of benefits and costs of economic growth applied to developing countries e.g. Zimbabwe

The Benefits of economic growth include:

Higher Incomes,. This enables consumers to enjoy more goods and services

Lower unemployment: With higher output firms tend to employ more workers creating more employment.

Lower Government borrowing: Economic growth creates higher tax revenues and there is less need to spend money on benefits such as unemployment benefit.

Improved public services: With increased tax revenues the govt can spend more on the NHS and education

Money can be spent on protecting the environment

Costs of economic growth:

1. *Inflation*: If AD increases faster than AS then economic growth will be unsustainable. The output gap will narrow causing inflation to increase.
2. *Boom and Bust Economic Cycles*. If Economic growth is unsustainable then high inflationary growth may be followed by a recession.
3. *Balance Of Payments Deficit*: Increased Economic growth causes an increase in

spending on imports therefore causing a deficit
4. Increased economic growth will lead to increased output and therefore increased pollution and congestion. This will cause health problems such as asthma and therefore will reduce the quality of life
5. Higher rates of economic growth have often resulted increased inequality, however this depends upon things such as tax rates and the nature of economic growth

10. The Earth summit brought more consciousness on the environmental impacts of production activities in the world. (a) How do economists deal with the negative environmental impact of production?

The question require a cost – benefit analysis approach to assessment of economic activities and this includes assessment of social and private costs of production; shadow pricing;
The most common external costs arising from production are:

- noise.
- pollution of atmosphere, rivers etc..
- danger to workers and public.
- congestion.

The most common external costs arising from consumption are:

- pollution from motor vehicles.
- litter.
- noise pollution.
- externalities from smoking and drinking alcohol.

External benefits from production and consumption are often grouped together; the following are the most commonly used examples:

- industrial training by firms.
- education which leads to an increase in human capital.
- healthcare.
- knowledge.
- employment created.
- arts and sports.
- neighbourhood watch schemes.

(b) Should industries that pollute the environment close down in the interest of a clean environment?

The discussion should centre on the candidate' application of cost-benefit analysis on production (Cost-benefit analysis (CBA) is a framework for evaluating the social costs and benefits of an investment project. This involves identifying, measuring and comparing the private costs and negative externalities of a scheme with its private benefits and positive externalities, using money as a measure of value.)
Candidates should assess whether there is a net benefit or net cost to allowing them to produce i.e. MSB>MSC.
Evaluation could be on assessment of costs and benefits, or difficulties in implementing costs-benefit analysis

11. The Keynesian approach to unemployment is higher public spending.

(a) How would higher public spending reduce unemployment?

Explanation should be based how fiscal policy may be used to address unemployment:
Tackling unemployment

- Better information about job availability
- Subsidise employment in specific regions or industries

- Increase government spending
- Cut taxation
- Retraining schemes: national, regional and industry-specific
- Intervene in trade by using quotas and tariffs
- Use the exchange rate to boost demand for home-produced products and services
- Incentivise employment by removing low-paid from income tax liability

(b) Discuss the possible solutions to the unemployment in your country?

Measures to deal with unemployment

Employment policy:

- Stimulate spending in the economy - increase people's spending power by cutting taxes, reducing interest rates
- increase labour mobility both in sense of changing profession and geographical – free flow of labour and capital in SADC
- The Training Agency's main aims are concerned with helping the school-leaver and the long-term unemployed by providing training, assisting the education system to become more responsive to the needs of the labour market, and supporting the self-employed and their small firms.

Training policies:

- youth training
- training for work
- the enterprise allowance scheme

Training policies are basically geared towards overcoming mismatch problems between unemployed labour and job vacancies. The aim is to reduce skill shortages and make labour more mobile.

12. Inflation has often been branded "public enemy number one".

(a) Why is inflation viewed as a public enemy?

Explanation of the costs of inflation:

- redistribution of income between different sectors of the economy, including between the poor and the wealthy who are able to protect themselves against the harmful effects of inflation
- discourages savings particularly if real interest rates are low or even negative
- misallocates resources away from productive assets as investors direct their finances towards speculative, non-productive assets
- affects fixed income earners because their real income or purchasing power falls as inflation rises and their nominal income stays the same
- encourages borrowing because future loan repayments will be in inflated currency
- reduces international competitiveness, particularly if the domestic inflation rate is higher than inflation rates overseas. This, in turn, could cause balance of payments problems
- creates investment uncertainty and so businesses are unlikely to commit themselves to capital projects.

(b) Discuss how authorities could reduce inflation in your country.

Discussion should focus the use of monetary and fiscal policies to curb inflation applied Zimbabwe: Monetary authorities aim at reducing and absorbing excess supply of money in an economy. The following are some of the anti-inflationary monetary measures: -

1. The volume of legal tender money may be reduced either by withdrawing a part of the notes already issued or by avoiding large-scale issue of notes.
2. Restrictions on bank credits.
4. Increasing bank rate and other interest rates.
5. Sale of Govt., securities in the open market by central bank.

6. Raising the legal reserve requirements
7. Prescribing a higher margin that bank and other lenders must maintain for the loans granted by them against stocks and shares.
8. Regulation of consumer's credit.
9. Rationing of credit etc.

The following are some of the important anti-inflationary fiscal measures: -

1. Reduction in the volume of public expenditure.
2. Rise in the levels of taxes, introduction of new taxes and bringing more people under the coverage of taxes.
3. More internal borrowings by public authorities.
4. Tariffs should be reduced to increase imports and thus allow a part of the increased domestic money income to 'leak-out'.
5. Inducing wage earners to buy voluntarily Govt., bonds and securities etc.

Thus, Fiscal measures succeed to a greater extent to contain inflation in its own way.

Cost-push (wage-push and profit-push) inflation:

- Government can clamp down on the power of trade unions and/or firms with monopolistic power
- Evaluation:
    - Trade unions can be very powerful, making it difficult for the government to be triangulated with the management and the trade unions.
    - Trade union power threatened by outsourcing in recent years
    - Not feasible to restrain monopolistic multinational companies which are engines of growth to the economy
- Encourage increases in productivity through the retraining of labour / investment grants / tax incentives
- Evaluation:
    - Ensures productivity keeps up with rising wages
    - Difficult to retrain older workers who lack basic literacy and skills and usually have strong inertia to changes and learning

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1. **(a) Explain what is meant by basic economic problem of scarcity**
   Detailed explanation of the economic problem of scarcity (the situation where the limited resources available are unable to satisfy the unlimited human wants). Scarcity leads to choice (3 fundamental choices to make:
   What and How Much to produce: Type and amount, allocation of scarce resources; How to produce: Method of production varies according to aim and resources. Aim to choose most efficient method of production, use resource to fullest; For Whom to produce: Give to those who want products most) and opportunity cost(The cost of any activity measured in terms of the next best alternative foregone).
   The PPF diagram is used to illustrate
   1. Scarcity: Points outside PPC unattainable
   2. Choice: Only one point can be chosen
   3. Opportunity Cost: Downward sloping nature
   4. (Productive) Efficiency: Points on the PPC

(b) Discuss whether the basic economic problem is best solved in the free market economy
Discussion should be based on how the free market economy answers the basic economic questions compared to other economic systems such as mixed economy and planned economy
What to produce?
The **consumption decision** is made in the markets for goods and services. People spend their money on the goods they want most, thus registering votes. Popular goods attract more votes, sell quickly and rise in price. Unpopular goods attract few votes, remain unsold and fall in price. Producers respond to these price changes in order to make profits. They expand the output of popular goods and cut back output of unpopular goods, thus allocating resources in a way consistent with what consumers want.
How to produce?
Producers in competition with each other make the **production decision**. They will produce goods as efficiently as possible to keep their costs to a minimum. This allows them to keep prices low to compete with other firms, and to make maximum profits on the goods they sell.
Who to
The **distribution decision** is made in the markets for factors of production. People own various factors and they sell the services of these factors to producers. The price that they receive for the factors will be their income, which in turn determines how many goods and services they can afford to buy, and hence their share of the economy's output.

2. **(a) Explain the factors that influence the price elasticity of demand.**
   Explanation of the price elasticity of demand:
   The main ***determinants/factors*** which determine the degree of price elasticity of supply are as follows:

   (i) Time period. Time is the most significant factor which affects the elasticity of supply. If the price of a commodity rises and the producers have enough time to make adjustment in the level of output, the elasticity of supply will be more elastic. If the time period is short and the supply cannot be expanded after a price increase, the supply is relatively inelastic.

   (ii) Ability to store output. The goods which can be safety stored have relatively elastic supply over the goods which are perishable and do not have storage facilities.

(iii) Factor mobility. If the factors of production can be easily moved from one use to another, it will affect elasticity of supply. The higher the mobility of factors, the greater is the elasticity of supply of the good and vice versa.

(iv) Changes in marginal cost of production. If with the expansion of output, marginal cost increases and marginal return declines, the price elasticity of supply will be less elastic to that extent.

(v) Excess supply. When there is excess capacity and the producer can increase output easily to take advantage of the rising prices, the supply is more elastic. In case the production is already up to the maximum from the existing resources, the rising prices will not affect supply in the short period. The supply will be more inelastic.

(vi) Availability of infrastructure facilities. If infrastructure facilities are available for expanding output of a particular good in response to the rise in prices, the elasticity of supply will be relatively more elastic.

(vii) Agricultural or industrial products. In agriculture, time is required to increase output in response to rise in prices of goods. The supply of agricultural goods is fairly inelastic. As regards the supply of manufactured consumer goods, it is comparatively easy to increase production in a short period.

(b) Discuss whether the different elasticity of demand concept could be useful to a tobacco farmer.

Discussion of the importance of elasticity concepts applied to a tobacco farmer:
Price elasticity of demand-production planning; helps in fixing the prices of different crops; helps in fixing the rewards for farm inputs and wages; and explains the paradox of poverty in the midst of plenty.
Application of the income elasticity of demand concept-helps in the demand forecasting of the farmer; helps in production planning and marketing; helps in ensuring stability in production.
Application of cross elasticity of demand concept- helps to study the impact of change in the price of a commodity which possesses either substitutes or complementaries; helps in formulating various alternative business strategies to promote different items in the market
Evaluation must be based counterargument on the non-economic determinants affecting the farmer such as draught, floods, politics etc

3. (a) Explain the difference between the economist's and the accountant's definition of profit.

Explanation of the difference between Accounting Profit and Economic Profit—the "profitability" of a firm depends upon which measure of profit we use: *accounting profit* or *economic profit.*

1. ACCOUNTING PROFIT—the difference between total revenues and explicit costs. That is,

- Accounting profit = Total revenue – Total (explicit) costs
- Accounting profit is what most people think of when they hear (or say) the word "profit." There is another measure of profit that has more value in economic analysis

2. ECONOMIC PROFIT—*the difference between total revenue and* explicit and implicit costs. That is, Economic profit = Total revenue – (Explicit costs + Implicit costs)

- Economic profit is usually lower (and never higher) than accounting profit (because economic profit includes implicit costs).
- A firm that just covers its operating costs plus its implicit costs (often thought of as the cost of capital/ownership) is making *zero economic profit.* In economics, a firm that is making zero economic profit is said to be making **NORMAL PROFIT**. Any profit

greater than normal profit (i.e., if the firm is making positive economic profit) is considered to be “excess” profit.

(b) Are profitable firms necessary efficient firms?

4. **(a) Compare and contrast the features of perfect competition and monopolistic competition.**
   Explanation of the difference in comparison between perfect competition and monopolistic competition

Perfect competition	Monopolistic competition
-is a market situation where there are large number of buyers and sellers buying and selling homogeneous products at a single uniform price. There is high degree of competition. There are no selling expenses such as advertising because the product is homogeneous. The firm is taker thus the firm has perfectly elastic demand curve Perfect knowledge Freedom of entry and exist	-is market structure in which a large number of firms produce and sell products that are differentiated but close substitute There is competition among the firms producing close substitutes Firms incur selling cost to promote sales The firm is a price maker and has a downward sloping demand curve Imperfect knowledge Barrier to entry

(b) Discuss whether perfect competition is the most efficient market structure.
Perfect competition is the idealized market structure that achieves an efficient allocation of resources. The conditions of perfect competition, including (1) large number of small firms, (2) identical products sold by all firms, (3) freedom of entry into and exit out of the industry, and (4) perfect knowledge of prices and technology, ensure that perfect competition efficiently allocates resources. This is in fact the purpose of perfect competition: a market structure that illustrates perfection, the best of all possible resource allocation worlds. The real world falls short of this perfection
Perfect competition is used as a yardstick to compare with other market structures (such a monopoly and oligopoly) because it displays high levels of economic efficiency. In both the short and long run, price is equal to marginal cost (P=MC) and therefore allocative efficiency is achieved – the price that consumers are paying in the market reflects the factor cost of resources used up in producing / providing the good or service. Productive efficiency occurs when price is equal to average cost at its minimum point. This is not achieved in the short run – firms can be operating at any point on their short run average total cost curve, but productive efficiency is attained in the long run because the profit maximising output is achieved at a level where average (and marginal) revenue is tangential to the average total cost curve. The long run of perfect competition, therefore, exhibits optimal levels of static economic efficiency. There is of course another form of economic efficiency (P = SRMC = LRMC = SRAC = LRAC)

5. **How far can economic theory explain differentials in wages?**
   Discussion should focus how economic theory may use wage determination to explanation wage differentials
   MRP theory of labour and supply & demand theory are use to illustrate wage differentials.
   <u>Wage Differentials:</u>
   Wages everywhere tend to approximate to the marginal productivity of labour. But, the marginal productivity of labour is different in different employments and grades. It varies with the degree

of scarcity of each kind of labour in relation to the demand for it. Following are the causes of differences in wages in different employments, professions and localities:

(a) Differences in efficiency: that is, differences in education, training, and conditions under which the work is performed.

(b) Existence of non-competing groups: These groups arise because of the difficulties in the way of mobility of labour from low-paid to high-paid employments. These difficulties may be due to geographical, social and economic reasons.

(c) Difficulty of learning a trade: The number of those who can master difficult trades is small. Their supply is less than demand for them, and their wages are higher.

(d) Differences in agreeableness or social esteem: Disagreeable employments must pay higher wages in order to attract labourers. If disagreeable work are performed by unskilled workers, who cannot do anything better, wages may be quite low, e.g., sweepers.

(e) Future prospects: If an occupation provides opportunities for future promotion, people will accept a lower star in it, as against another occupation offering higher initial rewards, but no chances of promotions in the future.

(f) Hazardous and dangerous occupations: generally offer higher emoluments.

(g) Regularity or irregularity of employment: also exerts a strong influence on the level of wages.

(h) Collective Bargaining: The differences in the strength and militancy of trade unions also account for differences in wages in different industries.

Evaluative comments include the recognition that there are other factors (non-economic)

6. **(a) With examples, explain market failure.**

Explanation market failure with examples:

Market Failure in Market Economy occurs when free markets, operating without any government intervention, fail to deliver a socially efficient allocation of resources to produce goods and services

Sources

1. Externalities (Either positive or negative)
2. Underproduction of Merit Goods (Goods/services that have been deemed socially desirable and under-consumed through the political process, usually because of external benefits)
3. Overproduction of Demerit Goods (Goods/services that have been deemed socially undesirable and over-consumed through the political process, usually because of external costs)
4. Failure to provide Public Goods (Total Market Failure)
5. Imperfect competition
6. Imperfect Information
7. Immobility of Factors of Production

(b) Assess the effectiveness of policies used by government to correct market failure.

Critical analysis of effectiveness of policies used to correct market failure:

Correction of Market Failure

Public provision: Public goods; May be extended to merit goods (e.g. education, vaccination); Question of Qty provided; Issue of determination of public demand; Concern about balance in provision of mix of merit and public goods

Market Solutions

1. Taxes: Shifts PMC upwards, Tax should = EMC, Externality internalised

- Advantages: Permits the markets to operate; Ensures firms bear full social costs; Magnitude can be adjusted in response to magnitude of problem; Encourages firms to find alternatives to avoid the tax (e.g. for pollution)
- Disadvantages: Unfeasible to use different tax rates (Too many factors to consider); Lack of knowledge (Measuring external costs and apportioning blame is extremely difficult); If taxes are lower than benefits from production, firms will continue producing (e.g. pollution tax lower than clean-up cost)

2. Marketable permits: Cap and trade system, internalising externalities; Market-based system that places economic value on reducing external costs; Direct const penalty for producing externalities, Immediate economic incentive to reduce them

- Advantages: Establishing market for externalities is effective means of controlling its production through market forces and internalising external cots (higher permit price, greater incentive to reduce externality production)
- Disadvantages: Permits cheaper than reducing externality production would be ineffective; Permits are not effective if externality discharged into common property, difficult to prevent those without permits from producing these externalities; Enforcement is difficult, no way of knowing source of externality produced; Difficulty in determining number of permits to auction off, difficult to withdraw/reduce number of permits

3. Subsidies: Shifts PMC downwards, should = EMB, externality internalised

- Advantages: Permits the markets to operate; Ensures firms pass benefits to consumers; Magnitude can be adjusted in response to magnitude of problem
- Disadvantages: Breeds inefficiency, reduces incentive for firms to stay efficient by finding lowest cost of production; Increase income inequality, difficulty in accurately estimating subsidy to impose due to difficulty to measure level of EMB; Extent of co-payment for merit goods is debatable

4. Identifying Property Rights: Define who owns property, its uses, the rights others have to it, and the transfer of such rights

- Advantages: Encourage R&D (intellectual property rights); Internalise externalities; Reduce need for government to estimate positive/negative externality (Property owner should have better knowledge of property than the government
- Disadvantages: Government my bear the cost of monitoring infringement of property rights; Costs of merit goods may increase due to patent rights, passed on to consumers; Firms may monopolise as a result of possessing intellectual property rights; Difficulty applying IP rights when externality arises from another country; Process of extending rights may be extremely difficult, resulting in overproduction for a long time; Difficult even for property owners to assess value of those rights

5. Regulation: Production limits; Age limits; Regulate monopoly power through marginal/average pricing; Exclusive bus lanes; Bursary grants (to consumer rather than producer)

- Advantages: Simple and easy to understand and administer; May be possible to invoke emergency action; Case-by-case approach may be used; Provision of information to overcome market failure
- Disadvantages: Blunt weapons (single time effect); Regulators bear high investigation costs; Provision of information leads to higher production costs

6. Total Ban: Absolutely zero output

- Advantages: Easier to manage negative externalities using ban; Protects community (especially in the case of harmful drugs)
- Disadvantages: Cost of monitoring entry of banned products may be high; May work against welfare of society (depends on relative size of welfare loss)

7. Nationalisation: Public ownership; Output controlled to take into account of social costs and benefits

- May result in lack of incentive, abuse of monopoly power, bureaucracy, political interference

7. **(a) What is meant by terms commercialization and privatization?**
   Explanation of commercialisation: Commercialisation can be defined as the re-organisation of enterprises, wholly and partially owned by the Government, in which such commercialised enterprises shall operate as profit-making commercial ventures without subvention from the Government. A critical component of the commercialisation programme, the performance contract is designed to govern the relationship between the government and the commercialised enterprise. Under it, the Board and management of the enterprises will guarantee the attainment

of certain levels of financial and operational performance in return for enhanced operational autonomy.

Explanation of privatisation: privatisation means the transfer of government-owned shareholding in designated enterprises to private shareholders, comprising individuals and corporate bodies. Privatisation is an umbrella term to describe a variety of policies which encourage competition and emphasize the role of market forces in place of statutory restrictions and monopoly powers.

(b) Discuss whether privatization leads to efficiency of firms.

Discussion should focus advantages of privatisation may lead efficiency of firms:

Advantages:

- ➢ Revenue for the government – reduces public-sector borrowing requirement. Allows the government to make tax cuts without reducing spending. Revenue might come in from higher corporate tax receipts from the privatized companies
- ➢ Increased competition due to contestable markets and profit motives which translates to Benefits for consumers in the form of lower prices, wider choices and better qualities as X-inefficiency is reduced
- ➢ Increased efficiency and flexibility as private companies are normally more successful in raising capital, lowering prices and cutting out waste. Little governmental interference allows the company to respond to market forces, and make commercially sensible decisions and investments
- ➢ Wider share ownership increases accountability to the public
- ➢ Cost-push inflation is reduced. Private firms are less willing to accept inefficient working practices. Wage raises have to be justified by higher productivity.

Disadvantages:

- ❖ Long term revenue loss – future profits from industries are lost by the state
- ❖ Natural monopolies are best left to the public sector as duplication of services is unnecessary – wasteful and inefficient and not in the best interests of consumers
- ❖ Competition may not increase replacing a public-sector monopoly with a private-sector one does not increase competition as firms are still able to act like monopolists
- ❖ Market forces may not ensure greater efficiency – like before, remaining as private-sector monopolies are likely to earn supernormal profits even if they are inefficient. Large firm size also prevents firms from being taken over
- ❖ Private-sector firms may not act in public interest as they do not take into account negative externalities (like resultant unemployment) and are unlikely to base their output and pricing on social justice and equity

Evaluation should whether the privation may lead to efficiency of firm

8. (a)Explain the differences between gross national product at factor cost and net domestic product at market prices.

Explanation of the difference between GNP at factor cost and NNP at market prices

GNP is the basic national income accounting measure of the total output or aggregate supply of goods and services. It has been defined as the total value of all final goods and services produced in a country during a year. GNP is a 'flow' variable, which measures the quantity of final goods and services produced during a year.	Net national product (NNP) or national income at market price can be obtained by deducting depreciation from GNP. NNP is a sounder measure of a nation's output than GNP, but most of the economists work with GNP. This is so because depreciation is not easier to estimate. Whereas, the gross investment can be estimated fairly-accurately.

Market Price: The value of the output at the shop level/ the prices purchases have to pay for the goods & services sold on the organised market Factor Cost: What the factors of production received for the goods and services produced May diverge due to indirect taxes and subsidies • Indirect taxes raise market price • Subsidies lower market price • GDP (Mkt Price) – Indirect tax + subsidies = GDP (Factor cost) The concept of domestic product is based on the production units located within economic territory, operated both by residents and non-residents.	NNP equals the total final output produced within a nation during a year, where output includes net investment or gross investment less depreciation. Therefore, NNP is equals to: **NNP = GNP – Depreciation** It is the net market value of all the final goods and services produced in a country during a year. Market Price: The value of the output at the shop level/ the prices purchases have to pay for the goods & services sold on the organised market GNP (FC) – Depreciation = NY = NNP(FC) = NNE(FC) = NNI(FC) The concept of national product is based on residents, and includes their contribution to production both within and outside the economic territory.

(b) Is the gross domestic product statistics adequate for measuring changes in living standard within a country?

Question focuses on changes on 'changes in living standards' and within a country. Candidates should explain the use of GDP as measurement of SOF. These are: (a) Clear picture of the economy (b) Promotion of efficiency and stability of the economy (c) Measurement of economic welfare (d) Interrelationship of different sectors of the economy (e) Monetary, fiscal and trade policies

Problems that limit usefulness include that of measurement of SOL using GDP; distribution of income; environmental factors; etc

The main problems or flaws involved in the construction of GDP are as under:

(i) Non marketed items: GDP ignores transactions that do not take place in organized markets. For example, the services performed in the home such as cleaning, cooking, child care, painting of houses by the residents themselves etc., go unrecorded. GDP statistics, thus, understate the true level of production in the country.

(2) Ignores the underground economy: There are certain economic activities that should have been included in the GDP account but they are not shown up because the activity is either illegal or unreported. For instance, a teacher doing tuition work at home but does not declare income to evade taxes. The waiters and waitresses do not report all their tips to avoid paying tax. The profits of illegal trade such as drugs sale etc. also go unrecorded.

(3) Human cost of productions: If GDP increases as a result of people having to work for longer hours and in unhygienic conditions, its net benefit will be less to the citizens of a country.

(4) GDP ignores externalities: When there is industrial growth in the country, its side effects such as pollution of air, water etc., are not taken into account.

Evaluation: GDP statistics are a measure of output of a country and should be primarily seen in this context. However, if a country's industrialists give a high priority on a clean environmental, quality production and relaxed way of life and still increase production, the GDP would be a good measure of economic welfare of its citizens.

9. (a) What is meant by free trade area and economic union?

A well explained description of the terms is expected with examples

{i} free trade area;

In such type of economic integration the countries forming free trade area remove tariff walls amongst each other. However, each country has right to impose tariff against non-member countries imports. In this respect the example of "European Free Trade Area (EFTA) is given which comprised of Austria, Denmark, Norway, Sweden and Switzerland. The EFTA was formed in 1960.

{ii} economic union:

This is such a type of economic integration where in addition to above properties of common market the stress is laid upon uniformity or policies regarding currency credit, government expenditure and taxation. The best example of economic union was "Benelux" whose members were Belgium, Netherland and Luxemburg. Such economic union has nowadays been merged into EC. The EC has also assumed the form of economic union. Its present name is European Union (EU) which is having a common currency by name Euro. Again the members of EU have to unify their economic policies. The economic union is an extreme type of integration; it is not practically possible because it will have the effect of surrendering economic and political independence of member countries**.**

(b) Assess the benefits of free trade to a country.

Assessment of benefits of free trade to a country:

1. If all resources in countries with comparative advantage are diverted into the production of the goods at which they have the lowest opportunity cost then (assuming constant returns to scale) the production will double.

2. Trade allows countries to benefit from more goods and services by specializing in the production of the goods in which they have comparative advantage.

3. Consumers have a wider range of goods at lower prices than they do without trade.

4. Trade enables countries to consume outside their PPF thus expanding the curve.

5. Economies of scale are achieved because countries by specializing may increase output and gain lower unit costs.

6. Efficiency is gained due to international competition which is a motive for countries to become more competitive seeing that now they have to compete at an international scale.

7. Political, social and cultural gains by bringing countries together.

Free trade has the following disadvantages:

i. With the removal of trade barriers, structural unemployment may occur in the short term.

ii. Increased domestic economic instability from international trade cycles, as economies become dependent on global markets.

iii. International markets are not a *level playing field* as countries with surplus products may dump them on world markets at below cost.

iv. Developing or new industries may find it difficult to become established in a competitive environment with no short-term protection policies by governments, according to the infant industries argument.

v. Free trade can lead to pollution and other environmental problems as companies fail to include these costs in the price of goods in trying to compete with companies operating under weaker environmental legislation in some countries.

10. (a) What are the causes of inflation in your country?

Explanation of causes of inflation:

Demand side causes: Increase in aggregative effective demand is responsible for inflation. In this case, aggregate demand exceeds aggregate supply of goods and services. Demand rises much faster than the supply. We can enumerate the following reasons for increase in effective demand.

1. Increase in money supply

2. Increase in disposable income

3. Increase in private consumption expenditure and investment expenditure

4. Increase in Exports

5. Existence of Black Money

6. Increase in Foreign Exchange Reserves

7. Increase in population growth creates increase in demand for every thing in a country.

8. High rates of indirect taxes would lead to rise in prices.

9. Reduction in the rates of direct taxes would leave more cash in the hands of people inducing them to buy more goods and services leading to an increase in prices.

10. Reduction in the level of savings creates more demand for goods and services.

Supply side

Generally, the supply of goods and services do not keep pace with the ever-increasing demand for goods and services. Thus, supply does not match with the demand. Supply falls short of demand. Increase in supply of goods and services may be limited because of the following reasons.

1. Shortage in the supply of factors of production

2. Operation of law of diminishing returns

3. Hoardings by Traders and speculators

4. Hoarding by Consumers

5. Role of Trade unions

6. Role of natural Calamities

7. War. During the period of war, shortage of essential goods create rise in prices.

8. International factors also would cause either shortage of goods and services or rise in the prices of factor inputs leading to inflation. E.g., High prices of imports.

9. Increase in prices of inputs with in the country.

Role of Expectations

Expectations also play a significant role in accentuating inflation. The following points are worth mentioning:

1. If people expect further rise in price, the current aggregate demand increases which in its turn causes a raise in the prices.

2. Expectations about higher wages and salaries affect very much the prices of related goods.

3. Expectations of wage increase often induce some business houses to increase prices even before upward wage revisions are actually made.

Thus, many factors are responsible for escalation of prices.

(b) Assess the effectiveness of policies used to cure inflation.

<u>Critical assessment of the effectiveness of policies used to cure inflation</u>

Supply-Side policies as remedy for Inflation: Cost-push (wage-push and profit-push) inflation: Government can clamp down on the power of trade unions and/or firms with monopolistic power

- Evaluation: Trade unions can be very powerful, making it difficult for the government to be triangulated with the management and the trade unions. Trade union power threatened by outsourcing in recent years; Not feasible to restrain monopolistic multinational companies which are engines of growth to the economy

- Encourage increases in productivity through the retraining of labour / investment grants / tax incentives
    - Evaluation: Ensures productivity keeps up with rising wages; Difficult to retrain older workers who lack basic literacy and skills and usually have strong inertia to changes and learning

Prices and incomes policy: Any form of direct or indirect intervention by the government on wage-price setting with a view to influence the rate of inflation; Operates through AS curve; Includes price controls, price fixing, wage freeze, wage reduction in the public sector; Effective against cost-push inflation only; Can be removed once the target rate of inflation has been achieve and stabilised

- Evaluation: Distorts market forces, expanding sectors will find it more difficult to attract labour, contract sectors will hang on to labour; Initial policy becomes ineffective once restraints are removed as wages and prices resume to unrestrained level; Difficult to enforce in the private sector; May result in black markets; Earnings (Wages + Overtime Pay + Bonuses) tend to rise faster than wage rates; Addition of fringe benefits by expanding sectors to overcome wage restraints may still add to the costs of production of the firms

11. Population is growing faster in developing countries than in developed countries. (a) Describe the characteristics of a developing country.

Explanation of the following characteristics of developing countries:
1. A Dualistic Economy
2. Widespread poverty: a) Income poverty or material deprivation; b) Health and education c) Vulnerability (helplessness) and exposure to risk d) Voiceless-ness and powerlessness
3. Predominance of Agriculture
4. Low levels of Living: a) Low per capita income; b) Other quality of life indicators –Nutrition
5. Pressure of population
6. Low rate of Capital formation
7. Deficiencies in Infrastructure
8. Widespread chronic unemployment
9. Poor quality of Human Resources
10. Low lever of World or Global Competitiveness
11. *Disparities, inequalities and imbalances*

(b) Discuss the implications of population growth for both the developing and developed countries.

Discussion of the implication of population growth for developing countries (increase in unemployment, decrease in SOL) and developed countries (increase in workforce). Population growth can worsen SOL if not matched with increased production. Large strain on economies already suffering from high unemployment. The candidate could argue that developed countries need population growth to provide for workforce that will produce the resources for the ageing population.

Effects of an Over-Populated Country
a) Low per capita GNP.
b) Health hazard.
c) Lack of educational facilities.
d) Housing & slum problems.
e) Air, water & land pollution.

f) Lack of food
g) Traffic congestion
h) Unemployment
i) Less savings as most income is spent on consumer goods.

Advantages of an increasing in population
a) Increase in the market size. More people would need more demand for all kinds for goods & services. It will be possible for firms to specialize in the production of certain goods.
b) Increase in investment.
c) More young people are more willing to move in search for jobs.
d) Facilitates mobility of labour.

Disadvantages of an increasing in population
a) It may lead to a fall in the standard of living. Not enough consumers goods to be purchased since most of the investment will be in capital rather than consumer goods.
b) It can cause more environmental problem. City become crowded & rise of slump areas.
c) Increase pressure on the availability supply of land.
Detailed discussion and evaluative comments should be based on the effects of population growth between the two types of economies

12. (a) What is {i} economic growth :

ECONOMIC GROWTH: economic growth refers to a rise in national or per capita income and product. If a production of goods and services in a country rises, by weather means and along with it average income increases, the country has achieved economic growth.
Economic growth can be either positive or negative. Negative growth can be referred to by saying that the economy is *shrinking*. Negative growth is associated with economic recession and economic depression
Economic growth on the other hand, is a narrower concept than economic development. It is defined as the increase in the value of goods and services produced by every sector of the economy. It is usually expressed in terms of the gross domestic product or GDP of the country. Economic growth is defined by increases in GDP. Whereas, economic development is more of a vague measure usually incorporating social measures such as literacy rates or life expectancy as a means of measuring a country's level of development.

{ii} economic development?

ECONOMIC DEVELOPMENT: economic development implies more, particularly improvements in health, education and other aspects of human welfare. Countries that increase their Income but do not also raise life expectancy, reduce infant mortality, and increase literacy rates are missing out of some important aspects of development. The economic development of a country is defined as the development of the economic wealth of the country. Economic development is aimed at the overall well-being of the citizens of a country, as they are the ultimate beneficiaries of the development of the economy of their country.
Economic development is a sustainable boost in the standards of living of the people of a country. It implies an increase in the per capita income of every citizen. It also leads to the creation of more opportunities in the sectors of education, healthcare, employment and the conservation of the environment.

(b) Assess the effectiveness of policies of borrowing and trade instruments of effecting development in developing countries.

Exchange Rate Policy and Macroeconomic Objectives:

Achieve high growth: Through trade balance

  - Especially pertinent to economies which rely on trade for growth
  - Devaluation of currency raises trade surplus / turns deficit into surplus, allows actual growth

- Through attracting foreign investment
  - Stable exchange rate encourages investments which result in real and potential growth
  - Long Term investor would delay investment if currency is expected to depreciate, but weaker currency makes exports more competitive, ceteris paribus
  - Short Term investor would invest if currency is expected to appreciate, unless short term interest rate falls correspondingly
  - Policy of appreciation need not interfere with capital inflows as these depends on many other factors as well

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1. **(a) Explain how resources are allocated in {i} market economies {ii} planned economies.**
Explanation of how the following three questions of economic problem are answered in the two economic systems:
1. What should be produced in the economy and in what quantities? [It deals with the allocation of resources to make the goods and services in right quantities that society wants with society's limited resources]
2. How should production be organised? [It deals with production, methodology, organization and technology for best outcome.]It determines the way society's limited resources are combined in the production of goods and services]
3. For whom should production take place? [It is the problem of distributing Economic goods and services.]
Planned or command economies:
In a planned economy, the consumption, production and distribution decisions are made by a group of planners appointed by the government/state. The system has the following features
    - All factors of production are owned by the state
    - Planners make decisions to maximise the common good
    - The government plays the central role in the economy

The **consumption decision** is made by planners who collect information on what the economy and its consumers want.
The **production decision** is made by planners who set output targets for firms and allocate resources to them so that these targets can be achieved.
The **distribution decision** is made by planners who can use ration cards and distribution centre to share out the economy's output.
Market economies:
In a free market economy, the consumption, production and distribution decisions are solved by the operation of market forces and the price mechanism. The system has the following features
    - All factors of production are privately owned
    - People make decisions to maximise their own self interest
    - The government does not have a role in the economy

The **consumption decision** is made in the markets for goods and services.
*Producers in competition with each other make the **production decision**.*
The **distribution decision** is made in the markets for factors of production.

(b) Is it truth that true that resources are more efficiently allocated in the market economies than in the planned economies.
Discussion should focus on the comparison of market economies vs planned economies based their efficiency in resource allocation.
Market Economy: Efficient system making use of the price mechanism; Price changes signals surpluses and shortages; Shortages can cause windfall profits; Gluts incur losses; Reallocation of resource takes place with firms entering profit-making markets and exit loss-making markets
1. Economic efficiency is attained; Productive efficiency achieved when goods are produces at lowest achievable cost (Any point on the PPC); Allocative efficiency achieved when no one can be made better off without someone being worse off (requires perfect competition and absence of externalities); Socially efficient allocation when Social Marginal Benefit = Social Marginal Cost, welfare maximised.
Efficiency; Most of their industries are assumed to be perfectly competitive and so allocative and productive efficiency will occur. It makes sense that free market economies allocate their resources more efficiently. Decisions about what to produce are made by the people who will

actually consume the goods. Planners are less likely to make the correct decisions across the whole economy

Choice: Firms will produce whatever consumers are prepared to buy. Remember that the consumer is sovereign. Due to the free enterprise factor, there are no restrictions on what the firms can produce. It is of no surprise, therefore, that there will be a much larger choice of goods and services in a free market economy compared with a command economy. The planner will be more concerned with making sure there are enough essential goods to go around rather than allocating resources efficiently between all goods.

2. (a) Explain {i} constant returns to scale {ii} diminishing returns to scale.

Explanation of terms {i} constant returns to scale

Constant Returns to Scale: For the firm above, economies of scale assure that the larger it becomes, the lower its average total costs get. Efficiency in production improves whether through the lower price of inputs achieved through bulk-ordering, its ability to attract and hire skilled managers, the lower per unit cost of shipping larger quantities of products, or other such benefits of being big. At a certain point, however, the benefits of getting larger begin to diminish. This firm's tenth factory is its *minimum efficient scale:* The level of total output this firm must achieve to minimize its long-run average total cost. Beyond this level of production, as this firm continues to grow, it will see no further cost benefits; in other words, it will achieve *constant returns to scale (size).*

{ii} diminishing returns to scale

The shape of short run costs (MC, ATC and AVC) is determined by the law of diminishing returns. Since short-run costs are determined by the productivity of the variable resource in the short-run (labor), diminishing returns assures that at first, since a firm can expect to get MORE output for additional units of labor (as fixed capital is used more efficiently) ATC declines as output increases. But beyond a certain point, diminishing returns sets in and the additional output attributable to more units of the variable resource declines. Inevitably, a firm will experience higher and higher average costs as its output continues to grow, since it's only able to vary the amount of labor used, not capital.

(b) As firms grow bigger, they enjoy economies of scale. Does this mean that firms should continue to growth?

Discussion should be based on costs and benefits of economies of scale enjoyed by large firms

Are larger firms always more efficient (lower ATC) than small firms? It depends. Large scale production can result in Economies of Scale (falling ATC as output expands), but may eventually result in Diseconomies of Scale (rising ATC as output expands).

Mass production, assembly line production, and specialization results in economies of scale/increased efficiency - e.g automobile production, university education, large farms. Spreading fixed costs of operation over large number of units/students.

However, large organizations can run into Diseconomies of Scale. Bureaucratic procedures, inefficiencies of large organizations, harder to coordinate large organizations, harder to monitor employees, lack of innovation/entrepreneurship, etc.

3. (a) Explain the factors affecting elasticity of supply.

Explanation of Factors affecting Price Elasticity of Supply

The main *determinants/factors* which determine the degree of price elasticity of supply are as under:

(i) Time period. Time is the most significant factor which affects the elasticity of supply. If the price of a commodity rises and the producers have enough time to make adjustment in the level of output, the elasticity of supply will be more elastic. If the time period is short and the supply cannot be expanded after a price increase, the supply is relatively inelastic.

(ii) Ability to store output. The goods which can be safety stored have relatively elastic supply over the goods which are perishable and do not have storage facilities.

(iii) Factor mobility. If the factors of production can be easily moved from one use to another, it will affect elasticity of supply. The higher the mobility of factors, the greater is the elasticity of supply of the good and vice versa.

(iv) Changes in marginal cost of production. If with the expansion of output, marginal cost increases and marginal return declines, the price elasticity of supply will be less elastic to that extent.

(v) Excess supply. When there is excess capacity and the producer can increase output easily to take advantage of the rising prices, the supply is more elastic. In case the production is already up to the maximum from the existing resources, the rising prices will not affect supply in the short period. The supply will be more inelastic.

(vi) Availability of infrastructure facilities. If infrastructure facilities are available for expanding output of a particular good in response to the rise in prices, the elasticity of supply will be relatively more elastic.

(vii) Agricultural or industrial products. In agriculture, time is required to increase output in response to rise in prices of goods. The supply of agricultural goods is fairly inelastic. As regards the supply of manufactured consumer goods, it is comparatively easy to increase production in a short period.

(b) Due to an increase in tourist trade in Zimbabwe, supply of wood carvings increased drastically.

Discuss how the elasticity of supply affects wood carving industry. An increase in tourism may cause an increase in demand which will be matched by increase in the supply of wood carvings. The supply of the good is supply inelastic in the short run and supply elastic in the long run.

The elasticity of supply depends on

1. ***Resource substitution possibilities:*** The easier it is to substitute among the resources used to produce a good or service, the greater is its elasticity of supply.

2. ***The time frame for supply decisions****:* The more time that passes after a price change, the greater is the elasticity of supply.

The magnitude of the cross elasticity of demand depends on following factors:

1. The *closeness of substitutes:*

The closer the substitutes for a good or service is, the more elastic the demand for it.

2. The *proportion of income spent on the good.*

The greater the proportion of income consumers spend on a good, the larger is the demand elasticity for that good.

3*. Necessities and Luxuries*

Necessities, such as food or housing, generally have inelastic demand. Luxuries, such as wood carvings, generally have elastic demand.

4. The *time elapsed since a price change.*

The more time consumers have to adjust to a price change the more elastic the demand for that good.

4. **(a) Describe briefly the main forms of imperfect competition.**

Brief explanation of the main forms of imperfect competition eg. Monopolistic completion, oligopoly and monopoly:

Monopoly is that market form in which a single producer controls the whole supply of a single commodity which has no close substitutes. Monopoly may be defined as a condition of

production in which a person or a number of persons acting in combination have the power to fix the price of the commodity or the output of the commodity. It is a situation where there exists a single control over the market producing a commodity having no substitutes and no possibilities for any one to enter the industry to compete.
Monopolistic competition is a market structure in which a large number of small sellers sell differentiated products which are close, but not perfect substitutes for one another. Under this market, the products produced and sold are different, but they are close substitutes for one another. This leads to competition among different sellers.

(b) Discuss the means by which the government of your country may control the power of monopolies.
Discussion should be based the methods the government uses to control monopolies applied. These may include the following;

- Price regulation e.g. price of goods provided by public utilities;
- Taxation
- Reducing barriers to entry
- Preventing collusion
- Breaking large firms monopolies commission

Evaluation should take into account whether government interfering in the operations of monopolies good or bad when applied Zimbabwe.

5. (a) Using substation and income effects, distinguish between normal and inferior goods.

The effect on the demand for various goods following a price rise as a result of the income effect will depend on whether the good in question is normal or inferior. Following the price rise, real incomes **fall**, so for a normal good the income effect will cause the demand for the good to **fall** (because of the **positive** income elasticity). For an inferior good, the **fall** in real income will lead to a **rise** in the demand for the good as a result of the income effect (because of the **negative** income elasticity).

(b) Discuss why it is not always possible to predict revenue implications of a fall in the price of firm's goods.
Discussion should focus on the effect of price change to Total Revenue and price elasticity of demand

- Total revenue is the price of a good multiplied by the quantity sold
- Total revenue changes as the price of a good changes, but an increase in price does not always mean an increase of revenue
- Looking at the demand elasticity is a good way to determine how a price change will affect the total revenue
- If the demand is elastic, then a rise in price will decrease revenue and vice versa because the buyers' demand will change according to price
- If the demand is unit elastic, then total revenue will never change
- If the demand is inelastic, then cutting the price will not result in an equivalent increase in demand, so total revenue will decrease

By measuring the ratio of percent change in quantity demanded to percent change in price, the price elasticity of demand answers our questions. The result of the ratio is an *elasticity coefficient.* The value of the elasticity coefficient tells us whether demand is *elastic*, *inelastic*, or *unitary elastic*. If demand is elastic, then a change in price causes a proportionally larger change in quantity demanded. If demand is inelastic, then a change in price causes a proportionally smaller change in quantity demanded. If demand is unitary elastic, then a change in price causes a proportionally similar change in quantity demanded

6. **(a) Explain the following terms:**
   Detailed explanation of the terms

- {i} economic rent; -is a payment received by a factor of production over and above what would be needed to keep it in its present value. I.e. it is the amount which someone can earn which is in excess of their transfer earnings (what they could earn elsewhere). It is a demand determined reward to labour and will be earned when labour is to some degree in inelastic supply.
  (Economic) Rent is
  - the part of anticipated return that is not necessary to keep a factor in its current use.
  -the part of anticipated return that can be taken away without affecting its current use.
  - the part of anticipated return over and above the transfer earnings.

  {ii} quasi rent;
  Quasi rent is a surplus earned by investments of production other then land. It is the income derived from appliances and machines, which are the product of human effort. Quasi rent stands for whole of the income, which some agents of production yield when demand for them is suddenly increased. It is earned during a period that their supply cannot be increased in response to increase in demand for them. Hence it is a short period concept. It has also been defined as the excess of total revenue earned in the short run over and above the total variable costs. QUASI RENT = TOTAL REVENUE – TOTAL VERIABLE COST The concept of quasi rent can be understood with the help of an example. At the time of independence of Pakistan, the demand for houses increased due to sudden increase in population but the supply could not be increased due to the scarcity of building material. The abnormal increase in the return on capital invested in capital (building) is quasi rent.

  and
  {iii} transfer earning.

  The amount which factor can earn in its next best paid alternative use called transfer earning. In this sense if the factor is earning above its transfer earnings, the surplus or excess earnings is called economic rent.
  Transfer earnings is
  - the part of anticipated return that is the minimum amount a factor must earn in order to prevent it from transferring to another use.
  -the part of anticipated return that is the minimum amount a factor must earn in order to keep it in its current use.
  -the part of anticipated return that is necessary to keep a factor in its current use.

(b) Does MRP theory adequately explain the pricing of the use of urban land?
Discussion should focus on whether MRP theory of distribution adequately explains rates of urban land:
Marginal Revenue Productivity is the *extra* revenue earned when an additional unit of factor of production is employed. MRP is also subject to the Law of Diminishing Returns. By ***marginal productively theory of a factor*** is meant the value of the marginal physical product of the factor. It is worked out by multiplying the price of the output per unit by units of output.
Formula:
VMP = MP x P
Value of Marginal Product (VMP) = Marginal Physical Product x Price
The marginal productivity theory contends that in a competitive market, the price or reward of each factor of production tends to be equal to its marginal productivity
Land

House land differs to other Factors of Production

1. Fixed supply
2. No initial cost to society

Rent is price determined, not price determining.

Increase in price of land

1. Increase in population
2. Land for industry
3. Transport
4. Agriculture
5. Leisure
6. Tourism

Location of firms and industries

Location factors to be considered:

1. Land
2. Labour
3. Capital and Infrastructure
4. Back up services
5. Government regulations
6. Markets

7. **(a) Explain**

{i} real growth
Thorough explanation of the term: Nominal growth includes price changes and, if there has been any inflation, it exaggerates the measured rate of growth. Clearly, if all prices were to double but output were to remain the same, it is not true to think that we have a hundred percent growth rate!
"Nominal rate of growth" = change in GDP over the year (e.g., 2.9%).
And
{ii} nominal growth.
Explanation of the term: Real growth = GDP minus the rate of inflation; e.g., if inflation is 1.4%, the real growth rate is (2.9 - 1.4) = 1.5%.
Growth as an indicator of the standard of living

(b) Discuss how fiscal and monetary policies may be used to stimulate economic growth.
Discussion should focus on how fiscal and monetary policies may be used to stimulate economics growth:
Fiscal policy is more effective in promoting economic growth by increasing government spending or reducing tax rates, both of which are politically appealing. Here, fiscal policy is more effective than monetary policy. The Central Bank will use monetary policy to lower interest rates and promote economic growth. In recessionary times, people are more reluctant to spend or borrow money, even when rates are extremely low. There is still worry that expansion will not pay off and so people won't borrow the money. At the same time, banks are more reluctant to lend money at the lower interest rate. This is why monetary policy is unlikely to induce economic growth in times of recession, leaving it up to fiscal policy to pick up the slack. Both fiscal policy and monetary policy each serves its own purpose and is most effective in its own way. Monetary policy succeeds in slowing economic growth while fiscal policy succeeds in expanding economic growth. Together the two have the ability to stabilize the economy.

8. **(a) Explain the reasons why government may impose minimum and maximum price legislation. (**

Explanation of the reasons why government may impose minimum and maximum price legislation or Objectives of price controls

- Keep price of good at affordable level
- Support incomes at higher level than market equilibrium
- Stabilise price
- Prevent exploitation by suppliers in times of shortage
  Effective price Floor: Legally established minimum price above the market equilibrium
- Creates surplus
- Government may absorb surplus
- Inefficient allocation of resource (Agricultural produce price floor)
- Unemployment (Minimum wage law)
  Price Ceiling
- Effective price Ceiling: Legally established maximum price below the market equilibrium
- Creates shortage
- Rationing may be needed
- Goods sold on 1st come 1st serve basis
- Inefficient allocation of resource (too little produced)
  May result in Black Market

(b) Discuss the effect, to society, of price controls on goods.
Discussion of the effects of price control on goods to society based on the short run and long run period. Positive effects may include:

- Lower price
- Better access to goods
- Higher standards of living for consumers in the short run
- Suppression of inflation

Negative effects may include:

- Black Market: Sellers ignore government's price restrictions and sell illegally at whatever price equates illegal DD and SS; If all goods are sold in black market, Price = point on DD where Qs intersects, higher than normal equilibrium price; Normally, only some quantity of price controlled good is sold in black market; When Price Ceiling and Black Market co-exist, government will only achieve goal of restricting production, but cannot keep prices down or satisfy notion of equity in the consumption of temporarily scarce commodity
- It target symptoms rather than causes of inflation
- May stimulate further inflation in the long run
- Shortage of goods unfair business practices like conditional selling
- Under the counter trading

9. **(a) Explain the causes of inflation in your country.**
Explanation of causes of inflation applied to Zimbabwe based on the following:
Increase in aggregative effective demand is responsible for inflation.
1 in the level of savings creates more demand for goods and services.
Supply-side :

Generally, the supply of goods and services do not keep pace with the ever-increasing demand for goods and services. Thus, supply does not match with the demand. Supply falls short of demand. Increase in supply of goods and services may be limited because of the following reasons.

1. Shortage in the supply of factors of production
2. Operation of law of diminishing returns
3. Hoardings by Traders and speculators
4. Hoarding by Consumers
5. Role of Trade unions
6. Role of natural Calamities
7. International factors also would cause either shortage of goods and services or rise in the prices of factor inputs leading to inflation. E.g., High prices of imports.
8. Increase in prices of inputs with in the country.

Role of Expectations

Expectations also play a significant role in accentuating inflation. The following points are worth mentioning:

1. If people expect further rise in price, the current aggregate demand increases which in its turn causes a raise in the prices.
2. Expectations about higher wages and salaries affect very much the prices of related goods.
3. Expectations of wage increase often induce some business houses to increase prices even before upward wage revisions are actually made.

Thus, many factors are responsible for escalation of prices.

(b) Should government be concerned with controlling inflation in a country?

Discussion should focus on benefits and costs of an inflational situation in a country and whether it requires government intervention in countries. These are:

Positive side of effects of inflation:

1. Leads to rise in investment
2. Creates better opportunities
3. Encourage entrepreneurship
4. Inflation tax
5. Full utilization of resources:
6. Leads to increase in the demand for money
7. It is a necessary cost of development

Effects on production: 1. Disturbs the working of price- mechanism; 2. adverse effects on investment and production; 3. adverse effects on savings and capital formation; 4. Creates business uncertainty; 5. Reduces production; 6. leads to change in the pattern of production; 7. Leads to hoardings and black marketing; 8. Develops a sellers market; 9. encourages speculative activities; 10. Distortion in resource allocation;

Effects on distribution: 1. leads to unequal distribution of income and wealth; 2. Inflation creates hardships for fixed income earners; 3. Debtors gain and creditors lose; 4. Adverse effects on wage-earners and salaried class; 5. Entrepreneurs and business community gain; 6. Effects on farmers.

(C) Social and political effects of inflation

1. Social effects

D) External effects of Inflation: 1. reduces the volume of exports; 2. Create exchange rate difficulties; 3. Discourage the inflow of foreign capital; 4. Decline in international competitiveness.

10. (a) Explain how import substation works.

(b) Discuss the strategies a country may use to reverse a negative movement on its balance of payment.

There are a number of policy options available to reduce a balance of payments deficit.

- Exchange Rate Adjustment

Devaluation results in expenditure switching. Foreigners buy more of our exports and less of their own and other countries' production, whilst domestic producers buy fewer imports and more domestically produced goods.

The extent to which exchange rates affect exports and imports will depend upon the elasticity of demand for the products and the nature of the contracts that have been agreed.

After a depreciation of the dollar demand for exports will grow faster if the demand for Zimbabwe goods overseas is elastic. However, the depreciation raises the dollar price of imports causing total spending on imports to rise. Export demand will also be inelastic in response to the exchange rate change in the short term; therefore the earnings from exports may be insufficient to compensate for higher spending on imports. The current account deficit may worsen for some months.

Providing that the elasticities of demand for imports and exports are greater than one, in the longer term then the trade balance will improve over time. This is known as the Marshall-Lerner condition

- Demand Management

This is an expenditure reducing policy as aggregate demand falls causing fewer imports to be demanded. This is very effective in the Zimbabwe as we have a very high marginal propensity to import. This can be carried out using either monetary or fiscal policies.

- Monetary policy

Higher interest rates reduce aggregate demand in four ways;

- Discouraging borrowing by both households and companies
- Increasing the rate of saving (the opportunity cost of spending has increased)
- The rise in mortgage interest payments will reduce homeowners' real 'effective' disposable income and their ability to spend. Increased mortgage costs will also reduce market demand in the housing market
- Business investment may also fall, as the cost of borrowing funds will increase. Some planned investment projects will now become unprofitable and, as a result, aggregate demand will fall.

These policies will reduce the demand for imports by households and firms in the Zimbabwe.

- FISCAL POLICY
  - Higher direct taxes (causing a fall in disposable income)
  - Lower Government spending
  - A reduction in the amount the government sector borrows each year (PSNCR)

These fiscal policies increase the rate of leakages from the circular flow and reduce injections into the circular flow of income and will reduce demand for imports.

Supply Side Policies

These should lead to increased exports and reduced imports as the quality of Zimbabwean goods improve whilst they decrease in cost. Examples of supply side policies are:

- changes in size & quality of the labour force available for production
- changes in size & quality of capital stock through investment
- technological progress and the impact of innovation
- changes in factor productivity of both labour and capital
- changes in unit wage costs (wage costs per unit of output)
- changes in producer taxes and subsidies
- changes in inflation expectations - a rise in inflation expectations is likely to boost wage levels and cause AS to shift inwards

11. **To what extent is it necessary, in a modern economy, for government to interfere with the operation of the price mechanism? [25]**

Discussion should focus on the role played by price mechanism as compared to resource allocation using government. The price mechanism enables the community to tackle the fundamental problems of the economy, viz (a) what to produce? (b) how much to produce? (c) how to produce? For whom to produce? And adapt itself to change.

Markets usually work well, ensuring an efficient allocation of resources between different consumption and investment activities;

− however, there are many circumstances in which market forces, left to themselves, will fail to maximise economic and social welfare and, as a consequence, there will be a case for Government intervention.

There are efficiency, equity and ethical arguments for Government intervention:

- though since Government intervention has costs as well as benefits none of them is a sufficient reason for intervention;
- though since Government intervention has costs as well as benefits none of them is a sufficient reason for intervention;
- the existence of public goods, externalities, imperfect competition and imperfect information;
- most relevant to public services such as health and education are externalities, imperfect competition and imperfect information;
- Imperfect information is particularly important not only because it may contribute to imperfect competition, but because it may undermine the efficient functioning of insurance and capital markets on which efficient provision of health care and education depend. As a consequence, health insurance may not be available at any price, for example, for high cost medical conditions of uncertain likelihood;
- there are a range of equity arguments for Government intervention including vertical and horizontal equity; social inclusion and intergenerational equity.
- cash benefits are to be preferred to benefits in kind as a means of redistributing income unless there are merit good, political economy or access arguments for using benefits in kind;
- ethical considerations may also lead to Government intervention. For ideological reasons (beyond the scope of this note), some people may be averse to market provision of health care or to the involvement of profit-making providers. Others may not wish to see markets operating (however economically efficient) in for example human blood, human organs or human embryos.

12. **'An increase in a country's Gross National Product will always lead to an improvement in its welfare'. Discuss the validity of this assertion. [25]**

Discussion should focus on whether an increase in GNP may lead to an improvement in the SOL. The Gross Domestic Product (GDP) of a country is commonly defined as the total market value of all final goods and services produced in a country in a given year. The fact that it is measured regularly and quite consistently in practically all countries of the world allows a direct comparison of the standard of living in individual countries. The frequent measuring also makes it possible to quickly recognize changing trends. For example, it is used to determine whether an economy is growing faster or slower than in the previously measured period and to compare it with other economies in the world. When GDP is calculated in relation to the population of a country, one speaks of the average GDP per capita. This is often used as an indicator of a country's standard of living.

There is thought to be a strong positive correlation between real GDP and economic wellbeing. **Greater production means "the good life". But… there are some shortcomings.**

1. **Non market transactions—**by not counting some kinds of production (homemaker, work done for oneself), we understate the well-being.
2. **Leisure—**the decline of the workweek in terms of hours worked, and the additional of a range of fringe benefits are not accounted for and thus we understate our well-being. The "psychic income" of working is also ignored.
3. **Improved Product Quality—**GDP is a quantitative measure, not qualitative. Improvement in quality over time is not truly measured and well-being is understated, if we are really getting more for our money
4. **Composition and Distribution of Output—**GDP tells us nothing about who gets the goods and services produced, or the "goodness" of the goods and services. A shift to a more unequal distribution of income (rich are richer, poor are poorer) is not reflected in a rising GDP.
5. **Per Capita Output—**if GDP growth is less than population growth, the figures to not reflect a lower well-being.
6. **GDP and the Environment—**"gross domestic byproducts" accompany the growth of GDP. The costs of pollution reduce our well-being; these spillover costs are associated with production, but are not deducted from GDP, overstating our economic wellbeing.
7. **The Underground Economy—**both illegal activities and unreported activities are not reported
8. **Government transfer payments—**are not counted as part of GDP. These are the payments made for Social Security, Veterans, unemployment benefits, and welfare programs like AFDC and Food Stamps. The logic of this is that NO current production is generated. Yet…these sources of income are used to purchase goods and services and hence

ECONOMICS PAPER 3 JUNE 2009

1. **(a) Explain what is meant by allocative efficiency and X-efficiency [10]**

Detailed explanation of allocative efficiency with the aid of PPC diagram:
Allocative efficiency is achieved when the value consumers place on a good or service (reflected in the price they are willing to pay) equals the cost of the resources used up in production.
Allocative efficiency occurs when price = marginal cost, when this condition is satisfied, total economic welfare is maximised.
Pareto defined allocative efficiency as a situation where no one could be made better off without making someone else at least as worth off.
In the perfect competition diagram below, where MC = MR for the firm, we have allocative efficiency because the firm's price *is* the marginal revenue (it can sell any amount at the unchanged price - each extra unit sold at that price provides the marginal revenue), so MC = P. In fact, at that point we have more equalities MC = P
= MR = AR.
Thorough explanation of X- efficiency with aid if a PPF graph:
This kind of productivity exists when we are on the production frontier; this means we are using the least resources possible to produce any given output. This also means that we are at the minimum point on the AC curve. This happens when we are in perfect competition **–** so economists prefer this state and may refer to as it "X-efficiency" **–** it is where we are truly efficient.
Where market equilibrium is efficient, we cannot make someone better off without making someone else worse off

(b) To what extent does government intervention improve efficiency in an economy? [15]

Discussion should focus on extent government improve efficiency in an economy:

Markets usually work well, ensuring an efficient allocation of resources between different consumption and investment activities;
− however, there are many circumstances in which market forces, left to themselves, will fail to maximise economic and social welfare and, as a consequence, there will be a case for Government intervention;

- the efficiency arguments for Government intervention include : the existence of public goods, externalities, imperfect competition and imperfect information;
- the efficiency arguments for Government intervention most relevant to public services such as health and education are externalities, imperfect competition and imperfect information;
- imperfect information is particularly important not only because it may contribute to imperfect competition, but because it may undermine the efficient functioning of insurance and capital markets on which efficient provision of health care and education depend. As a consequence, health insurance may not be available at any price, for example, for high cost medical conditions of uncertain likelihood;
- there are a range of equity arguments for Government intervention including vertical and horizontal equity; social inclusion and intergenerational equity.
- ethical considerations may also lead to Government intervention. For ideological reasons (beyond the scope of this note), some people may be averse to market provision of health care or to the involvement of profit-making providers. Others may not wish to see markets operating (however economically efficient) in for example human blood, human organs or human embryos.
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2. Discuss the benefits to society of changing from a command economy to a market economy. [25]

Discussion may centered on the advantages of a free market economy vs disadvantages of command or planned economy: these includes

Advantages of free market economy:

- Competition in markets promotes an efficient use of resources.
- Competition produces a greater variety of goods and hence more choice for consumers.
- Risk taking and initiative are encouraged by the profit motive, and these are likely to promote economic growth.
- The price mechanism adjusts quite quickly to changing economic conditions so that resources are not wasted producing unwanted goods or being unemployed.

Disadvantages of planned economy:

- Resources used in planning are not available to produce goods and services to satisfy wants.
- Planners may get the plan wrong causing gluts and shortages of goods.
- Once in operation it is difficult to adjust the plan to cope with changing economic conditions.
- There is limited choice and variety of goods for consumers.
- There is little incentive to work hard or to take risks because the state owns all resources and planners decide on the distribution of goods. The economy is likely to grow more slowly and technology may lag behind others.
- Planners may be corrupt in their decision making

Evaluation may also focus of Problems of transition from planned to a free market economy such as: Falling growth; Lack of legal institutions; Lack of financial resources; High unequal distribution.; Corruption at highest level; High inflation rates and falling exchange rate; Development of Barter economies.; Black markets and organised crimes; Increased unemployment and falling demand for domestic goods.; Lack of necessary funds

3. (a) Explain the factors that influence the price elasticity of demand for a product. [10]

Definition of price elasticity of demand as degree of responsiveness of quantity demanded to a change in price accompanied by formula

Detailed explanation of the factors influencing price elasticity of demand: i.e.

- Nature of the commodity
- Existence of substitutes
- Number of uses for the commodity
- Durability and reparability of commodity
- Possibility of postponing the use of a commodity
- Levels of income of the people
- Proportion of expenditure on the commodity habits
- Period of time
- Existence of complementary goods

(b) Discuss the relevance of elasticity concepts to a farmer. [15]

Discussion of the importance of elasticity concepts applied to a farmer:

Price elasticity of demand-production planning; helps in fixing the prices of different crops; helps in fixing the rewards for farm inputs and wages; and explains the paradox of poverty in the midst of plenty.

Application of the income elasticity of demand concept-helps in the demand forecasting of the farmer; helps in production planning and marketing; helps in ensuring stability in production.

Application of cross elasticity of demand concept- helps to study the impact of change in the price of a commodity which possesses either substitutes or complementaries; helps in formulating various alternative business strategies to promote different items in the market

Evaluation must be based counterargument on the non-economic determinants affecting the farmer such as draught, floods, politics etc

4. (a) Explain

Explanation of the terms with illustrative examples

{i} horizontal merger;

A horizontal merger is a merger between two competitors. Suppose, for example, that tomorrow Pepsi were to buy Coca-Cola. This would be a horizontal merger.

Horizontal mergers may negatively affect the competitive situation in an industry. Therefore, they frequently run afoul of regulatory officials. A horizontal merger often increases the degree of concentration in an industry. **{ii} lateral merger;**

A lateral merger is a union of two companies that a.) are not competitors, and b.) not part of the same supply chain. If Microsoft were to purchase a fast food chain, this would be a lateral merger. Software has no relationship to fast food; fast food has no connection to software (other than providing sustenance for programmers who work long hours.)

Causes of lateral merger are believed to include efficiency, financial, competition, growth, economies of scale motivation. These diversifications do have implications for conduct and hence market performance e.g. a large firm may have the potential to engage in predatory pricing to eliminate competitors in some markets because it can subsidize its losses in those markets with earnings from other markets.

and {iii} vertical merger. [12]

A vertical merger occurs when a supplier buys a reseller, or vice versa. The key point is that the two companies have a buyer-seller relationship.

Suppose that a jewelry retailer purchased a company that manufactures jewelry. This would be a vertical merger. Or, suppose that a pharmaceutical company acquired a drugstore chain. Vertical mergers are more likely to be approved by regulatory authorities. Consumers can benefit from the increased efficiencies that result from supply chain integration--- often in the form of lower prices and/or better service.

(b) Discuss the benefit of a big firm to society. [15]

Discussion of the benefits of big firm (existing as oligopolies and monopolies) should focus on their advantages and disadvantages to society. These are:

Advantages of large firm

(a) Control over distribution: A large firm is in a position to choose the distribution channels because of the popularity of its products. It can even open its own retail depots and provide goods to the customers at lower prices. It can also provide after sales services, home delivery and other services to the customers.

(b) Services of experts: A larger firm can appoint talented sales personnel to organize various areas of marketing.

(c) Advertising: A large firm can spend sizable amounts on advertising because of its higher capacity. Sine production is carried on a large scale, advertisement and other sales promotions activities will prove to be economical.

(d) Competition: A large firm can meet competition in the market by quoting competitive prices, carrying on competitive advertising and so on.

(e) Economy in selling: A large firm sells a number of product lines in large quantities it can have its own brand names and can popularize them. Because of large scale distribution overheads per unit are comparatively less as compared to a small firm.

Disadvantages:

(i) Large firms tend to be bureaucratic in administration.

(ii) There is lack of personal contact with the customers.

(iii) There are greater business risks because of huge investment. A large firm cannot easily adapt itself to a new technology because of the high cost involved in changing form one technique to another.

(iv) There may be problems of effective coordination and control.

(v) There may be difficulty in getting talented personnel to man various positions

5. (a) Explain the difference between oligopoly and monopoly. [10]

Detailed explanation of the main differences between oligopoly and monopoly:

Oligopoly and monopoly have some similarities, both tend to be relatively large and possess significant market control, but also have a few important differences; oligopoly market has more than one firm. The dividing line between oligopoly and monopoly, however, can be blurred due to the closeness of substitutes and the inclination of oligopoly firms to collude.

Oligopoly is a market structure containing a small number of relatively large firms that often produce slightly differentiated output and with significant barriers to entry. Monopoly is a market structure containing a single firm that produces a good with no close substitutes and with significant barriers to entry. While it might seem as though the difference between oligopoly and monopoly is clear cut, such is not always the case.

A comparison between these two market structures is bound to be illuminating.

- One or Few: The primary difference between oligopoly and monopoly is that monopoly contains a single seller, whereas oligopoly has two or more sellers. Such a difference might seem to provide a clear separation. But not necessarily.
- Substitutes: In some cases, the difference between oligopoly and monopoly is blurred by the closeness of substitutes. A monopoly produces a good with NO close substitutes.
- An oligopoly firms produces a good with a small number of relatively close substitutes.

(b) Discuss the view that oligopoly is a more beneficial market structure to society than monopoly. [15]

Discussion should be based comparison of benefits and costs to society between oligopoly and monopoly

Benefits include:

• Price stability-Price does not change much (until we get a price war!).

• There is fierce competition to improve the product in order to increase the demand for one's own output - so we may see fast technical change, great dynamism and much R & D effort.

• "Countervailing Power" - if a single monopoly is bad (as we feel), then a few more competing firms can stand up against it, so the situation has to be better.

• The size of firms is usually larger – this means they can reap economies of scale

The disadvantages of Oligopoly

• An oligopoly restricts output where it can, so less is produced than could be, and at higher position on the cost curve.

• Price is higher than if the firms in the market were perfectly competitive.

• Collusion to try to establish a cartel and behave like a monopoly is likely; if successful, we get all the problems of monopoly.

• Price wars may emerge, perhaps caused by new entrants, or the existing firms reduce price because they fear the high price might attract entrants.

• There may be wastes (for society) of high advertising costs, or offers to consumers of free trips or lotteries. These are not cheap to run and use real resources.

• We may get bribery or other pressure on, government to keep or establish Marketing Boards or other devices of restriction.

• There is a time and energy waste involved when firms are forced to watch rivals, try to guess their likely innovations, or whether they will react to what the first firm did.

• Industrial espionage and other illegal acts may be promoted. Some firms are reputed to pay people to search the waste bins of their rivals!

• Employment is restricted, because an oligopoly keeps output down.

• Uncertainty levels are increased; this is generally felt to be bad thing.
Evaluation should also focus on the weakness of monopolies. These include the following:
• It limits output and keeps price high - as just said. Really this means that a monopolist misallocates (and misuses) resources.
• This behaviour of the monopolist redistributes income from all the consumers of the product (they are paying more than they need) to one firm or person (the monopolist). This is an equity issue.
• A monopolist may develop political and social power over others which reduce the efficiency of democracy and the amount of equity. There is a strong political danger from a very few rich and powerful people emerging and changing the course of events.
• A monopolist may behave badly in an anti-social way. For instance, he or she may force out a potential rival firm by selling at give-away prices (well below cost). After they have forced out the honest competitor, they will put the price back up again.
• Lack of competition tends to encourage inefficiency in the firm. The monopolist tends to rest on his laurels, has no need to try hard, and lacks dynamism – *this is probably the main criticism* - said Austin Robinson.
• As a result, we can get the emergence of lazy managers and owners.
• And it may mean that technical progress is slow, leading to slow growth of the country as a whole, and a lower standard of living than we could enjoy.
• A monopoly breeds inefficiency which means that the cost curves will be higher than they need be; this means that the intersection of MC and MR may be higher.
• Resources are misallocated - too many are going to the monopolist who does not fully use them. This is a waste for society. It really means that the price mechanism is prevented from working efficiently.

6. (a) With reference to the labour market, explain the following:

Detailed explanation of the terms

- {i} economic rent; -is a payment received by a factor of production over and above what would be needed to keep it in its present value. I.e. it is the amount which someone can earn which is in excess of their transfer earnings (what they could earn elsewhere). It is a demand determined reward to labour and will be earned when labour is to some degree in inelastic supply.
(Economic) Rent is
- the part of anticipated return that is not necessary to keep a factor in its current use.
-the part of anticipated return that can be taken away without affecting its current use.
- the part of anticipated return over and above the transfer earnings.

{ii} quasi rent;

Quasi rent is a surplus earned by investments of production other then land. It is the income derived from appliances and machines, which are the product of human effort. Quasi rent stands for whole of the income, which some agents of production yield when demand for them is suddenly increased. It is earned during a period that their supply cannot be increased in response to increase in demand for them. Hence it is a short period concept. It has also been defined as the excess of total revenue earned in the short run over and above the total variable costs. QUASI RENT = TOTAL REVENUE – TOTAL VERIABLE COST The concept of quasi rent can be understood with the help of an example. At the time of independence of Pakistan, the demand for houses increased due to sudden increase in population but the supply could not be increased due to the scarcity of building material. The abnormal increase in the return on capital invested in capital (building) is quasi rent.

and

{iii} transfer earning.

The amount which factor can earn in its next best paid alternative use called transfer earning. In this sense if the factor is earning above its transfer earnings, the surplus or excess earnings is called economic rent.
Transfer earnings is
- the part of anticipated return that is the minimum amount a factor must earn in order to prevent it from transferring to another use.
-the part of anticipated return that is the minimum amount a factor must earn in order to keep it in its current use.
-the part of anticipated return that is necessary to keep a factor in its current use. **[12]**

(b) Discuss the extent to which trade unions contribute to wage differential in your country. [13]
Discussion should focus on ability influence wage differential applied in Zimbabwe:
- ➢ wages differential among occupation depend on following:
- ➢ Nature of the work. Is it dangerous or not?
  b) Difference in educational qualification.
  c) Members of trade union.
  d) Number of working hours.
  e) Gender discrimination. Male or Female.
  f) Level of talent of the employee.
  g) Satisfaction of a person.
  h) Fringe benefit. E.g.: Not only get the wages but also can travel to other places for free.
- ➢ Reasons for wage differential for same occupation
  a) Maternity leave for female.
  b) Level of responsibility.
  c) Nature of occupation. E.g.: Same jobs are only allow women.
  d) Lack of training
- ➢ Reasons for wage differential between urban and rural areas
  a) High level of training in urban areas.
  b) Higher cost of living in urban areas
- ❖ Methods to raise wages
  a) The trade union has to work on the market forces of demand for and supply of labour to influences wage rate. To raise wages, it can either restrict supply of labour or increase demand for labour.
- ❖ Factors that limits to power of Trade Union
  a) The size of the trade union can affect the demand for higher wages.
  b) Changes in the elasticity of demand for a firm's good.
  c) Profits will be reduced when cost of production increases.
  d) Economic condition
  e) Trade Union will be less successful if labour substituted easily with capital or machinery.

7. (a) Explain what is meant by market failure? [10]
Explanation of Market Failure in Market Economy
Occurs when free markets, operating without any government intervention, fail to deliver a socially efficient allocation of resources to produce goods and services
Sources
1. Externalities
2. Underproduction of Merit Goods (Goods/services that have been deemed socially desirable and under-consumed through the political process, usually because of external benefits)
3. Overproduction of Demerit Goods (Goods/services that have been deemed socially undesirable and over-consumed through the political process, usually because of external costs)

4. Failure to provide Public Goods (Total Market Failure)
5. Imperfect competition
6. Imperfect Information
7. Immobility of Factors of Production

(b) Microeconomic objectives are not always consistent and may sometimes conflict. Discuss whether government's microeconomic policy of efficiency and equity can be achieved at the same time in your country. [15]

Discussion should focus on whether government's microeconomic policy of efficiency and equity can be achieved at the same time applied in Zimbabwe

Explanation of the conflict between microeconomics objectives: There is often a trade-off between economic efficiency and equity. Efficiency means that all goods or services are allocated to someone (there's none left over). When a market equilibrium is efficient, there is no way to reallocate the good or service without hurting someone. Equity concerns the distribution of resources and is inevitably linked with concepts of fairness and social justice. A market may have achieved maximum efficiency but we may be concerned that the "benefits" from market activity are unfairly shared out

- Efficiency: Efficiency is achieved when society is able to get the greatest amount of satisfaction from available resources. With efficiency, society cannot change the way resources are used in any way that would increase the total amount of satisfaction obtained by society. The pervasive scarcity problem is best addressed when limited resources are used to satisfy as many wants and needs as possible.
  While efficiency is indicated by equality between demand price and supply price for a given market, there are no clear-cut comprehensive indicators for attaining this efficiency goal. While it is possible, in theory, to pinpoint what is needed for efficiency, the complexity of the economy makes the task difficult to accomplish in practice.
- Equity: Equity is achieved when income and wealth are fairly distributed within a society. Almost everyone wants a fair distribution. However, what constitutes a fair and equitable distribution is debatable. Some might contend that equity is achieved when everyone has the same income and wealth. Others contend that equity results when people receive income and wealth based on the value of their production. Still others argue that equity is achieved when each has only the income and wealth that they need.

8. **To what extent does the comparative advantage theory determine trade flows in your country?**
   The theory predicts that gains will arise from trade in line with a country's comparative advantage. Candidates may outline a pattern of trade e.g. exports of primary produce, reliance on tourism, export of manufactures, import of capital goods etc. for their economy and relate this to the country's factors of production. They may challenge the theory on the basis of its assumptions (no transport costs, 2 countries, mutual demands etc.) or on 'real world' problems e.g. unequal trade arrangements, obstacles to trade, inability to exploit resources etc.
   Weaknesses of the comparative advantage theory are
   - Due to the law of increasing opportunity cost, a country will lose her CA with increasing specialisation, making complete specialisation not possible in the real world
   - Difficult to realise the benefits of specialisation and trade due to factor immobility
   - International transport costs can be very high, making it cheaper to produce in the home country than import
   - Countries might produce goods without CA due to protectionism
   - Sufficient differentiation of similar goods may make the products competitive worldwide

9. **Assess the usefulness of national income statistics in measuring and comparing living standards in your country. [25]**

Assess of usefulness of national income statistics if measuring and comparing living standards in Zimbabwe:

The Gross Domestic Product (GDP) of a country is commonly defined as the total market value of all final goods and services produced in a country in a given year. The fact that it is measured regularly and quite consistently in practically all countries of the world allows a direct comparison of the standard of living in individual countries. The frequent measuring also makes it possible to quickly recognize changing trends. For example, it is used to determine whether an economy is growing faster or slower than in the previously measured period and to compare it with other economies in the world. When GDP is calculated in relation to the population of a country, one speaks of the average GDP per capita. This is often used as an indicator of a country's standard of living.

However, as a measure of the standard of living in a country, GDP has its limitations and shortcomings.

- It does not differentiate between economic output that actually benefits the population and economic bads in a country, such as, for example, expenses for warfare, pollution-producing industries, etc.
- It does not include unreported activities such as illegal trading or black-market labour.
- It does not reflect non-market activities such as unpaid housework, childcare, and care for the elderly at home, community services or similar activities.
- The distribution of wealth within a country can be very uneven. When there is a high concentration of enormous wealth in a very small group, and the vast majority of a population is very poor, the average income may be relatively high, although the standard of living of the majority population is low.
- GDP can only measure the material standard of living, without taking into account the quality of life as perceived by each individual, which cannot be standardized across a population or countries.
- Economic output can increase due to technological advances requiring less employment, thereby decreasing the employment ratio.
- The age distribution within a country may be such that a relatively small group of working-age people have to support a large group of old people, resulting in a lower employment rate and consequently a lower standard of living.

Despite these limitations, GDP per capita still seems to be the best indicator for measuring a country's standard of living.

10. Interest rates in Zimbabwe further increased in the month of March 2006 due to high inflation in the economy. (a) Explain the effect of high interest rates in the economy. [12]

Explanation of the Effect of an Increase in interest Rates in an economy:

1. Cost of Borrowing is more expensive:
2. Mortgage and loan repayments increase.
3. Return on savings increase.

1.1 If borrowing is more expensive consumers will take out fewer loans. Firms will borrow less. Therefore consumer spending and investment will fall (or increase at slower rates)

1.2 Higher mortgage payments reduce disposable income so consumer spending will be lower.

1.3. Saving is more attractive, so this will also reduce consumer spending.

If Consumer Spending and Investment falls, this will lead to lower AD. Therefore this cause a fall in Real GDP, or fall in rate of economic growth.

- Lower growth will tend to increase unemployment. With less output, firms demand less workers.
- Lower growth will also help to reduce inflation**.**

(b) Discuss how interest rate can be used to solve inflation in the economy. [13]

Discussion should be based on the use of interest as a method to cure inflation in an economy

1. Depends on situation of Economy: If the economy is at full employment, a rise in interest rates may reduce inflation, but not growth. However, if there is already spare capacity then rising interest rates could cause a recession.

2. Depends on Other Components of AD: For example, if exports are rising, or if consumers confidence is high; rising interest rates may not reduce AD.

3. Income effect of higher interest rates: Higher return on saving may give some consumers a high income. This will be consumers like pensioners. However, in the UK, the savings ratio is quite high; therefore the income effect of a rise in interest rates is likely to be quite low. The substitution effect will be higher.

Interest Rates and Exchange Rates

Interest rates also cause an appreciation in the exchange rate. Higher interest rates make it more attractive to save money in the Zimbabwe. Therefore, this causes hot money flows into the Zimbabwe and an appreciation in the exchange rate

How Interest Rates Affect Inflation.

Higher interest rates help reduce the rate of economic growth and therefore reduce inflation because:

- Higher interest rates increase the cost of borrowing. Therefore consumers are less willing to buy on credit. Firms are less willing to borrow to invest.
- Higher interest rates increase the return from saving. Therefore consumers may spend less and save more.
- Higher interest rates increase monthly mortgage repayments. Therefore, homeowners have less disposable income after paying their mortgage. This point is increasingly significant given the levels of debt in the Zimbabwe.
- Higher interest rates increase the value of the dollar. (more attractive to make deposits in the Zimbabwe, causing hot money flows). The stronger pound reduces exports and increases quantity of imports. Therefore, AD falls.

Higher interest rates may also reduce demand for houses and if house prices fall it will cause a negative wealth effect which will reduce consumer spending.

11. (a) Explain the factors that influence economic growth. [10]

Explanation of the Causes of economic Growth:

Capital Accumulation: Increase quantity and improve quality of capital equipment; Funds needed can be obtained from savings and FDI; Increases productivity

Investment in Human Capital: Human capital: the accumulated skill and knowledge of workers; Most fundamental source of economic growth; Acquired through education, training, and work experiences; Increases productivity

Foreign Trade and Investments: Provides local industries access to overseas markets; provides a source for importing the necessary inputs needed by domestic markets; Help to establish new industries; Provide a spur to economic growth for many developing countries; Encouraged by tax holidays

Technological Advancements: New ways to get more out of same resources; Increases productivity of resources; Both human and physical capital increases necessary to reap these benefits;

Research and Development: Basic research: search for knowledge without regard to how the knowledge will be used; Applied research: Answer particular questions or apply scientific discoveries to the development of scientific products; Aims to improve productivity through technological discovery

Dynamic Entrepreneurship: Contributes by looking for new markets and new methods of production

(b) Discuss the costs and benefits of economic growth to an economy such as that of Zimbabwe. [15]

Discussion the cost and benefits of economic growth applied to developing countries

Economic Growth means an increase in real GDP. This increase in real GDP means there is an increase in the value of national output / national expenditure.

The Benefits of economic growth include:

Higher Incomes,. This enables consumers to enjoy more goods and services

Lower unemployment: With higher output firms tend to employ more workers creating more employment.

Lower Government borrowing: Economic growth creates higher tax revenues and there is less need to spend money on benefits such as unemployment benefit.

Improved public services: With increased tax revenues the govt can spend more on the NHS and education

Money can be spent on protecting the environment

Costs of Economic Growth

· Despite the benefits of economic growth there are potential costs.

· These costs will be greater if the rate of economic growth is too fast

1. *Inflation:*. If AD increases faster than AS then economic growth will be unsustainable. The output gap will narrow causing inflation to increase.

2. *Boom and Bust Economic Cycles*. If Economic growth is unsustainable then high inflationary growth may be followed by a recession.

3. *Balance Of Payments Deficit*: Increased Economic growth causes an increase in spending on imports therefore causing a deficit

4. *Environmental Costs*: Increased economic growth will lead to increased output and therefore increased pollution and congestion. This will cause health problems such as asthma and therefore will reduce the quality of life

5. *Reduced Inequality:* Higher rates of economic growth have often resulted increased inequality, however this depends upon things such as tax rates and the nature of economic growth

12. (a) Analyse the difficulties of measuring unemployment. [10]

Reasons to underestimate unemployment:

1. Disguised unemployment: more people than necessary are hire red to do a job, usually in the public sector.
2. Underemployment: where people want to have full time jobs but are only capable of finding part time jobs. As a result people could be registered as unemployed or depending on the hours of work they find formally registered as employed and as a result unemployment is underestimated.
3. Plus any other relevant argument.

Reasons to overestimate unemployment:

1. Many times people are registered as unemployed in order to collect the unemployment benefits but have no intention to work.
2. Mothers with young children who had a job now give up their employment, stay at home to raise children but for a certain period they receive unemployment benefits.

Plus any other relevant argument.

(b) Assess the effect of unemployment in an economy. [15]

An assessment of the consequences of unemployment, which may include:

The economy not producing at its potential output, and so actual output is below potential output. Candidates may use a PPC to show this

A misallocation of resources, which means the economy suffers from allocative inefficiency because consumer welfare is not being maximized
the loss of potential tax revenue for the government because income tax revenue will fall as less people are working, and consumption-based tax revenue will fall as less goods and services are being purchased
Social costs can increase such as, arguably, crime rates, divorce, stress and suicide
Deterioration of human capital (de-skilling) occurs when people who have been unemployed for long periods of time lose skills and become demotivated
Less investment and a negative multiplier effect because businesses are likely to postpone or cancel plans to expand their productive capacity as they are worried about falling demand.

ECONOMICS PAPER 3 JUNE 2010

1. **'There is no economic function which can be performed by government that cannot be carried out equally well by the free operations of price mechanism'. Discuss [25]**
   Discussion should focus on whether the private sector is adequate and efficient in resource allocation than the government and the need for government intervention.

Market Economy: Efficient system making use of the price mechanism; Price changes signals surpluses and shortages; Shortages can cause windfall profits; Gluts incur losses; Reallocation of resource takes place with firms entering profit-making markets and exit loss-making markets

Economic efficiency is attained

- Productive efficiency achieved when goods are produces at lowest achievable cost (Any point on the PPC)
- Allocative efficiency achieved when no one can be made better off without someone being worse off (requires perfect competition and absence of externalities)
- Socially efficient allocation when Social Marginal Benefit = Social Marginal Cost, welfare maximised

Market Failure in Market Economy: Occurs when free markets, operating without any government intervention, fail to deliver a socially efficient allocation of resources to produce goods and services

Sources:

1. Externalities (Either negative or positive)
2. Underproduction of Merit Goods (Goods/services that have been deemed socially desirable and under-consumed through the political process, usually because of external benefits)
3. Overproduction of Demerit Goods (Goods/services that have been deemed socially undesirable and over-consumed through the political process, usually because of external costs)
4. Failure to provide Public Goods (Total Market Failure)
5. Imperfect competition
6. Imperfect Information
7. Immobility of Factors of Production

Correction of Market Failure

Public provision: Public goods; May be extended to merit goods (e.g. education, vaccination)

Market Solutions

1. Taxes
2. Marketable permits
3. Subsidies
4. Identifying Property Rights
5. Regulation
6. Total Ban
7. Nationalisation

2. **(a) Explain the factors that affect cross elasticity of demand for goods. [10]**
   Explanation of the following factors of cross elasticity of demand:
   There are several factors influencing the Cross Elasticity of Demand. They are as follows:
   1. Nature of Commodity: -It is one of the important determinants of elasticity of demand. For example, the demand tends to be elastic for luxury goods like cars, perfumes, etc. and inelastic for necessities like salt, medicines, etc.
   2. Availability of Substitute: - The commodities having many substitutes in the market have relatively elastic demand for example, soaps, shampoo, biscuits, and cold drinks, etc. have many substitutes; therefore, they have elastic demand. On the other hand, salt has no substitute and therefore it has always inelastic demand.

3. Number of uses: -The commodity is having many uses have relatively elastic demand. When its price falls, it can be put into many uses but when its price rises, it can be put only for important purposes.
The demand for a commodity having a specific use has relatively inelastic demand.
4. Income of the Consumer: - Change in price does not affect the demand of rich people. Thus people who have high level of income have relatively inelastic demand. The demand of poor individual changes according in price, thus it is relatively elastic.
5. Proportion of Income: - If an individual spends small proportion of his income on a commodity, it has relatively inelastic demand. For example, Paper pins. On the other hand, if an individual spends a major proportion of his income on a commodity, it has relatively elastic demand for example, Perfumes.
6. Urgency and postponement: -If the use of commodity is urgent, the demand is relatively inelastic. For example, medicines. On the other hand, if the use of commodity can be postponed to a future date, demand will be relatively elastic. For example, ice cream.
7. Influence of habits: -If an individual becomes habituated to use certain commodity, then the demand becomes inelastic. For example, smoker‘s demand for cigarette.

(b) Discuss the significance of elasticity of demand to a supermarket in a city centre. [15]
Discussion should be based on the importance of elasticity concepts applied to a supermarket operating in a city (central shopping area)
Usefulness of PED to the supermarket
Government taxation policies

- Either aim to raise revenue, discourage/encourage consumption
- PED would play some part in determining successfulness of policies
- Raising revenue/increasing consumption
    - Indirect taxes should be levied on goods with inelastic demand
    - Increase in Price > Decrease in $Q_{uantity}$
- Decreasing consumption
    - Indirect taxes should be levied on goods with elastic demand
    - Greater effect on $Q_{uantity}$

Pricing policies of firms

- Policies will be helpful as long as TR>TC

Effect on prices stability

- Draw the weird triangle graph thingy for an example

$D_{elastic}$, $D_{ineleastic}$, $S_0 \rightarrow S_1$
Product differentiation

- A firm’s products can be changes so that PED is more elastic
    - Gives the firm the ability to increase prices to increase TR

Importance of income elasticity:
Usefulness of PED
Government taxation policies

- Either aim to raise revenue, discourage/encourage consumption
- PED would play some part in determining successfulness of policies
- Raising revenue/increasing consumption
    - Indirect taxes should be levied on goods with inelastic demand
    - Increase in P > Decrease in Q_{DD}
- Decreasing consumption
    - Indirect taxes should be levied on goods with elastic demand
    - Greater effect on Q_{DD}

Pricing policies of firms

- Policies will be helpful as long as TR>TC

Effect on prices stability

- Draw the weird triangle graph thingy for an example

$D_{elastic}$, $D_{ineleastic}$, $S_0 \rightarrow S_1$

Product differentiation

- A firm's products can be changes so that PED is more elastic
  - Gives the firm the ability to increase prices to increase TR

Usefulness of cross elasticity of demand:

- Pricing strategies for substitutes: If a competitor cuts the price of a rival product, firms use estimates of cross-price elasticity to predict the effect on the quantity demanded and total revenue of their own product.
- Pricing strategies for complementary goods: For example, popcorn, soft drinks and cinema tickets have a high negative value for cross elasticity– they are strong complements.
- Advertising and marketing: In highly competitive markets where brand names carry substantial value, many businesses spend huge amounts of money every year on persuasive advertising and marketing. There are many aims behind this, including attempting to shift out the demand curve for a product (or product range) and also build consumer loyalty to a brand. When consumers become habitual purchasers of a product, the cross price elasticity of demand against rival products will decrease. This reduces the size of the substitution effect following a price change and makes demand less sensitive to price. The result is that firms may be able to charge a higher price, increase their total revenue and turn consumer surplus into higher profit.

3. **(a) Explain how small firms survive in the face of competition from large firms. [12]**

Explanation of reasons or advantages of small firms over large firm:

- Close supervision
- Economic independence
- Close contact with customers Personal Services to Customers: Where personal services are important from the point of view of the customers, small scale firms are more suitable.
- Greater adaptability to changes
- It is very easy to set up a business on small scale.
- Greater Flexibility: A small scale business is more flexible than a large scale business.
- Limited Market: when the market for a product is limited, it is preferable to operate on small scale.
- Introduction of New Ideas or Products: When new ideas or products are to be tired out, it is preferable to start on a small scale because the new idea or product requires sufficient market testing.
- Relations with Employees: There are certain lines of business n which close rapport with the employees is essential to provide high quality service to the customers.
- Government Assistance: In many countries, encouragement by the State is given to the small scale firms.
- Social Benefits: Small firms offer large scale employment and help in checking monopoly and concentration of economic power.
- Support to Large Firms: Small firms act as complementary to large firms.

(b) Discuss the benefit Zimbabwe may get from promoting small to medium scale enterprises. [13]

Discussion of small to medium scale firms to Zimbabwe based on following advantages and disadvantages:

1. Employment: Small scale firms use labour-intensive techniques and, therefore, they have high potential to provide employment to a larger number of people per unit of capital. For every worker

employed in large scale industries about three workers are engaged in small scale and cottage industries.
2. Balanced Regional Development: small scale industries promote decentralized development and help to remove regional disparities in industrialisation. Decentralized development contributes to the process of self-sustained growth and avoids concentration of industries in particular areas. By providing employment in rural areas they help to check migration and overcrowding in urban areas. Small scale firms can be a useful means of rural reconstruction and development. Development of decentralized sector also improves the standard of living of people in backward regions.
3. Optimization of Capital: Small scale firms require less capital per unit of output and, therefore, greater output can be obtained with small investment.
4. Mobilization of Local Resources: Small scale industries facilitate Mobilization and utilization of local resources and family skills which might otherwise remain talent or utilized. Small business promotes a new cadre of small entrepreneurs and self-employed and encourages local talent. The growth of small enterprises helps in tapping talent resources like entrepreneurial skills and small savings especially in rural areas. Small business helps to protect technical skills and handicrafts.
5. Exchange Earnings: Small scale industries help in reducing pressure on the country's balance of payments in two ways. First, they do not require imports of sophisticated machinery and equipment. Secondly, they earn valuable foreign exchange through exports of their products.
6. Egalitarian Society: Small scale industries help in reducing concentration of economic power in a few hands. They promote a more equitable distribution of national income and wealth. Development of small scale industries helps to reduce monopolies and exploitation of consumers. Benefits of small scale firms are derived by a wider population. A large part of the earnings is distributed among workers.
7. Feeder to Large industries: small scale sector is complementary to the large scale industries. Small scale industries manufacture various types of components, spare parts, tools and accessories which are required by the large scale sector.
8. Social Advantage: Small scale units offer opportunity for an independent way of life to people with small means. They offer savings in social overheads like education, housing and medical facilities by taking industry nearer to the people. They help to raise per capita income an standard of living in the country. A system of widely diffused ownership permits wider participation of people in the process of economic development. Small scale sector provides a base for democracy, socialism and self-government.

4. **(a) Contrast the equilibrium position of a monopoly with a perfectly competitive firm. [10]**

Explanation of the equilibrium position of a monopoly and perfect competitive firm:
The main points of ***difference*** and ***similarities*** of ***monopoly model with competitive model*** are as follows:

Monopoly	Perfect competition
(1) The firm is in equilibrium at that level of output where MR equals MC.	(1) The most profitable output is also at a point where MR is equal to MC.
(2) The AR and MR curves are negatively inclined i.e., a firm can sell more goods at lower and fewer goods at higher prices. The MR curve ties below the AR curve.	(2) The AR and MR curves facing competitive producer are perfectly elastic, i.e., it is a horizontal straight line. A firm cannot alter the market price by selling more or by selling less. The AR and MR curves are equal and, therefore, coincide.
(3) The monopolist can earn supernormal profits in the short as well as in the long period. The firm need not equate the AR to the lowest point of AC in the long run.	(3) The firm can earn abnormal profits in the short run but in the long run only normal profits are earned. The firm is in equilibrium when MR = MC = AR = Minimum AC in the long run.

4) As the production of a commodity is in the hands of a single producer, therefore, a firm has control over the output and price of the commodity. (5) The single firm comprises the whole industry. The firm may not be of the optimum size. The possibility of the new firms to enter into the industry is restricted. (6) The equilibrium price is higher than MC. The monopolist always tries to maximize profits by fixing the price higher than the competitive price. The consumers, therefore, have to pay a higher price and thus stand at a disadvantage. (7) The monopoly firm is a price seeker. (8) A monopoly firm is not a price taker. Hence, it cannot have a supply curve. It chooses output and price in a way that gives. It the highest possible profit.	(4) The competitive producer has no control over the price of the commodity. It has to sell at the price determined by the intersection of the forces of demand and supply in the market. (5) There are many firms comprising an industry. All the firms are of the optimum size in the long run. The new firms can enter the industry. (6) The equilibrium price is equal to MC. The entrepreneur charges the price which gives him the normal profit in the long run. So customers do not stand at a disadvantage. (7) The competitive firm is a price taker. (8) A competitive firm cannot exert any influence on the price. The firm is a price taker and so has a supply curve. The portion of MC curve above AVC curve is supplied.

(b) Discuss the ways the government may use to regulate monopolies. [15]

Discussion should be based the methods the government uses to control monopolies applied. These may include the following;

- Price regulation e.g. price of goods provided by public utilities;
- Taxation
- Reducing barriers to entry
- Preventing collusion
- Breaking large firms monopolies commission

Evaluation should take into account whether government interfering in the operations of monopolies good or bad when applied Zimbabwe.

5. **To what extent does marginal revenue productivity {MRP} theory explain the determination of wages in Zimbabwe? [25]**

Discussion should focus on the ability of Marginal Productivity Theory of Wages help to explain wage determination in Zimbabwe:

This theory state that, under the condition of perfect competition, every worker of same skill and efficiency in a given category will receive a wage equal to the value of the marginal product of that type of labour. The marginal product of a labour in any industry is the amount by which the output would be increased if a unit of labour was increased, while the quantities of other factors of production remaining constant. Under perfect competition, the employer will go on employing workers until the value of the product of the last worker he employs is equal to the marginal or additional cost of employing the last worker. Further, under perfect competition, the marginal cost of labour is always equal to the wage rate, irrespective of the number of workers the employer may engage. Since every industry is subject to diminishing returns, the marginal product of labour must start declining sooner or later. Wages remaining constant, the employer stops employing more workers at that point where the value of marginal product is just equal to the wage rate:

To allow for this, a term 'marginal net product of labour' has been used instead of 'marginal product of labour'. The value of marginal net product of labour may be defined as being the value of the amount by which output would be increased by employing one more worker with the appropriate addition of other factors of production, less the addition to the cost of the other factors caused by increasing the quantities of other factors.

Criticism of Marginal Productivity Theory is based on its assumptions: This theory is true only under certain assumptions such as perfect competition, perfect mobility of labour, and homogenous character of all labour, constant rates of interest and rent and given prices of the product. It is a static theory. The actual world is dynamic. All assumptions are unrealistic.

Evaluation of the theory may focus on other theories of wages such as supply and demand of labour and other non economic determinants of wage rate. These include:

(a) Differences in efficiency:

(b) Difficulty of learning a trade

(c) Differences in agreeableness or social esteem

(d) Hazardous and dangerous occupations: generally offer higher emoluments.

(e) Government legislation

(h) Collective Bargaining: The differences in the strength and militancy of trade unions also account for differences in wages in different industries.

6. **(a) Explain the terms:**

{i} public goods;

Public goods are goods or services that can be consumed by several individuals simultaneously without diminishing the value of consumption to any one of the individuals. This key characteristic of public goods that multiple individuals can consume the same good without diminishing its value, is termed non-rivalry. Non-rivalry

is what most strongly distinguishes public goods from private goods. A pure public good also has the characteristic of non-excludability, that is, an individual cannot be prevented from consuming the good whether or not the individual pays for it. For example, fresh air, a public park, a beautiful view, national defense.

{ii} merit goods;

Merit goods are goods whose consumption the public sector promotes, based on a presumption that many individuals do not adequately weigh the benefits of the good and should thus be induced to consume more than they otherwise would. Many local governments support symphony concerts, for example, on grounds that the private market would not provide an adequate level of these cultural activities.

and {iii} externalities. [12]

It is the activity of one person/firm affecting the welfare of another in a way that is outside the market. In the presence of an externality, the market may fail to allocate resources efficiently

Positive externalities Occur when society benefits from the consumption or production of a commodity or service

Negative externalities Occur when costs are imposed on society from the consumption or production of a commodity or service

(b) Discuss why and how government often produce and distribute goods and services which are not economically priced. [13]

Discussion should focus on following reasons of the role of government:

- Providing the legal structure:
    - Government ensures property rights, provides enforcement of contracts, acts as a referee and imposes penalties for foul play.
    - Government intervention improves the allocation of resources by supplying a medium of exchange, ensuring product quality, defining ownership rights, and enforcing contracts.
    - These interventions widen the market and foster greater specialization in the use of property and human resources.
    - The appropriate amount of regulation is at the level where the marginal benefit and marginal cost are equal.

- Maintain competition:
    - Competition is the market mechanism that encourages producers and resource suppliers to respond to consumer sovereignty.
    - If producers (and/or resource suppliers) have monopoly power, the monopolist can charge higher-than-competitive prices and supplant consumer sovereignty with producer sovereignty (or economic rent).
        - If "natural monopoly" exists, government regulates price and service.
        - Where competitive markets are more efficient, anti-monopoly laws are designed to regulate business behavior and promote competition.
- Redistribution of income:
    - Transfer payments provide relief to the poor, dependent, handicapped, and unemployment compensation to those unemployed who qualify for benefits. Social Security and Medicare programs support the sick and aged.
    - Government intervenes in markets by modifying prices. Price support programs for farmers; minimum wage laws are examples.
    - The personal income tax takes a larger proportion of incomes of the rich than the poor.
- Reallocation of resources:
    - Market failure occurs when the competitive market system produces the "wrong" amounts of certain goods or services or fails to provide any at all.
    - Externalities (spillovers)
- Government provides public goods and quasi-public goods and services.
    - Public or social goods would not be produced through the market, because they possess the characteristics of *non-rivalry* and *non-excludability*. .
    - Merit goods are those that have large positive externalities, so government will sponsor their provision. Otherwise, they would be under-produced. Medical care, education, and public housing are examples.
    - Resources are reallocated from private to public use by levying taxes on households and businesses, thus reducing their purchasing power and using the proceeds to purchase public and merit goods. This can bring about a significant change in the composition of the economy's total output.
- Promoting stability:
    - An economy's level of output is dependent on its level of total spending relative to its productive capacity.
    - 2. The government may promote macroeconomic stability through changes in government spending and taxation.

7. **(a) Explain why a country would be worried by an imbalance on its balance of payment account. [10]**

   Explanation of negative effects of the imbalance of BOP account based on causes of BOP deficit:
   Following are the main causes of disequilibrium in BOP
   (a) Revenue oriented tariffs
   (b) Adverse terms of trade:
   (c) Import substitution policy
   (d) Export of primary commodities
   (e) Capital account problem
   (f) Trade restrictions of developed countries
   (g) Inflation
   (h) Ever-increasing demand for imports

   Concerns For surplus includes –unplanned saving; deprivation of variety; conspicuous consumptions; reduces trading partner's ability to buy in future and leads to conflicts

Concerns for deficit – inability to pay in future for exports may reduce essential import; may lead to higher taxation; depreciation of currency

b) Discuss the effectiveness of methods used to cure a balance of payments (BOP) deficit in your country. [15]

Discussion should be based on the methods used by government to cure BOP deficit.

General Measures to Correct BOP Disequilibrium:

To correct the different types of disequilibrium in BOP the following general measures are used:

(a) Exchange Depreciation (Price Effect) or Devaluation (by Government): Exchange depreciation means a reduction in the value of a currency in terms of gold or other currencies under *'free market'* conditions and coming about through a decline in the demand for that currency in relation to the supply. This is usually applied to *'floating exchange rates'*.

This official reduction of exchange rate is called *'devaluation'*. The purpose of both *'depreciation'* and *'devaluation'* is to cheapen the domestic goods and boost up the exports. But the governments regarded devaluation as a means of correcting a balance of payments deficit only as a measure of last resort.

(b) Deflate the Currency: According to this method, the currency is deflated. As the currency contracts, prices will fall, which will stimulate exports and check imports. But the method of deflation is also full of dangers. If prices are forced down while costs, which are proverbially rigid (especially as regards wages in countries where trade unions are well organised), do not follow suit, the country may face a serious depression and unemployment. Correcting the balance of payments, therefore, once disequilibrium has arisen is not an easy matter.

(c) Tariffs: Tariff is a tax levied on imports. It is synonymous with import duties or custom duties. Tariffs are used for two different purposes; for revenue and for protection. *'Revenue Tariffs'* are a source of government revenue and *'Protective Tariffs'* are meant to maintain and encourage those branches of home industry protected by the duties.

(d) Import Quotas: As a protective device, import quotas are alternative to tariffs. Under an import quota, fixed amount of a commodity in volume or value is allowed to be imported into the country during a specified period of time.

(e) Export Duties: When world prices are higher than domestic prices, there is an incentive to export. In such a situation, a government may levy export duties. Export duties are used to prevent exports. The reason may be that exported commodities are required domestically.

Merit and demerit of each method must be clearly discussed and evaluated

8. **(a) With illustrative examples, explain how the accelerator principle works. [12]**

Explanation of how the accelerator works using well illustrated examples:

The accelerator is the numerical value of the relation between an increase in income and the resulting increase in investment. In other words, the acceleration principle simply tells us that if owing to increase in people's incomes, the demand for consumption goods increases, the derived demand for the factors of production, producer's goods in particular, say machines to make the consumption goods will increase. But the point to be noted is that investment in the making of machines will even increase faster than the demand for the product.

When income increases, people's spending power increases; their consumption increases and consequently demand for consumer goods increase. In order to meet this enhanced demand, investment must increase to raise the productive capacity of the community. Initially, however, the increased demand will be met by over working the existing plants and machinery. All this leads to increase in profits which will induce entrepreneurs to expand their plants by increasing their investments. Thus a rise in income leads to a further induced investment thus acceleration in economy take place

(b) Discuss why a given level of investment does not yield the same level change and how the change in income affects income investment in an economy. [13]

Investment

Economic growth can be achieved in several different ways. However, each method involves the fundamental process of investment. Investment is the sacrifice of current benefits or rewards to pursue an activity with expectations of greater future benefits or rewards. In its simplest form investment means giving up consumption goods and producing capital goods.

The quantity and quality sources of economic growth all involve investment in one way or another. Increasing the quantity of capital is an obvious example. Exploration for natural resources, such as drilling for oil, also fits most common sense notions of investment. However, increasing in the quantity of labor also reflects investment. Parents sacrifice their own consumption to raise a family. Immigrants sacrifice as they travel to a new country.

The acquisition of education is also an investment, exemplified by college students who sacrifice four to five years of early adulthood for a college degree. The development of technology is also an investment with resources devoted to scientific research rather than being used for other production.

The bottom line is that economic growth is achieved through investment. Without investment, there is no economic growth.

9. **(a) Explain how a rise in money supply causes an increase in national income. [10]**

Detailed explanation of the effects of money supply increase on the national income:

Increase in money supply

Supply of money in circulation increases on account of the following reasons - deficit financing by the government, expansion in public expenditure, expansion in bank credit and repayment of past debt by the government to the people, increase in legal tender money and public borrowing.

An increase in money will cause people and institutions to have more disposable income increase demand for goods (increased spending) leading to inflation in the short run;

- Increased nominal national income
- Increase employment

(b) Why might the government of your country seek to control the rate of growth of money supply? [15]

Discussion should focus on reasons of the government's monetary policy used to cure inflation applied to Zimbabwe

Inflation is basically a monetary phenomenon. Excess money supply over the quantity of goods and services is mainly responsible for rise in prices.

The reasons may include inflation stabilization employment ETC

Monetary authorities aim at reducing and absorbing excess supply of money in an economy. The following are some of the anti-inflationary monetary measures: -

1. The volume of legal tender money may be reduced either by withdrawing a part of the notes already issued or by avoiding large-scale issue of notes.
2. Restrictions on bank credits.
3. Freezing and blocking particular type of assets.
4. Increasing bank rate and other interest rates.
5. Sale of Govt., securities in the open market by central bank.
6. Raising the legal reserve requirements like CRR and SLR
7. Prescribing a higher margin that bank and other lenders must maintain for the loans granted by them against stocks and shares.
8. Regulation of consumer's credit.
9. Rationing of credit etc.

Thus, the government to control inflation may exercise various quantitative and qualitative techniques of credit controls.

10. (a) Explain the effects inflation has on money's ability to perform its functions. [12]

Detailed explanation of effects of inflation on the following functions of money:

• a medium of exchange: Inflation reduces the effectiveness of money as a medium of exchange. High inflation means that it becomes difficult to place a value on goods because the value of money is always falling. In extreme cases of hyper inflation prices can rise so much that money becomes worthless and people resort to a barter economy.

• a measure of value:

• a store of value: As inflation increases, the volatility of the inflation rate tends to increase. This means that it is harder to place a value on money, thus it becomes more difficult to use it as a store of value.

• a standard for deferred payments

(b) How effective is the role played by the central bank in the economic development of your country? [13]

Discussion of the effective of the role played by the central bank in creating the machinery needed for development and viability; these include:

- Sound currency system
- Regulated and adequate money supply
- Creation of new financial institution
- Tackling balance of payment problems
- Restraining inflationary pressures

Evaluation should be centered on assess the effectiveness of central bank functions on economic development of Zimbabwe

11(a) With the aid of examples, describe:

A well explained description of the terms is expected with examples

{i} free trade area;

A free trade area occurs when a group of countries agree to eliminate tariffs between themselves, but maintain their own external tariff on imports from the rest of the world. The North American Free Trade Area is an example of a FTA. When the NAFTA is fully implemented, tariffs of automobile imports between the US and Mexico will be zero. However, Mexico may continue to set a different tariff than the US on auto imports from non-NAFTA countries. Because of the different external tariffs, FTAs generally develop elaborate "rules of origin". These rules are designed to prevent goods from being imported into the FTA member country with the lowest tariff and then transshipped to the country with higher tariffs. Of the thousands of pages of text that made up the NAFTA, most of them described rules of origin.

{ii} customs union;

A customs union occurs when a group of countries agree to eliminate tariffs between themselves and set a common external tariff on imports from the rest of the world. The European Union represents such an arrangement. A customs union avoids the problem of developing complicated rules of origin, but introduces the problem of policy coordination. With a customs union, all member countries must be able to agree on tariff rates across many different import industries

and {iii} common market.

A common market establishes free trade in goods and services sets common external tariffs among members and also allows for the free mobility of capital and labor across countries. The European Union was established as a common market by the Treaty of Rome in 1957, although it took a long time for the transition to take place. Today, EU citizens have a common passport, can work in any EU member country and can invest throughout the union without restriction

(b) Should developing countries engage in protection in their trade with other countries? [13]

Discussion should be based arguments for and against protectionism and come to a conclusion, concerning whether protectionism may be justified in international trade. Arguments for protectionism may include:
Protection of employment/declining industry – protect workers whose industries could not compete with foreign competition
Source of government revenue – tariffs raise revenue for the government
Strategic arguments – some industries (such as defence or agriculture) may need to be kept national for strategic reasons (*e.g.* in case of war)
Means to overcome a current account deficit – lowering import expenditure will reduce the current account deficit
Anti-dumping – to prevent foreign firms from selling goods at below their costs of production, which would destroy the domestic industry
Infant industry argument – small firms need to be protected to give them time to expand and gain economies of scale, which will allow them to compete internationally

Arguments against protectionism may include:
Inefficiency of resource allocation – resources need to be allocated to where they gain the highest yield and this may not be in the protected industry
Costs of long-run reliance on protectionist methods – protection may allow firms to remain inefficient and may reduce their incentive to reduce costs
Increased prices of goods and services to consumers
The cost effect of protected imports on export competitiveness – imported raw materials become costly, which causes the final price of a country's exports to increase
Retaliation – other countries may start a trade war by imposing trade restrictions
Damage to other economies – restricting the imports from one country means reducing that country's exports. This reduces that country's income and could lead to a multiplied fall in the rest of the world income.

12.(a) Explain the characteristics of developing countries. [10]

Detailed explanation of following characteristics of developing countries:

- *Defiance of capital*
- *Excessive dependency on agriculture*
- *Inequalities of income and wealth*
- *Dualistic economy*
- *Inadequate infrastructure*
- *Foreign trade orientation*
- *Rapid population growth and disguised unemployment under-utilisation of natural resources*

(b) Discuss the reasons why developing countries find it difficult to achieve economic growth. [15]

Detailed discussion of reasons or factors impeding growth in developing countries such as:

- Problems of investments [lack of funds and capital equipment]
- Inefficiency of industrial development
- Rapid population growth
- Migration to urban areas leading to increased unemployment
- Social and cultural factor
- Falling export earnings
- Trade barriers
- Activities of multinational companies