

Introduction to Economics

Chapter One

Nature of Economics

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Introduction

- The word economy comes from the Greek phrase “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.

Definition of Economics

- There is no universally accepted definition of economics (its definition is controversial).
- This is because different economists defined economics from different perspectives:
 - a. Wealth definition,
 - b. Welfare definition,
 - c. Scarcity definition, and
 - d. Growth definition
- Its definition varies as the nature and scope of the subject grow over time.

- But, the formal and commonly accepted definition is based on **two fundamental Economic facts**.

- i. Human (society's) material wants are unlimited.
- ii. Economic resources (Land, Labor, Capital and Entrepreneurship) are limited (**scarce**).

- Because of scarcity, economic resources should be **allocated efficiently**. Thus,
 - **Economics** is the science that study efficient allocation of scarce resources in an attempt to satisfy the unlimited human wants.

Scope of Economics

- **There are two branches of Economics**

A. 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.

B. Macroeconomics is a branch of economics that deals with the Economy.

Eg:- Total output (GDP),

- Total employment
- Inflation and etc

Methods of economic analysis

- Economics can be analyzed from two perspectives: positive economics and 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.
- **Example:**
 - The current inflation rate in Ethiopia is 12 percent.
 - The life expectancy at birth in Ethiopia is rising.
- Any disagreement on positive statements can be checked by looking in to facts.

- **Normative economics:** It deals with the questions like, what ought to be? Or what the economy should be?
- It is based on one's value judgments about what is good or what is bad.
- Since normative economics is based on 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 cannot 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.
- Any disagreement on a normative statement can be solved by voting (not by checking fact).

Inductive and deductive reasoning in economics

- **a) 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.
- **b) Deductive reasoning** is a logical way of arriving at a particular or specific correct statement starting from a correct general statement.
- In short, it deals with conclusions about economic phenomenon from certain fundamental assumptions or truths or axioms 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.

Scarcity, choice, opportunity cost and production possibilities frontier

- Scarcity refers to there **exists only a finite/limited/ amount of human and non-human resources.**
- In the *face of scarcity, therefore, choice becomes an inevitable feature of life.*
- Choice means selecting alternative uses of scarce resources or **setting priority.**
- Scarcity forces people to choose among alternative uses of economic resources *because all other wants cannot be satisfied simultaneously.*
- Because resources are limited, the output produced is limited too.
- Thus, an economic choice needs to be made as to what quantities of each product to produce.

There are four types of resources

- ^ **Labour:** refers to the *physical as well as mental efforts of human beings* in the production and distribution of goods and services. The reward for labour is called **wage**.
- ^ **Land:** refers to the *natural resources or all the free gifts of nature* usable in the production of goods and services. The reward for the services of land is known as **rent**.
- ^ **Capital:** refers to all the *manufactured inputs that can be used to produce other goods and services*. Example: equipment, machinery, transport and communication facilities, etc. The reward for the services of capital is called **interest**.
- ^ **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.

- **Note:** *Scarcity does not mean shortage.*
- Shortage is a *specific and short term problem* but *scarcity is a universal and everlasting problem.*
- *Scarcity → limited resource → limited output → we might not satisfy all our wants → choice (setting priority) → opportunity cost.*
- **Opportunity** cost is the amount or value of the next best alternative that must be **sacrificed (forgone) in order to obtain one more unit of a product.**

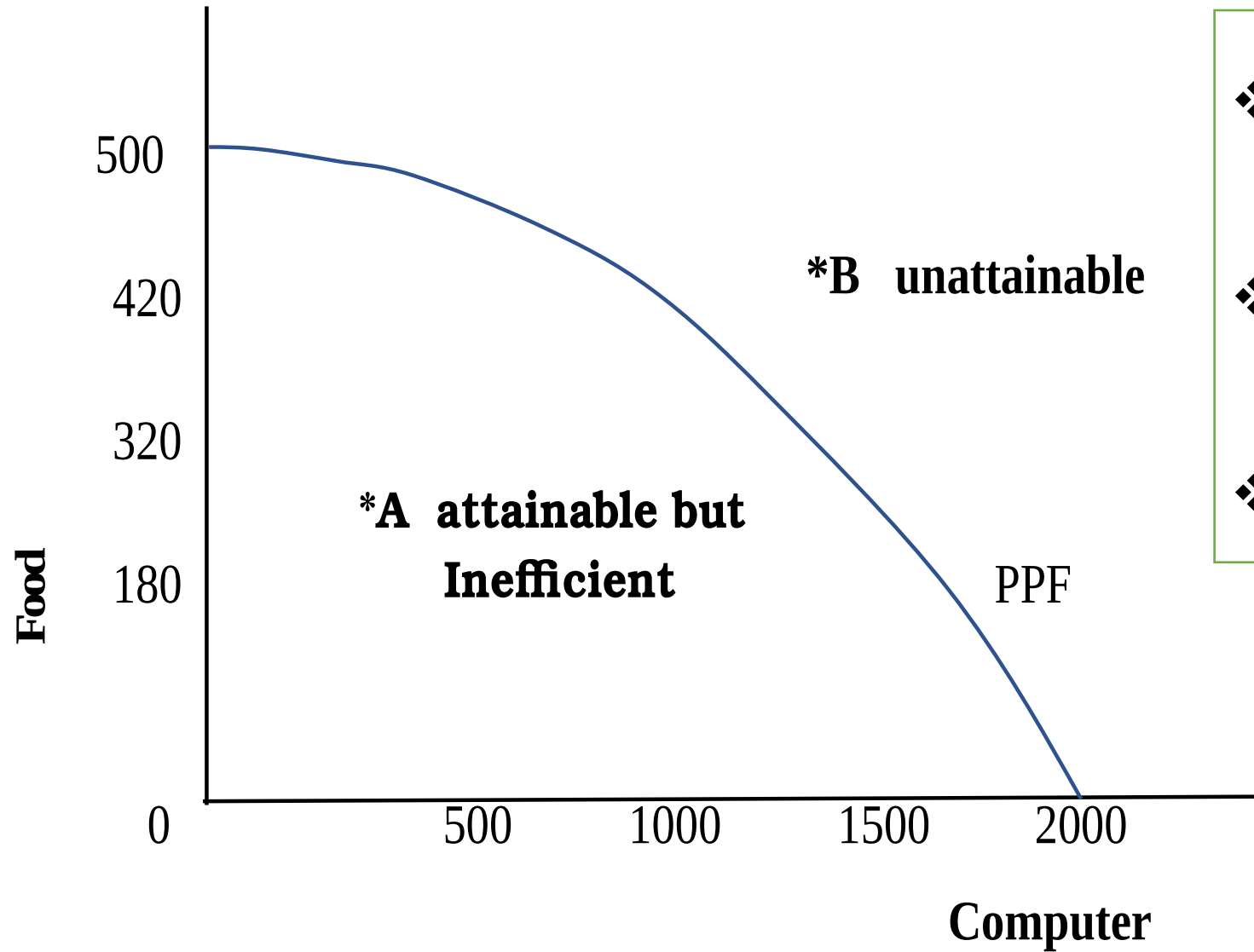
The Production Possibilities Frontier or Curve (PPF/ PPC)

- **PPF**- shows various combinations of two types of goods that an economy can produce when its **resource is fully employed**.
- *Assumptions used in illustrating the PPF*
 - i. Fixed resources
 - ii. Full employment of resources (production efficiency)
 - iii. Fixed technology
 - iv. Closed economy
 - v. Two products

- Suppose a hypothetical economy produces food and computer given its limited resources and available technology.

➤ **Alternative production possibilities of a certain nation**

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



- ❖ All points on the PPF are attainable and efficient
- ❖ Point **A** is attainable but inefficient
- ❖ Point **B** is unattainable

- **Production Possibility Frontier (PPF)**

- The **PPF** describes **three important concepts**:
 - i. **The concepts of scarcity**: - 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.
 - 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 PPF.

- **Opportunity cost** is the value of the next best alternative that is forgone due to scarcity of resources.

$$\text{Opportunity cost} = \frac{\text{The amount sacrificed of one good}}{\text{The amount obtained of the other good}}$$

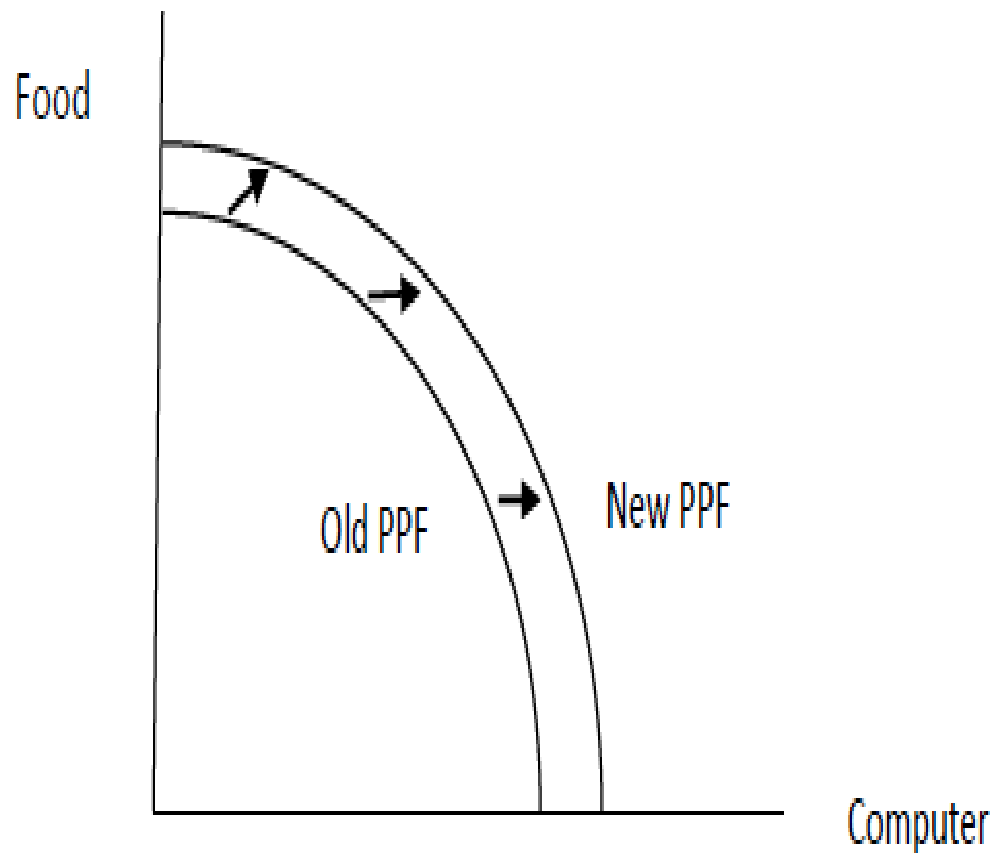
Example: when we go from B to alternative C is

➤ **Economic Growth and the PPF**

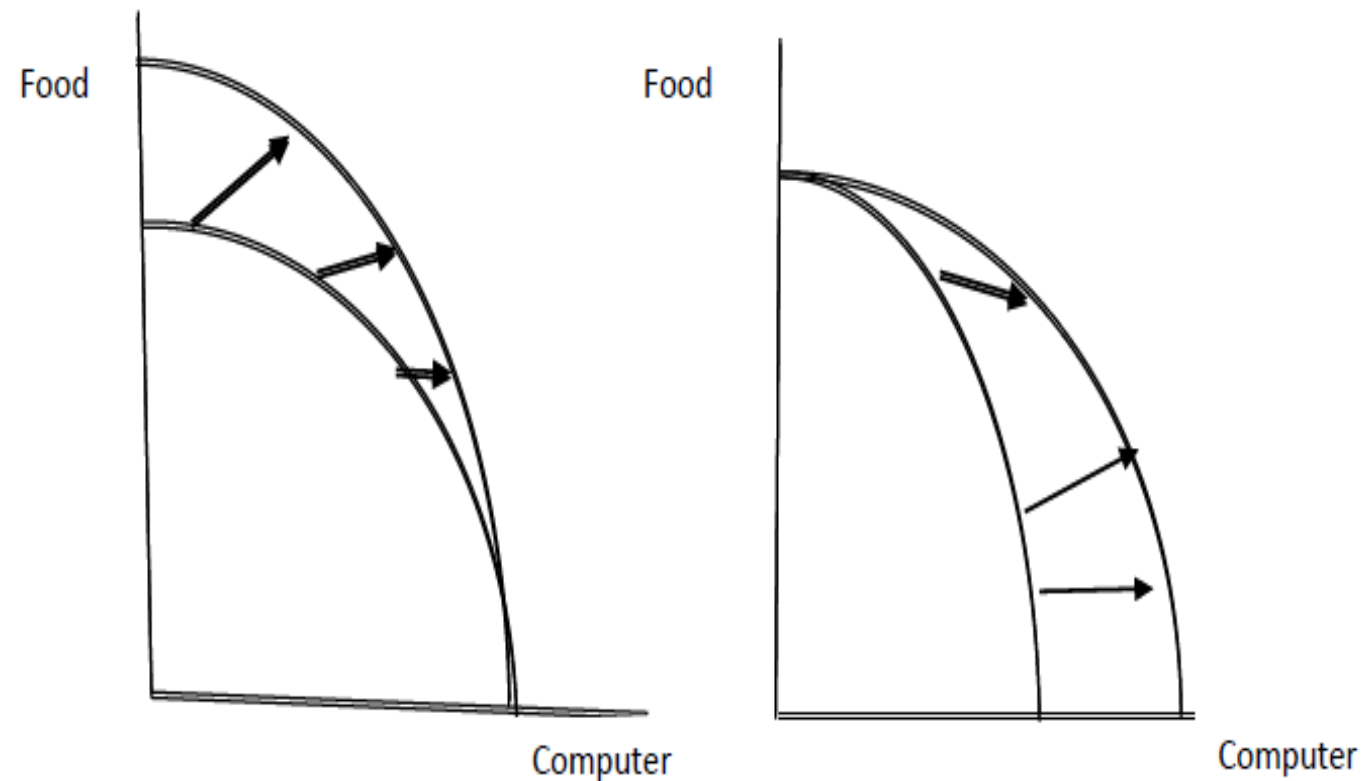
- **Economic growth** or an **increase in the total output** level occurs when one or both of the following conditions occur.

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

➤ Economic growth is represented by outward shift of the PPF.



Economic growth is represented by outward shift of the PPF



Improvements in technology and quality and/or quality of resources on national output

Basic economic Questions

- In every nation, no matter of what the form of government, what type of economic system, who controls the government, or how rich or poor the country is, **three basic economic questions must be answered.**
 1. ***What to produce***: what output and how much of each to produce is the question to be answered. This question is concerned with **composition / output mix** in the country.
 2. ***How to produce***: choice must be made about the particular **input mix**, the **way they are organized, method (technique) of production** to be adopted and **where the production takes place.**
 3. ***For whom to produce***: referred to as the problem of distribution.
 - Distribution of finished products to ultimate consumers.

- **Economic system:** is a set of *organizational and institutional arrangement established* to answer the basic economic questions of *what, how and for whom to produce*.
- There are **three types** of economic system.
 - a. **Capitalist economy:-** 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 market system or laissez faire*.

b. Command (Socialism) economy:- All resources are owned and controlled by the state.

- The three basic economic questions are answered by government.

c. Mixed economy:- 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.**

Decision making units and Circular flow of economic activities

1. Households: are consumers of final goods and services produced in the economy, and owners of resources (land, labor, capital and entrepreneurship) and earn income from labor and property they own.

- They are assumed to maximize their wellbeing/ utility.

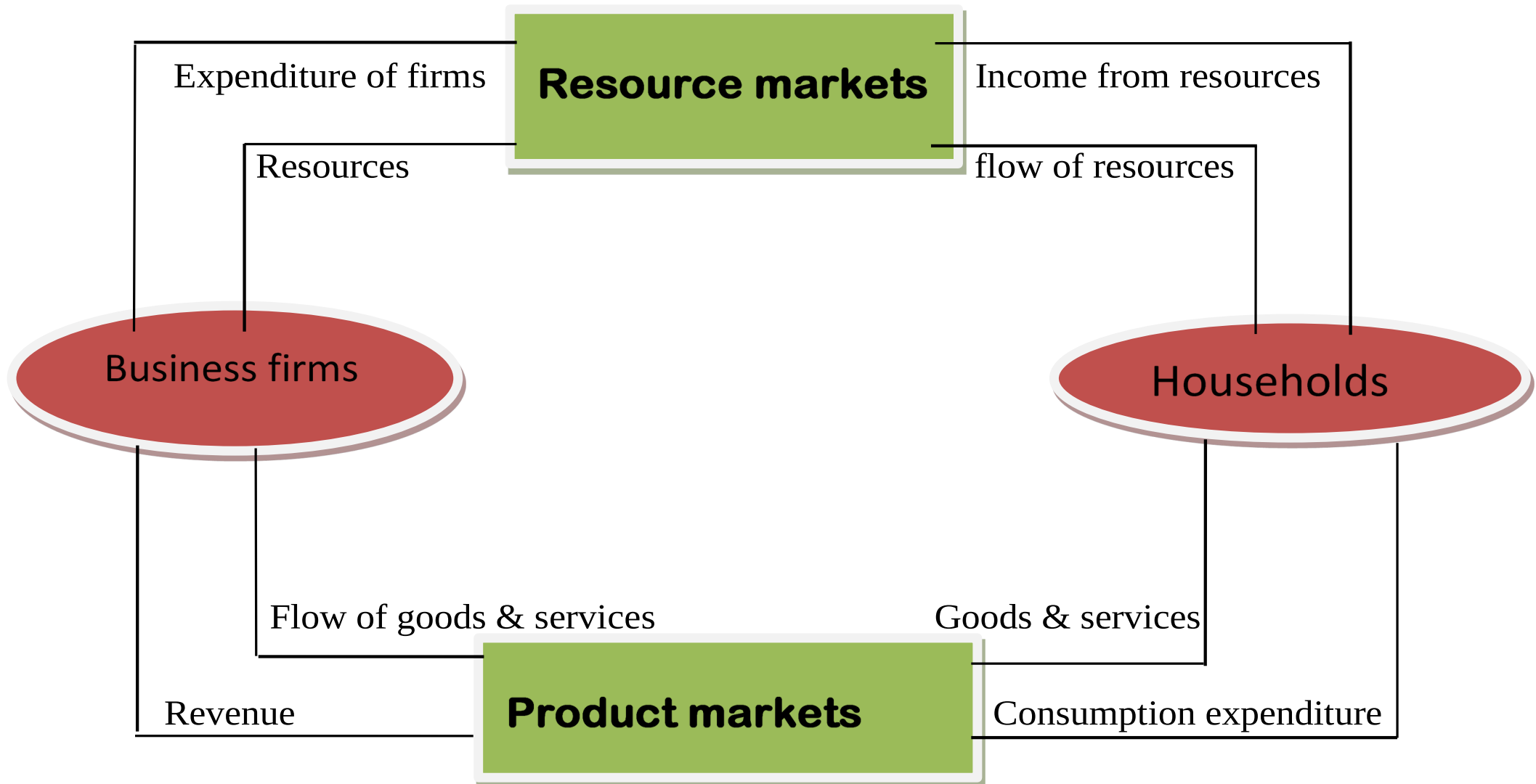
2. Business firms: are producing units in the economy. They hire workers and pay for use of properties households own. They use the resources to produce goods and services needed by the society (households and other firms).

- They have the objective of profit maximization.

3. Government: includes all government bodies at federal state and local levels.

- Government has power on households, firms and the markets.

Circular flow of economic activities



- In resources markets resources are traded and money in the form of consumers' income flows to households and resources flow to business firms.
- In product market income in the form of revenue flows to business firms and goods and services flow from firms to households.
- Generally, both households and firms engage in both markets, but on different side of each markets, once as a demander and then as a supplier.
- Households are suppliers in resource markets and demanders in product market, while firms are demanders in resource market and suppliers in product markets.
- In modern economies, government influences its economy first by producing some of the most important goods and services like education defense, law and order etc.
- second, government is concerned with regulating and fostering all economic aspects.

END OF CHAPTER ONE