



INTRODUCTION TO ECONOMICS

(ECON 1011)

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CHAPTER ONE



BASICS OF ECONOMICS



OUTLINE

- ❖ **Definition of Economics**
- ❖ **The Rationales of Economics**
- ❖ **Scope and Method of Analysis in Economics**
- ❖ **Scarcity, choice, opportunity cost and production possibilities frontier**
- ❖ **Basic Economic Questions**
- ❖ **Economic Systems**
- ❖ **Decision Making Units and the Circular Flow Model**



DEFINITION OF ECONOMICS

- ❖ **Economics** is one of the most exciting disciplines in social sciences. The word economy comes from the **Greek** word “**oikonomos**” which means “one who manages a household”.
- ❖ The science of economics in its current form is about **two hundred years** old. **Adam Smith** - generally known as the father of economics, brought out his famous book, **An Inquiry into the Nature and Causes of Wealth of Nations**, in the year **1776**.
- ❖ Though many other writers expressed important economic ideas before Adam Smith, economics as a distinct subject started with his book.

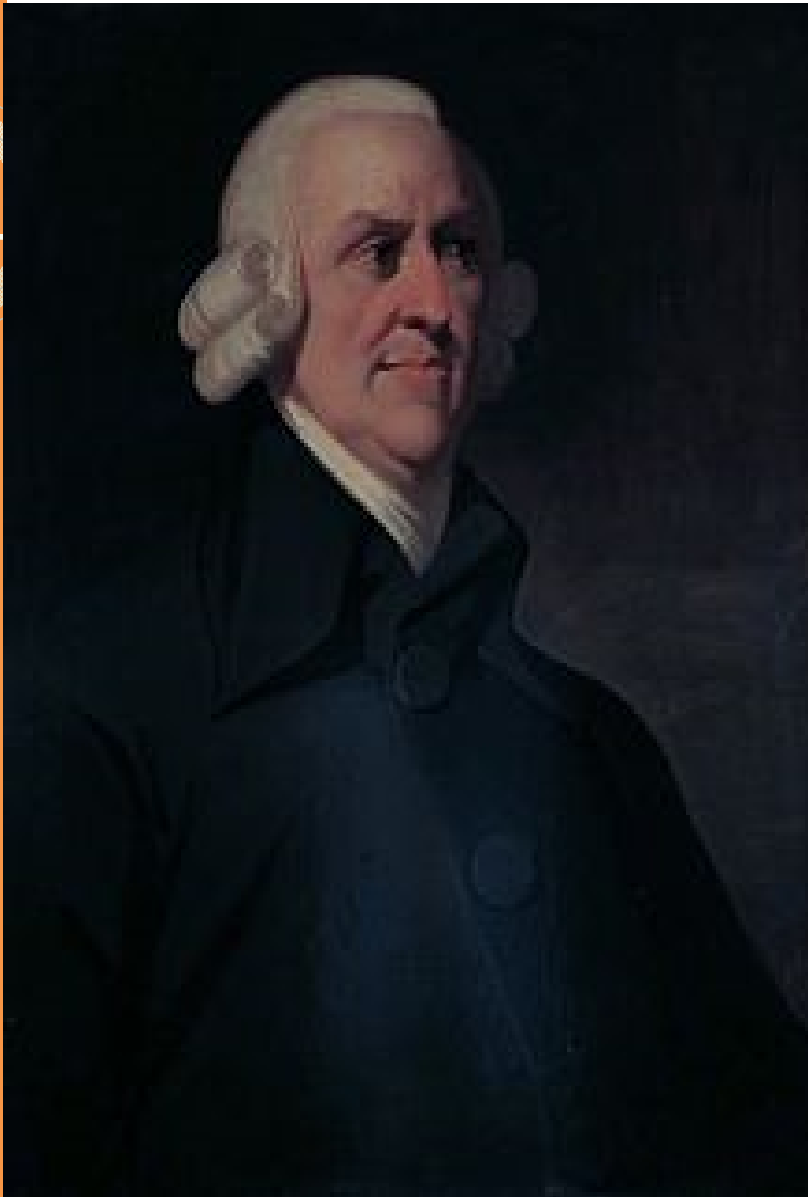
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- ❖ There is no universally accepted definition of economics (its definition is controversial). This is because different economists defined economics from different perspectives:

- ❖ Wealth definition
- ❖ Welfare definition
- ❖ Scarcity definition, and
- ❖ Growth definition

- ❖ Hence, its definition varies as the nature and scope of the subject grow over time. But, the formal and commonly accepted definition is as follow.

Economics is a social science which studies about efficient allocation of scarce resources in the production and distribution of goods and services so as attain the maximum fulfillment of unlimited human needs.

Adam Smith (1723 – 1790)



ELEBOOK CLASSICS

An Inquiry into the
Nature and Causes of
**THE WEALTH
OF NATIONS**



Adam Smith

ELEBOOK CLASSICS

ebc0072. Adam Smith: *Wealth of Nations*

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- ❖ The following statements are derived from the above definition.
 - Economics studies about scarce resources;
 - It studies about allocation of these resources;
 - Allocation should be efficient;
 - Human needs are unlimited

 - ❖ Therefore, the aim (objective) of economics is to study how to satisfy the unlimited human wants up to the maximum possible degree by allocating resources efficiently.

 - ❖ **Economics** is a study of problems regarding **choices** that must be made due to scarcity of resources. It examines how the scarce resources can be used to for the maximum fulfilment of human wants. In short, **Economics is a study of how society manage scarce resource.**

THE RATIONALE OF ECONOMICS

- ❖ There are two fundamental facts that provide the foundation for the field of economics.

1. Human or society's material wants are unlimited.

2. Economic resources are scarce or limited in supply.

Note: These two contradictory facts lay the foundation for the field of economics.

- The basic economic problem is about **scarcity and choice** since there are only limited amount of resources available to produce the unlimited amount of goods and services we desire.
- ♠ **Thus, economics is the study of how human beings make choices to use scarce resources as they seek to satisfy their unlimited wants.**



Scope and Method of Analysis in Economics

SCOPE OF ECONOMICS

- ◆ By scope of economics, we refer to the coverage of economics.
- ◆ The field and scope of economics is expanding rapidly and has come to include a vast range of topics and issues.
- ◆ In the recent past, many new branches of the subject have developed, including Development Economics, Industrial Economics, Transport Economics, Welfare Economics, Environmental Economics, and so on.
- ◆ However, the core of modern economics is formed by its two major branches: **Microeconomics and Macroeconomics**. That means economics can be analyzed at micro and macro level.

Microeconomics

- ★ **Microeconomics** is concerned with the economic behavior of individual decision making units such as households, firms, markets and industries. In other words, it deals with how households and firms make decisions and how they interact in specific markets.
- **Some of the issues that are studied in Microeconomics are:**
 - ☛ The behavior of consumers in maximizing satisfaction
 - ☛ How businesses made decision so as to obtain maximum possible profit
 - ☛ How prices of products and factors of production are determined in product and resource market.
- ♠ In general in microeconomics, our analysis is in terms of individual **firm, industry, or household**. **Adam Smith** is usually considered to be the founder of the field of microeconomics.

Macroeconomics

- ★ **Macroeconomics** is a branch of economics that deals with the effects and consequences of **the aggregate behavior** of all decision making units in a certain economy. In short it deals with the **economy as a whole** and discusses about the economy-wide phenomena.
- ★ Macroeconomics **does not** deal with individual household, firm or industry.
- **Some of the issues that are studied in Macroeconomics are:**
 - ☛ Total employment
 - ☛ National income
 - ☛ Total investment
 - ☛ Aggregate demand and supply
 - ☛ General price level, wage level and the like.
 - ☛ Total consumption
 - ☛ Total saving
 - ☛ Business cycle
 - ☛ National output

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- ❖ **R e m e m b e r**: like macroeconomics, microeconomics also **uses aggregate**. For example, in microeconomics, we can talk about the total market demand for wheat, the total market demand for maize, total market supply for automobile, etc.
 - ❖ In microeconomics, **we aggregate over homogeneous** or identical product, but in macroeconomics the aggregation is **at the economy level**. For example in microeconomics, we can not aggregate the total market demand for wheat and maize together. But in macroeconomics, we can aggregate the total demand of several products and talk about the total level of outputs currently produced in a country.
 - **Note**: Both microeconomics and macroeconomics are **complementary to each other**. That is, macroeconomics cannot be studied in isolation from microeconomics. The main difference between macroeconomics and microeconomics can be summarized as follows:

	Microeconomics	Macroeconomics
1.	Studies individual economic units of an economy.	Studies an economy as a whole
2.	Deals with individual income, individual prices, individual outputs, etc.	Deals with aggregates like national income and output and general price level
3.	Its central problem is price determination and allocation of resources.	Its central problem is determination of level of income and employment.
4.	Its main tools of analysis are the demand and supply of particular commodities and factors.	Aggregate demand and aggregate supply are its main tools of analysis.
5.	Helps to solve the problem of “what, how & for whom to produce‘ in an economy so as to maximize profits”	Helps to solve the central problem of “full employment of resources in the economy.”
6.	Discusses how the equilibrium of a consumer, a producer or an industry is attained.	Concerned with the determination of equilibrium levels of income and employment at aggregate level.
7.	Examples: Individual income, individual savings, individual prices, an individual firm’s output, individual consumption, etc.	Examples: national income, national savings, general price level, national output, aggregate consumption, etc.

SIGNIFICANCE OF ECONOMICS

- ❖ Economics is an extremely useful subject, and its study and knowledge has acquired greater importance in recent times. Hence, some of the advantages of studying economics are:
- ✎ Economics helps us to understand certain problems and questions affecting individuals and families.

Example: The effect of price rise on peoples standard of living.

- ✎ Economics explain problems and questions that affect society and the state as a whole, and suggest sustainable solution for them.

Example: What are the causes of unemployment, inflation and what policies government to adopt to control.

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- The study of economics is useful for economic planning and economic development of the country.
 - Economics explains the causes of fluctuations in economic activity and help us to understand business trend.
 - Economics help us to understand and solve crucial problems like poverty income inequality, trade deficit, unemployment and the like.
 - Economics helps us to understand and participate in international trade by examining the theory and practice of export, import, comparative cost, etc.
 - It also help us to understand how different economic systems function and how social welfare can be achieved through material means.



Therefore, we may conclude that the study and knowledge of economics is useful and important to each of us and to society as a whole.



Methods of Reasoning in Economics

- ❖ The fundamental objective of economics, like any science, is the establishment of valid generalizations about certain aspects of human behavior. These generalizations are known as **theories**.
- ❖ A theory is a simplified picture of reality.
- ❖ Economic theory provides the basis for economic analysis which uses logical reasoning. There are two methods of logical reasoning:

1. Inductive Reasoning and

2. Deductive Reasoning



♠ **Inductive Reasoning:** is a logical method of reaching at a correct general statement or theory based on several independent and specific correct statements. In short, it is the process of deriving a principle or theory by moving from **facts to theories**, and from **particular to general economic analysis**.

- The inductive method develops economic theory on the basis of **observations and experiments**.
- Inductive method involves the following steps.
 1. Selecting problem for analysis
 2. Collection, classification, and analysis of data
 3. Establishing cause and effect relationship between economic phenomena.

- 
- ❖ **Deductive Reasoning:** is a logical way of arriving at a particular or specific correct statement starting from a correct general statement.
 - ❖ In other words, deductive method is a method of reasoning which enables one to reach at a particular conclusion from a general statement or assumption through a process of logical arguments. The theory may agree or disagree with the real world and we should check the validity of the theory to facts by moving from **general to particular**.
 - ❖ Most of economic theories have been constructed through the deductive method. Major steps in the deductive approach include:
 1. Problem identification
 2. Specification of the assumptions
 3. Formulating hypotheses
 4. Testing the validity of the hypotheses

Deductive vs. Inductive

Deductive

- ❖ Go from general statements to specific statements.

- ❖ **Example:**

All animals are mortal

- **Cat is an animal**
- **Cat is mortal**

Inductive

- ❖ Go from specific to general ideas or statements

- ❖ **Example**

1. Mammals are mortal
2. insects are mortal
3. birds are mortal
4. Fishes are mortal
5. Plants are mortal
6. Reptiles are mortal

All living things are mortal



Integrated Deductive and Inductive Methods

- ❖ Which one is more appropriate for developing economic theories and principle- is it the deductive or the inductive approach.?
- ❖ The modern view point in this regard is that **both are needed** for the proper development of scientific economic theories.
- ❖ Indeed, the two are complementary rather than competitive. Modern economists begin by developing economic hypotheses through logical deduction and then test them through statistical or econometric methods.

POSITIVE VS. NORMATIVE ECONOMICS

Is economics a positive science or normative science, or both?

What is your justification?

❖ Economics can be analyzed from two perspectives:

A. Positive economics and

B. Normative economics.

♠ Positive economics: it is concerned with analysis of facts and attempts to describe the world as it is. It tries to answer the questions **what was; what is; or what will be?** It does not judge a system as good or bad, better or worse. In other words, it develops theories and laws to explain observed economic phenomena.



Example:

- ☐ The current inflation rate in Ethiopia is 12 percent.
 - ☐ Poverty and unemployment are the biggest problems in Ethiopia.
 - ☐ The life expectancy at birth in Ethiopia is rising.
 - ☐ Minimum-wage laws cause unemployment
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- ❖ All the above statements are known as **positive statements**.
 - ❖ These statements are all concerned with real facts and information. Any disagreement on positive statements can be checked by looking in to **facts**.

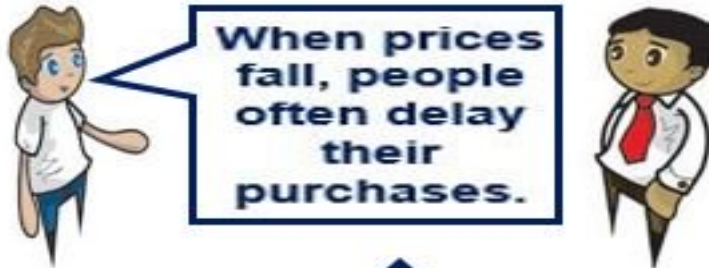
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- ♠ **Normative economics**: It deals with the questions like, **what should be** and it involves value judgment. It evaluates the desirability of alternative outcomes based on one's value judgments about what is good or what is bad. In this situation since normative economics is loaded with judgments, what is good for one may not be the case for the other.
 - ❖ Normative analysis is a matter of opinion (subjective in nature) which **can not be proved or rejected** with reference to **facts**.

Example:

- ☐ The poor should pay no taxes.
 - ☐ There is a need for intervention of government in the economy.
 - ☐ Females ought to be given job opportunities.
 - ☐ Government should rise the minimum wage.
- ❖ Any disagreement on a normative statement can be solved by **voting**.

Positive

is, was, will be



**Can be
proved**

**Connects cause
& effects**

Descriptive

Based on facts

Tells you what is

Objective

Normative

ought to, should



**Cannot be
proved**

Makes recommendations

Not based on facts

**Tells you should be/have
been**

Prescriptive

Subjective

Some Basic Concepts of Economics

1. Scarcity

- ◆ In any society, people want to have a variety of goods and services. Food, cloth, automobile, electric products, education are only few of what people desire to have.
- ◆ To produce these goods and services, they need economic resources. But economic resources are scarce. Hence the amount of goods and service that a society can produce would be **limited**.
- ◆ The fundamental economic problem that any human society faces is the **problem of scarcity**.

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- ❖ **Scarcity** refers to the fact that all economic resources that a society needs to produce goods and services are finite or limited in supply. But their being limited should be expressed in relation to human wants.

Thus, the term '**Scarcity**' reflects the imbalance between our wants and the means to satisfy those wants, i.e., it means limitation in the supply of a commodity relative to the need for it.

- ❖ Resources can be classified as:
 1. **Free resources and**
 2. **Scarce resource**

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- ♥ **Free Resources:** A resource is said to be free if the amount available to a society is **greater than** the amount people desire at **zero price**(if it would be supplied freely).

E.g. Sunshine, Solar Energy, etc.

- ♥ **Scarce(Economic) Resources:** A resource is said to be scarce or economic resource when the amount available to a society is **less than** what people want to have at **zero price**.

E.g. labor, land, machinery, etc.

- The same logic is applicable for goods and services. A **good or service** is said to be scarce or economic good when the amount available to the people in **less than** what the people want to have at **zero price**.

- 
- ❑ If a resource, goods or service is scarce, then it will have an economic value.

Note: Scarcity does not mean shortage. These two words often used interchangeably, but they mean different concepts in economics.

- ☛ We have already said that a good is said to be ‘**s c a r c e**’ if the amount available is **less than** the amount people wish to have at **zero price**.
- ☛ But, unlike to scarcity, we say that there is ‘**s h o r t a g e**’ of goods and services, or resources when people are unable to get the amount they want at the prevailing or **on going price**.
- ☛ **S h o r t a g e** is a specific problem and short term phenomenon, but **S c a r c i t y** is a universal problem and an everlasting phenomenon.

- 
- ❖ Economic resources are usually classified into **four categories**.

1. Labor:

- Refers to the physical as well as mental efforts of human beings used in the production and distribution of goods and services.
- This include various types of skilled and unskilled labor.
- The reward for labor is called **wage**.

2. Land:

- ❖ Refers to the natural resources or all the free gifts of nature usable in the production of goods and services. This include forest, water, oil, mineral deposits, original fertility of land, etc.
- It does not include those resources that are **transformed or altered** or improved by human beings.
- The reward for the services of land is known as **rent**.



3. Capital:

- ❖ Refers to all the manufactured inputs that can be used to produce other goods and services. This include all man made goods that are used for the further production of goods and services.
- ❖ **Example:** equipment, machinery, tools, buildings, transport and communication facilities (roads, bridges, trucks), improvement to land, etc.
- Capital is also known as **investment good**.
- It refer to **physical capital only**.
- It does not take financial (money) capital in to account.
- Financial capital is just a claim to own a physical capital.
- The reward for the services of capital is called **interest**.

4. Entrepreneurship:

- Refers to a special type of human talent that helps to **organize and manage** other factors of production to produce goods and services and takes risk of making losses.
- A person with such talent is known as **Entrepreneur**.
- Entrepreneurs are individuals who:
 - ☛ Organize factors of production to produce goods and services.
 - ☛ Make basic business policy decisions.
 - ☛ Introduce new inventions and technologies into business practice.
 - ☛ Look for new business opportunities.
 - ☛ Take risks of making losses.
- The reward for entrepreneurship is called **profit**.

The Factors of Production

Land



Land includes the "gifts of nature," or natural resources not created by human effort.

Capital



Capital includes the tools, equipment, and factories used in production.

Labor



Labor includes people with all their efforts and abilities.

Entrepreneurs



Entrepreneurs are individuals who start a new business or bring a product to market.



Capital Goods:

☛ are goods that are used to make other goods



Consumer Goods:

☛ are final products that are used or purchased directly by the consumer



2. Choice

- ❖ If resources are scarce, then output will be limited. If output is limited, then we cannot satisfy all of our wants. Thus, **choice** must be made.
- ❖ Due to the problem of scarcity, individuals, firms and government are forced to choose as to what output to produce, in what quantity, and what output not to produce.
- ❖ In short, **Scarcity implies choice. Choice, in turn, implies cost.**
- ❖ Cost is the forgone opportunity. That means whenever choice is made, an alternative opportunity is sacrificed. This cost is known as opportunity cost.

3. Opportunity Cost

- In a world of scarcity, a decision to have more of one thing, at the same time, means a decision to have less of another thing. The value of the next best alternative that must be sacrificed is, therefore, the **opportunity cost** of the decision.

Opportunity Cost: refers the amount or value of the next best alternative that must be sacrificed (forgone) in order to obtain one more unit of a given product.

- Scarcity → limited resource → limited output → we might not satisfy all our wants → choice involves costs → opportunity cost

4. The Production Possibilities Frontier or Curve (PPF/ PPC)

The Production Possibilities Frontier (PPF) is a curve that shows the various possible combinations of goods and services that the society can produce given its resources and technology.

- ❖ It also indicates the maximum possible amount of one good, say, food, that the society can produce given the output level of the other goods, say computer.
- ❖ To draw the PPF we need the following assumptions.



i. Efficiency

- The economy is operating at full employment and is achieving full production.

ii. Fixed Resources

- The quantity as well as quality of economic resource available for use during the year is fixed. That means both the quantity and quality of labor, capital, land and entrepreneurship available in the economy remain constant.

iii. Fixed Technology

- Technology does not change for a given period of time, say for a year.

iv. Two Product

- For simplicity purpose, let us assume that the society is producing two goods: say **Food** and **Computer**.

To make the concept of PPF clear, let's take the following example.

- ❖ Consider that Ethiopia produces only two types of products: Food and Computer. The following PP schedule (table) represents the various combinations of **'Food'** and **'Computer'** that Ethiopia can produce in a given period of time, say one year.

Table 1.1: Alternative production possibilities of a certain nation

Types of products	Unit	Production alternatives				
		A	B	C	D	E
Food	metric tons	500	420	320	180	0
Computer	number	0	500	1000	1500	2000

- ★ If we put 'Food' production on the vertical axis and production of 'Computer' on the horizontal axis, and draw the information given on the PP table, we get this curve.

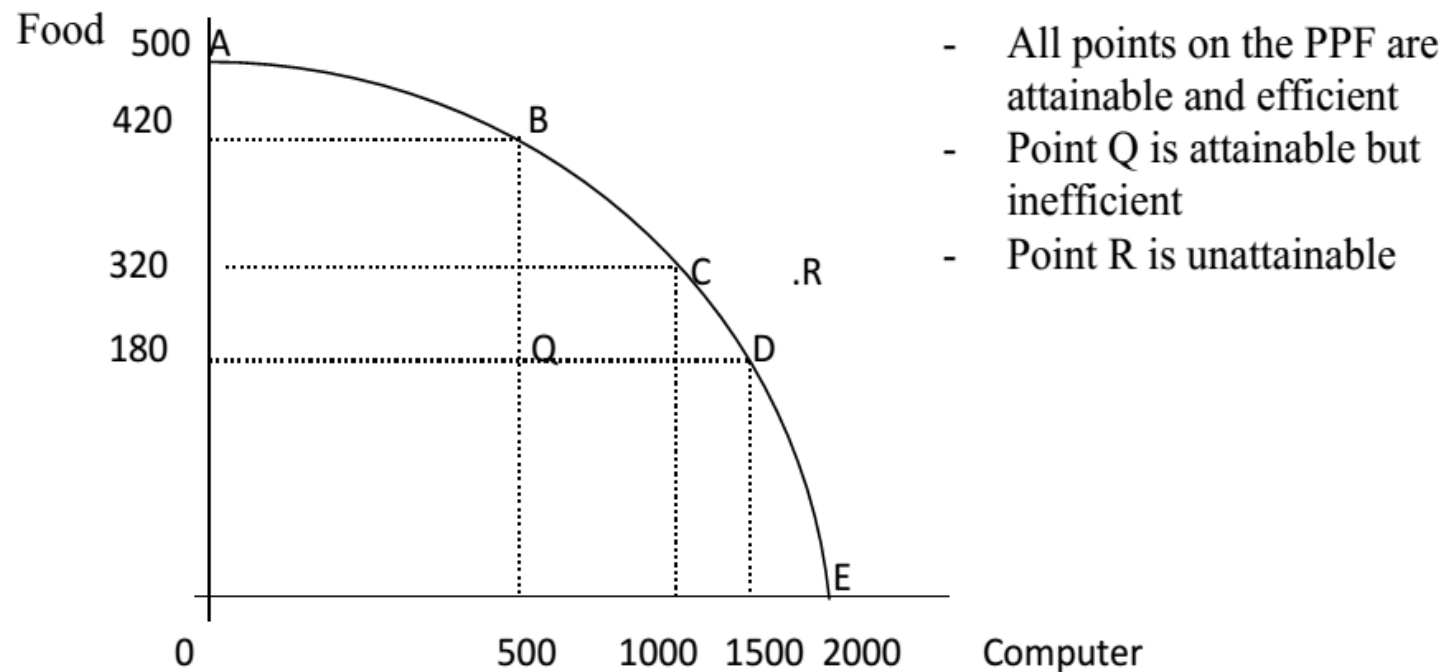


Figure 1.1: Production Possibilities Frontier

The PPF describes three important concepts:

i) The Concepts of Scarcity: - the curve indicate the maximum combinations of the two goods that the society can produce given its resources and technology. Any combinations of the two outputs outside the curve is **unattainable**. The idea is that the society cannot have unlimited amount of outputs even if it employs all of its resources and utilizes them in the best possible way.

ii) The Concept of Choice: - any movement along the curve indicates the change in choice.

For example: if the society produces at point B, it means that the society wants to have more food and less of computer. But if the society prefers point D, it means that the society chooses to have more computers and less food.

iii) The Concept of Opportunity Cost: - when the economy produces on the PPF, production of more of one good requires sacrificing some of another product which is reflected by the downward sloping of the PPF.


$$\text{Opportunity cost of a good} = \frac{\text{the amount of the next best alternative sacrificed}}{\text{the amount of the good gained}}$$

Example: Referring to Table 1.1 above, if the economy is initially operating at point B, what is the opportunity cost of producing one more unit of computer?

Solution: Moving from production alternative B to C we have:

$$OC = \frac{320 - 420}{1000 - 500} = \left| \frac{-100}{500} \right| = \underline{\underline{0.2}}$$

Interpretation

The economy gives up 0.2 metric tons of food per computer.

- 
- ❖ Related to the opportunity cost we have a law known as **the law of increasing opportunity cost**.

The law of increasing opportunity cost: states that as we produce more and more of a product, the opportunity cost per unit of the additional output increases. This makes the shape of the PPF concave to the origin.

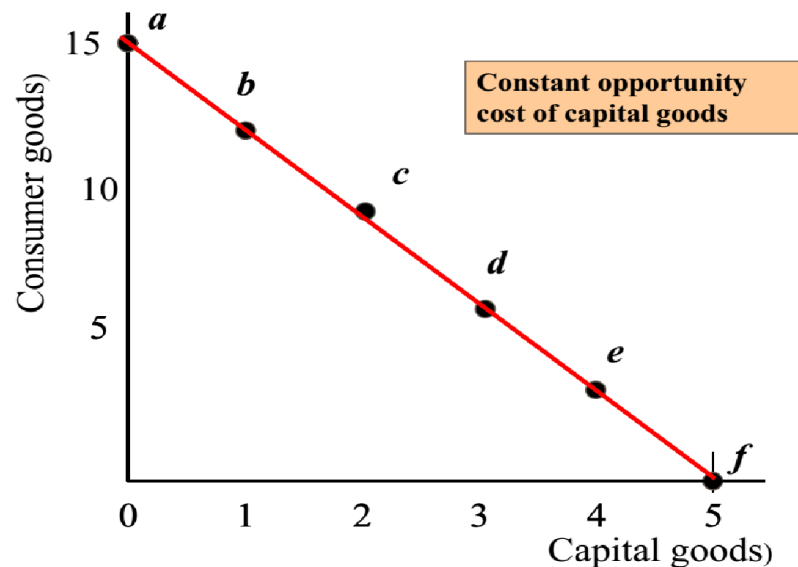
- ❖ The reason why opportunity cost increases when we produce more of one good is that economic resources are not completely adaptable to alternative uses (**specialization effect**).
- ❖ In other words, due to the existence of specialized inputs, resources may not be equally productive in different uses.

Law of Constant Opportunity Costs:

If factors of production are perfectly interchangeable each other then the **opportunity costs will be constant**, and hence the **PPF will be a straight line**.

It implies that the same amount of factors are transferred from the production of one good to produce the same extra amount of another good.

Figure 1.2 PPF and Constant Opportunity Cost



5. Economic Growth and the PPF

❖ **Economic growth** is the **increase in the real output level** of the economy overtime. Economic growth or an increase in the total output level occurs when one or both of the following conditions occur.

1. **Increase in the quantity or/and quality of economic resources**
2. **Advances in technology**

❖ Graphically, economic growth is represented by **outward shift of the PPF**.

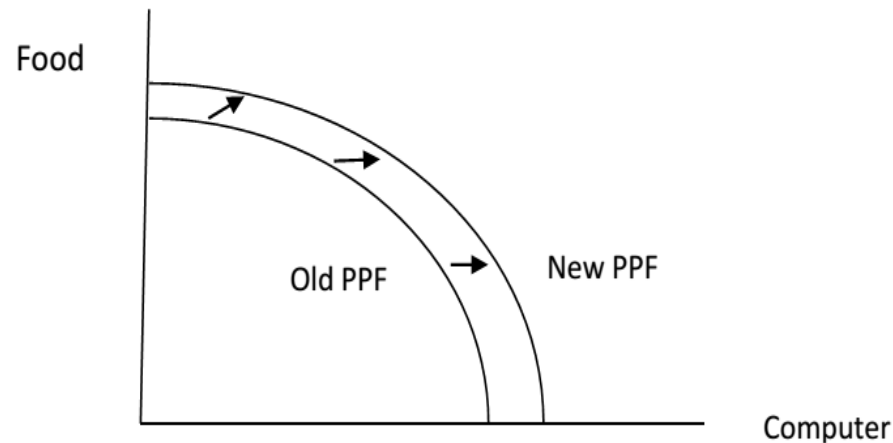
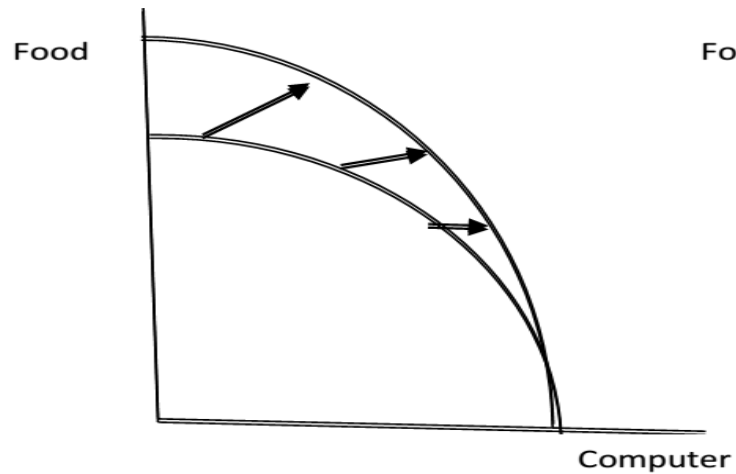


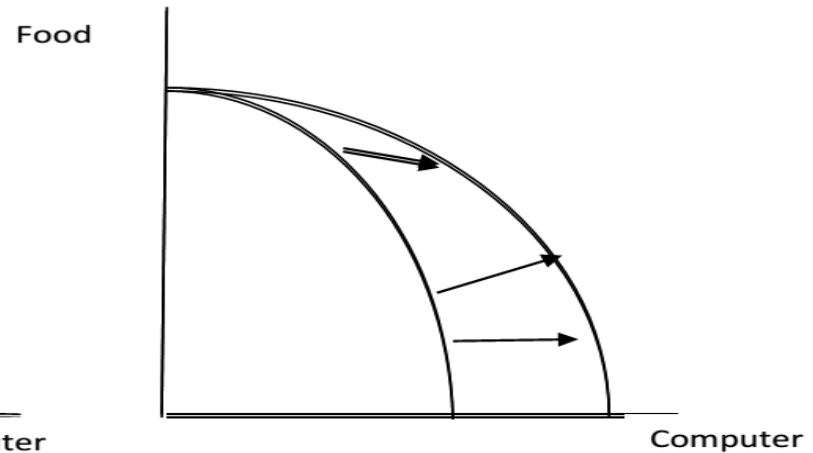
Figure 1.3: Economic Growths with a new PPC

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- ❖ **Technological advancement** allow the country to better utilize the available resources and get more of both products.
 - ❖ A change in technology can be **symmetrical or asymmetrical**.
 1. When technological changes occur in **both sectors**, such changes are known as **symmetrical technological changes**.
 2. On the other hand, when technological changes occur in **one of the sectors only**, that type of technological changes are known as **asymmetrical(non-symmetrical) technological changes**.

Effects of technological advancement
on Food production



Effects of technological advancement
on Computer production



❖ Effects of Technological advancement
on both products

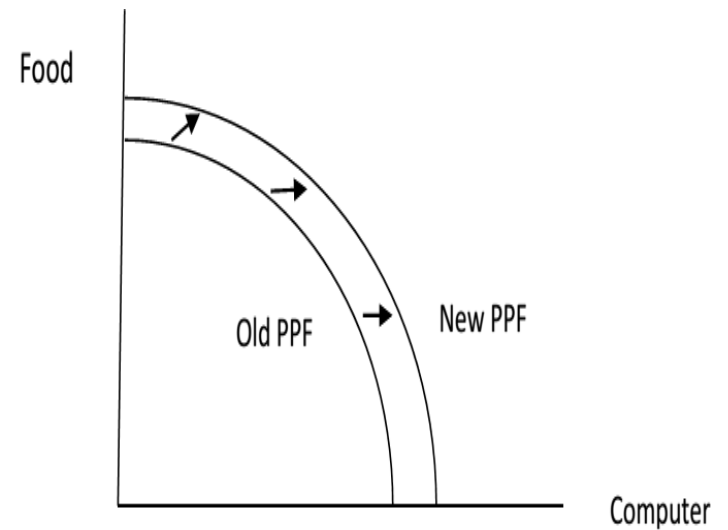
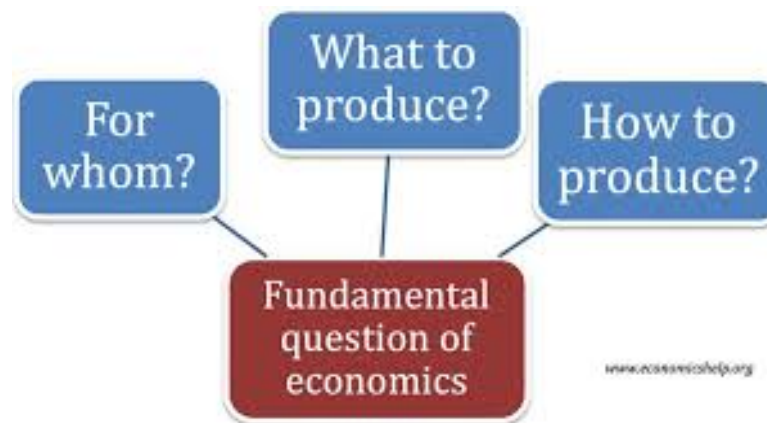


Figure 1.4: Economic Growth and the PPF

BASIC ECONOMIC QUESTIONS

- Economic problems faced by an economic system due to scarcity of resources are known as **Basic Economic Problems**. These problems are common to all economic systems. They are also known as **Central Problems of an Economy**. Therefore, any human society should confront and answer the following **three basic questions**.



What to Produce?

- ❖ Given the problem of scarcity, any society should decide **on what output to produce and what not to produce.**
- ❖ In short, this implies that every economy must decide **which goods and in what quantities are to be produced.**
- ❖ This problem is also known as **the problem of allocation of resources.**

How to Produce?

- ❖ Once an economy has reached a decision regarding the types of goods to be produced, and has determined their respective quantities, it must decide **how to produce them** i.e., **choosing between alternative methods or techniques of production.**
- ❖ Should the economy use **more of capital or labor intensive technology?** This problem is also known as the **problem of choice of technique** or a question of **technological choice.**



For Whom to Produce and Distribute?

- ❖ It relates to **how a material product is to be distributed** among the members of a society. The economy must decide, for example, whether to produce for the benefit of the few rich people or for the large number of poor people.
- ❖ This problem is also known as the **problem of distribution of national product**.

ECONOMIC SYSTEMS

- ❖ The above mentioned questions are **universal in nature** that every human society should answer. But the **solutions vary from society to society**.
- ❖ The way a society tries to answer the above fundamental questions is summarized by a concept known as **economic system**.

An economic system is a set of organizational and institutional arrangements established **to answer the basic economic questions**.

- ❖ Customarily, we can identify **three types** of economic system. These are **Capitalism, Command Economy and Mixed Economy**.



Capitalist Economy / Capitalism

- ❖ **Capitalism** is the oldest formal economic system in the world.
- ❖ It became widespread in the middle of the 19th century.
- ❖ In this economic system, all means of production are **privately owned**, and **production takes place** at the initiative of **individual private entrepreneurs** who work mainly for private profit.
- ❖ Government intervention in the economy is **minimal**.
- ❖ This system is also called **free market economy** or **laissez faire system**.
- ❖ In a pure capitalism, the three economic questions are answered as follows:

- 
- ❖ Firms address the “**What to Produce**” question by producing those goods and services that gives them the **maximum possible profit**.
 - ❖ The “**How to Produce**” question is answer by choosing the techniques of production which are **least costly**. That means the technology a firm choose to produce its products are least costly methods of production.
 - ❖ The “**For Whom to Produce and Distribute**” question is addressed depending on the **people`s purchasing power** to buy them. Those who have more purchasing power receive more goods and services.

Reading Assignment

Read thoroughly the main features, advantages and disadvantages of the three alternative economic systems.



Command Economy / Socialism

- Command economy is also known as **Socialistic Economy**.
- Under this economic system, the **economic institutions** that are engaged in production and distribution are **owned and controlled by the state**.
- Beginning with **Russia (1917)**, many countries of the world adopted this system **after the second world war**.
- However, in the recent past, Socialism has **lost its popularity** and most of the socialist countries are trying free market economies.
- Unlike Pure Capitalism, Command Economy is characterized by **public ownership of property/resource**, and economic activities are coordinated and directed by **the government through central planning**.

- 
- In such a system, almost all decisions regarding What, How and for Whom to produce are determined **by the government**.
 - In short, while in pure capitalism, production and distribution of goods and services are decided by **the private sector** through the market mechanism, in command economy , they are decided by **the government**.

Note: Between 1974-1991 **G.C Ethiopia** was more or less under the **command economic system** even though to **some extent**, there was still **private ownership of the means of production**, and **market had some role in coordinating economic activities** in the economy. Resources were allocated depending on the priorities set **by the government**.

Mixed Economy

- Pure Capitalism and Command Economy are the **two extreme types of economic system**. Both have their own advantages and disadvantages.
- **A Mixed Economy** is an attempt to **combine the advantages** of both the capitalistic economy and the command economy.
- It incorporates some of the features of both, and allows **private and public sectors to co-exist**.
- In other words, **Mixed Economy** is an economy containing the characteristics of both Capitalism and Socialism: a **combination of private and public ownership of the means of production, with some degree of control by the government**.

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- The concept of Mixed Economy is of **recent origin** and many developing countries have adopted the system of mixed economy.
 - In practice **every economy in the world is a mixed economy** in the sense that it combines significant elements of the two systems.
 - In fact, neither the **USA**, nor any other country in the world has a pure capitalist type of society. In strict sense of the world, there is **no country falls** completely under either pure capitalist or socialist type of economic system.
 - Rather today's real world economies **fall between pure capitalism and the command economic system**. The shortcoming of pure capitalism and command economy have led to the evolution of modern mixed economies.
 - In such a system, both **the government and the market decide** on the questions of What, How, and for Whom to Produce and Distribute.

Decision Making Units and Circular Flow Model

1. Decision Making Units

- ◆ Basically, there are three decision making units in a **closed economy**. These are **Households, Firms and the Government**. They are collectively known as “**Economic Agents**”.

Closed Economy: is an economy that **does not interact with the rest of the world**. That means there is **no import and export** of goods and services, **capital will not flow into the country** and **capital will not flow out of the country**.

1. Household:

- ❖ A household can be one person (individual) or more than one person (individuals) who live under one roof and make joint financial decisions.

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- ❖ Households are the **main owners of factors of production-** land, labor, capital and entrepreneurship.
 - ❖ They **sell the services of these factors** to producers and, in return, **receive their income** in the form of rent, wage, interest and profit.
 - ❖ They also use the money paid to their service (income) to buy goods and services from producers.
 - ❖ **Households make two decisions:**
 - a) **Selling of their resources, and**
 - b) **Buying of goods and services**



2. Firm:

- ❖ A firm (producer or business sector) is a production unit that uses economic resources to produce goods and services, and sell them to households, other firms and government.
- ❖ **Firms also make two decisions:**
 - a) **Buying of economic resources**, and
 - b) **Selling of their products.**

3. Government:

- ❖ A government is an organization that has **legal and political power to control** or influence households, firms and markets.

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- ◇ Government also produce and supply some types of goods and services known as **public goods and services** to the society.

Public Goods: are those goods that can be jointly consumed by many individuals, simultaneously, whether they pay or not, with no additional cost or decline of quality and quantity of the good.

❖ Street light, public education, public health, defense service, highways, etc. are some of goods and services provided by the government.

- ◇ But to provide such goods and services, government needs finance.
- ◇ Government collect the fund from households and firms in the form of compulsory charges, mainly **taxes**.

2. The Circular Flow of Model

- ♥ The above mentioned three economic agents interact in two markets:

A. Product Market:

- * Is a market where goods and services are transacted/ exchanged.
- * Precisely, it is a market where households and governments buy goods and services from business firms.

B. Factor Market (Resource Market):

- * Is a market where resources bought and sold.
- * In this market, owners of resources (households) sell their resources to business firms and governments.

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- ♠ The **Circular-flow diagram** is a visual model of the economy that shows how money (birr), economic resources and goods and services flows through markets among the decision making units.
 - ♠ Now, to clearly understand the economic interaction among the households, firms and government we will use two different models of circular flow.

A. Two-Sector Circular Flow Model:

B. Three-Sector Circular Flow Model:



A. Two-Sector Circular Flow Model:

- ♠ It is a model where there are only **firms and households interact**.
- ♠ In this model, we see the flow of goods and services from producers to households, and a flow of resources from households to business firms.

B. Three-Sector Circular Flow Model:

- ♠ It is a model where **firms, households and the government interact**.
- ♠ The only difference of the three sector model from the two sector model is that it involves government participation in the market.

Flow Types

❖ In any of these two models there are **two types of flow**:

1. Real Flow:

➤ It is a type of flow that shows the flow of real things i.e., shows the flow of:

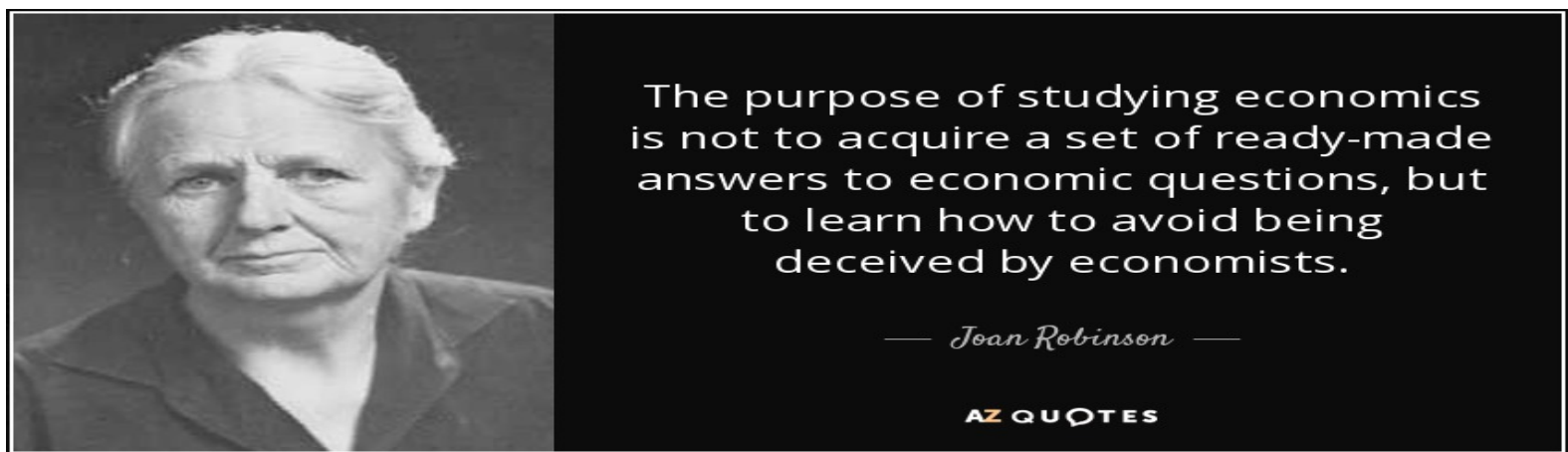
- ☛ **Resources** from the owners of means of production to producers and,
- ☛ **Goods and services** from the producers to the buyers

2. Money(Financial Flow):

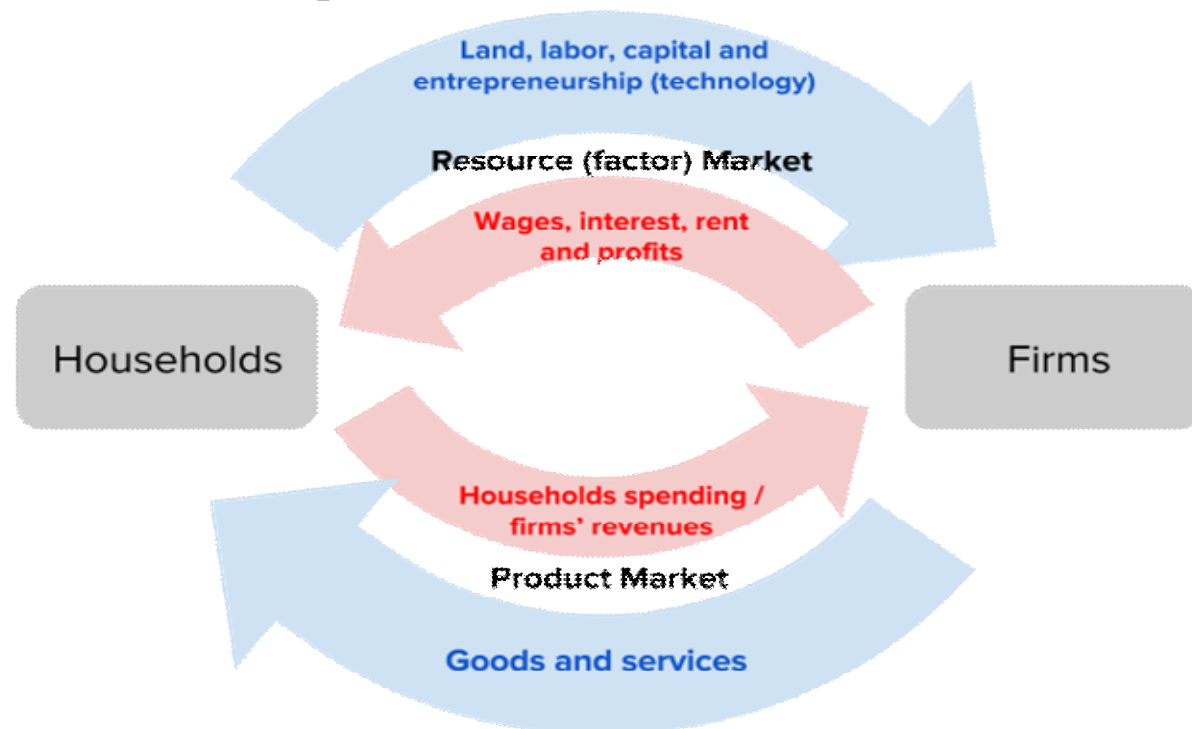
➤ It is a type of flow shows the flow of income and expenditure. i.e., flow of:

- ☛ **Money income** from buyers to sellers
- ☛ **Money expenditure** for the purchase of goods and services

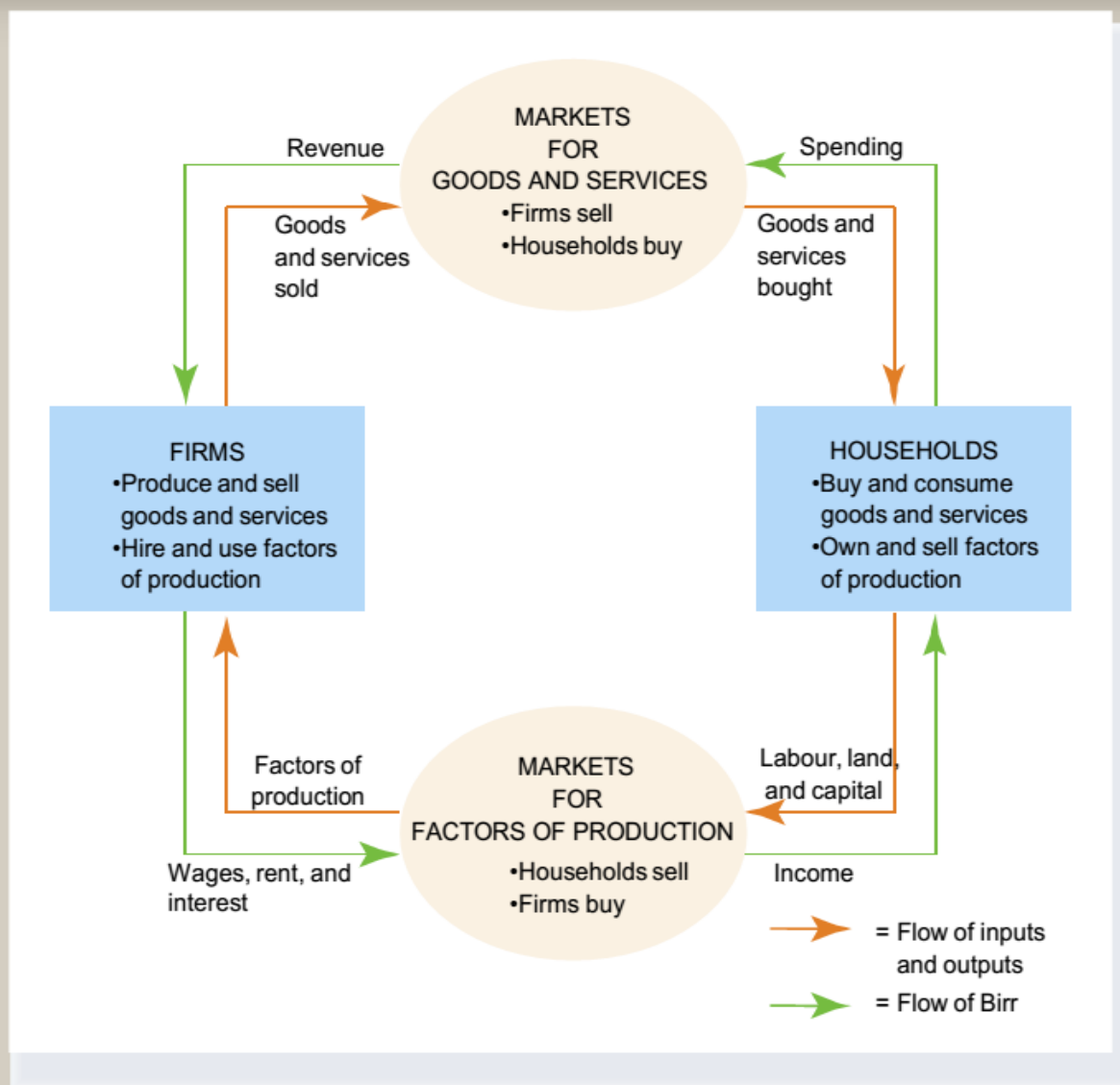
- ❖ In the following diagrams, the **clock-wise direction** shows the **flow of economic resources and final goods and services**. Business firms sell goods and services to households in product markets (See the upper part of the next two diagrams/slides).
- ❖ On the other hand, the lower part of these two slides show, where households sell factors of production to business firms through factor market. The **anti-clock wise direction** indicates **the flow of birr** (in the form of revenue, income and spending on consumption).

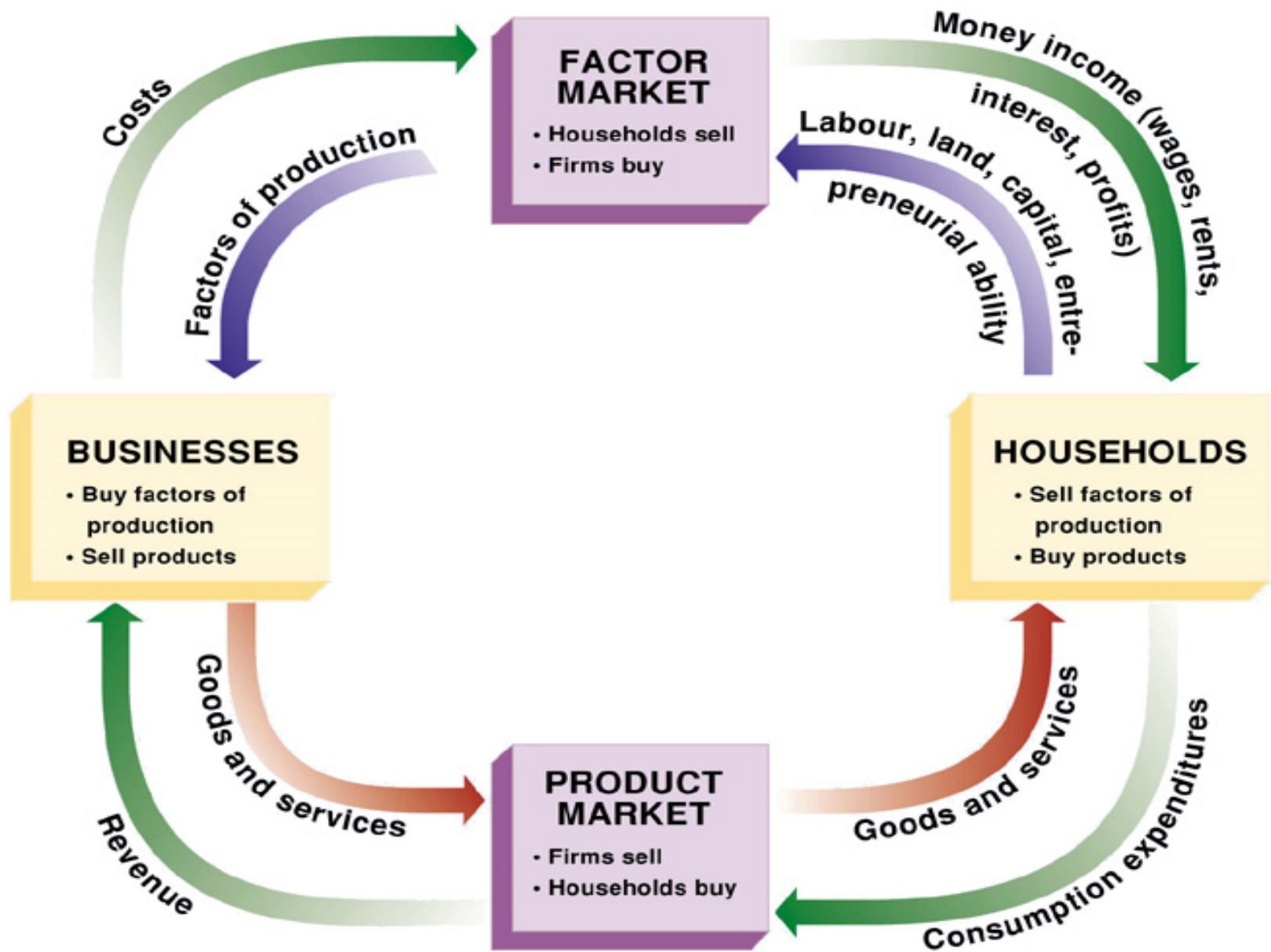


- **Households** by supplying their resources to firms **receive income**. This represents **expenditure** by firms to purchase factors of production which is used as an input to produce goods and services.
- On the other hand, **Firms**, by selling goods and services to households, receive money in the form of **revenue** which is **consumption expenditure** for households in the product market.

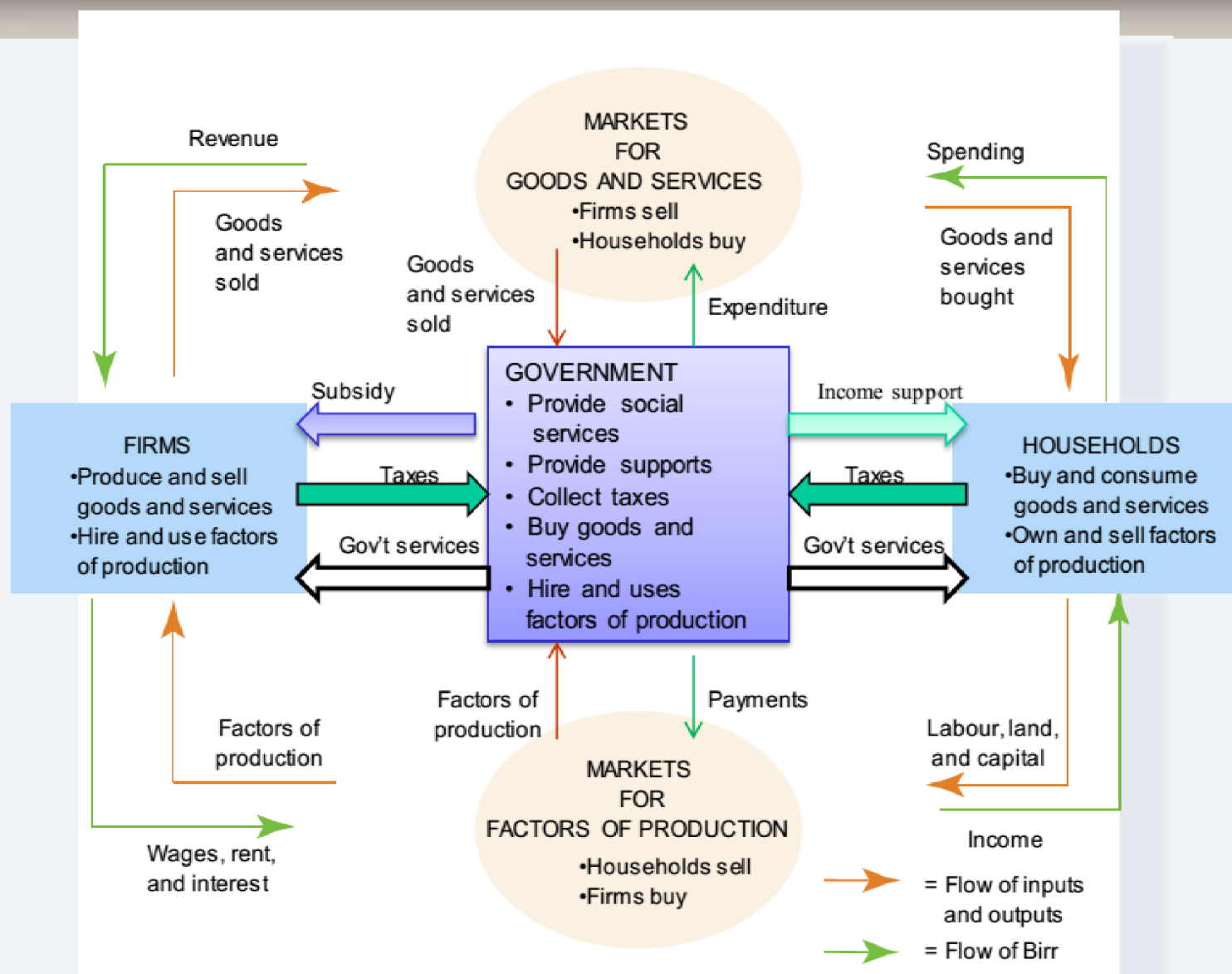


A Two sector model

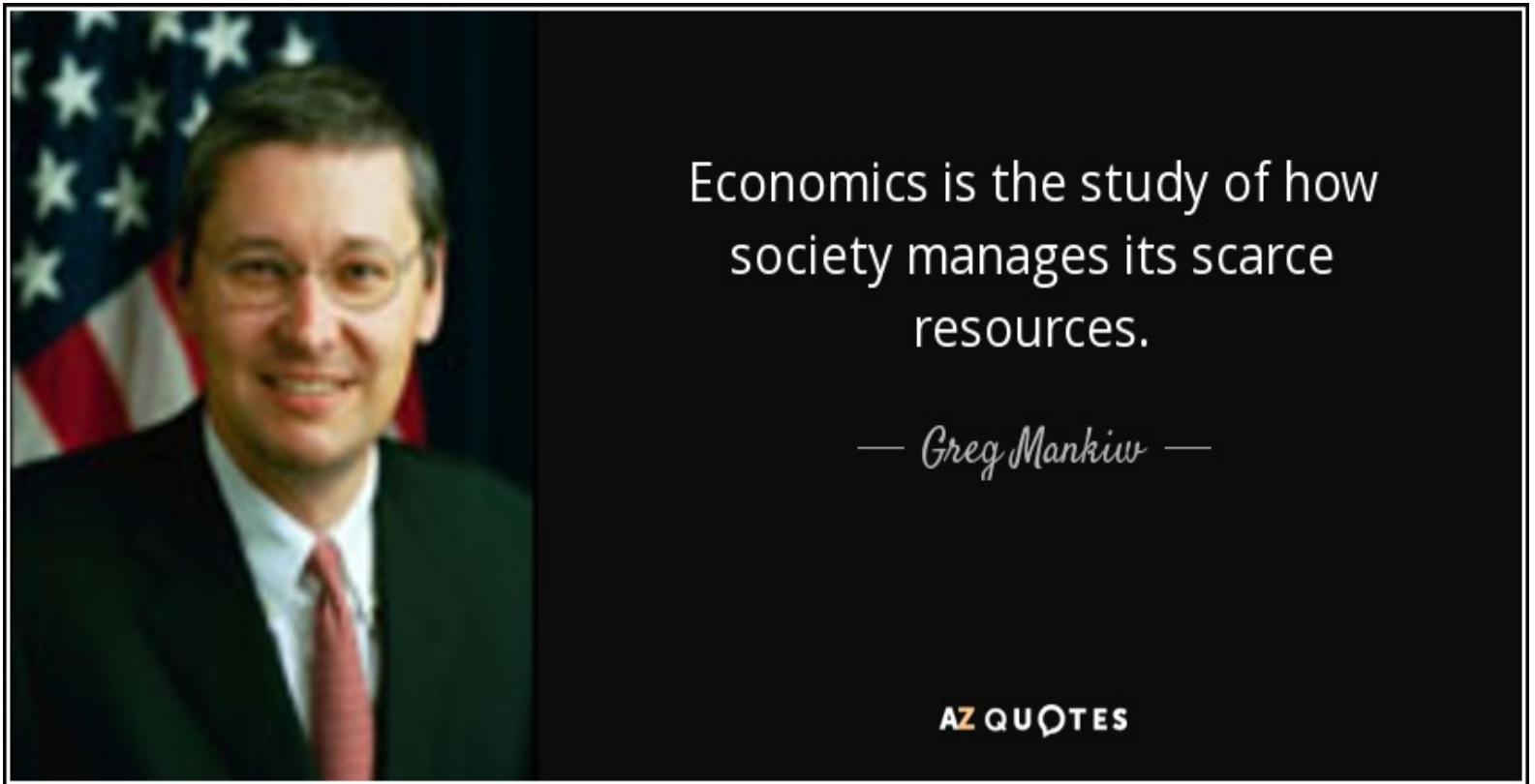




A Three sector model



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- To produce those goods and service, government needs **resource, goods and services**. It can buy **goods and services** from **firms** through the product market, and **resources** required for the provision of the services from the factor market by making payments to the resource owners (**households**).
 - The service provided by the government goes to households and business firms. The government might also support the economy by providing **income support** to **households** and **subsidies** to **business firms**.
 - At this point you might ask the source of government finance to make the expenditures, payments and additional supports to the firms and households. The main source of revenue to the government is the “**tax**” collected from households and firms.



The End