Basic Economic Entities in an Economy

Meaning of an Economy

Economy is a system which provides people with goods and services to directly or indirectly satisfy their wants. Hence, it is a total system comprising farms, factories, mines and shops, and other growing institutions which provide these goods and services to people.

Main Sectors of an Economy

- The production sector is the sector where goods and services are produced. It produces by hiring various factors of production.
- The consumption sector is also known as the household sector as it provides various factors of production to the production sector and in return receives payment for these services.
- The government sector acts as a consumer and a producer in an economy.
    - As consumer, the government purchases goods and services from the production sector and these goods and services are consumed by society.
    - As producer, the government receives the services of various factors of production and produces goods and services for the consumption of the entire society.

Basic Units of Economic Analysis

An institutional unit which can perform economic activities independently is called an economic entity.

Classification of Basic Economic Entity

Consumers, households, firms and the government are the four basic entities of an economy because they perform the basic economic activities of production and consumption in an economy.

Consumers

Consumers are the basic economic entities in an economy. They consume goods and services in the market. Generally, consumers consist of institutions, groups of individuals and individuals. Hence, economists have replaced the concept of the consumer with that of households.

Household

A household refers to a group of people living under a single roof and taking economic decisions jointly. Thus, a household is primarily a unit relating to consumption. Households are consumption units. The dual roles played by households are

- They purchase different consumer goods for self-consumption and pay prices for these goods.
- They are also the owners of different factors of production and sell these factors to firms. They earn factor income for supplying these factors.

Households and firms interact with each other in two kinds of markets. They are product markets and factor markets. When they interact in a market for factors of production, they are called factor markets.

Firm
A firm refers to a particular unit producing a commodity or service with a view to earn profit. The dual roles played by firms are

- They produce and sell different products in exchange of product-prices.
- They purchase different factors of production by paying factor-prices to the owners of those factor services.

In this way, an exchange relationship is established between the firms and the households.

Government
Certain goods and services are not produced by private firms, such as defence and home security which are provided by the government. Also, the government regulates the money supply and frames broad economic policies regarding domestic and international trade and taxation. The most important aim of the government is to maximise social welfare.

Classification of Consumers

- Direct consumer: In the process of providing an income to people, a variety of goods and services are produced in an economy. Initially goods are produced for self-consumption. The producers for self-consumption are called direct producers.
- Consumers by exchanging goods: Gradually man realised that he cannot produce everything that he wants. Therefore, he has to depend on others to satisfy his wants. Some people were specialised in the production of wheat, while few others specialised in the production of cloth. Each one of them produced more than his own requirements to exchange the surplus and obtain other goods of his requirement. Such a system is called the barter system.
- Modern consumers: In the modern economy, producers produce goods and services and make them available in the market for sale. Consumers purchase these goods and services from the market at the best bargain prices. These goods and services are purchased through the exchange of money.

Importance of Consumers

- Consumers are the source of demand for various goods and services produced in an economy.
- Different consumers have different preferences. Hence, producers are encouraged to diversify their products.
- The consumer also demands services such as transport, banking and communication. Hence, the growth of the service sector would depend on the number of consumers of these services.

Classification of Producers

- Primary producers: Primary producers are engaged in the production of goods by exploiting natural resources such as food and other crops, fishing and cattle rearing. These are called primary goods.
- Secondary producers: Secondary producers are engaged in the production of manufactured goods in various types of industries. These are called manufactured goods or finished goods.
- Tertiary producers: The primary and manufactured goods require various kinds of services such as transport, banking and insurance. The tertiary producers are engaged in producing these services.

Importance of Producers

- Supply of goods and services: Producers are the basis of supply of goods and services in an economy. If there is an increase in the number of producers, then there will be an increase in the supply of goods and services in the market according to the demand of consumers.
- Efficient use of resources: There are limited resources in an economy which can be efficiently used in the production process. The producers create demand for various factors of production in their productive activities.
- Increase in export earnings: The export earnings of a country would depend on the number of producers involved in the production of exportable goods. Hence, the volume of export earnings would increase with an increase in the number of producers producing export goods.

Role of Government

The role of the government is essential to stimulate or discourage economic activity. This role can be divided into direct role and indirect role.

Direct Role

- Development of infrastructure: The state's role is essential for the development of infrastructure. In the initial phase, investments will have to be made towards creating economic and social heads such as education, health, power and transport. The private sector does not undertake such activities as there is more risk with low profit.
- Removal of inequalities of income and wealth: In a free capitalist economy, income equality cannot be achieved to a large extent because ownership of private property is allowed. Hence, the government can adopt measures such as the progressive tax system, expenditure policy and nationalisation of industries to reduce inequalities of income and wealth.
- To direct the market forces: The market forces of demand and supply do not meet the economic needs of all sections of people. These market forces are favourable only to those who can spend more, i.e. luxury goods for rich people will be produced more in the economy at the cost of necessities of life.
- Industrial development: The private sector is basically engaged in the manufacture of a few consumer goods for domestic consumption which provides profit. Hence, the state can directly participate by setting up essential industries such as iron and steel and heavy electricals.
- Agricultural development: The state can play a positive role in improving the productivity and production of the agricultural sector.
- Organisational changes: The private sector is neither capable nor interested in undertaking certain organisational changes in the process of economic development of a country. The government can develop the means of transport for the expansion of market size and organise labour by reorganising labour unions.

Indirect Role

The government can also participate indirectly in the process of growth and development of an economy.
It can adopt the following measures for rapid economic development:

- Monetary policy: Monetary policy is the policy of the government regarding controlling and regulating the supply of money and credit in the economy. The government formulates a specific monetary policy to maintain equilibrium between the demand and the supply of money.
- Fiscal policy: Fiscal policy refers to the revenue, expenditure and public debt policy of the government. Inequalities of income and wealth are corrected through the fiscal policy of the government.

- Foreign trade policy: Adverse balance of payments and shortage of foreign exchange can be solved by the government through measures such as export promotion and import substitution.
- Price policy: Through price policy, the government can maintain stable prices within a narrow range.

Differences between Fiscal Policy and Monetary Policy

Fiscal policy	Monetary policy
Fiscal policy affects the revenue and expenditure of the government.	Monetary policy affects the aggregate supply of money in an economy.
Fiscal policy instruments are government expenditure, imposition of taxes, subsidy provision and public debt.	Monetary policy instruments are bank rate, statutory liquidity ratio, cash reserve ratio and differential interest rates.