**Important Terms**

**Capital.** Goods such as tools, machines, factories, and transportation networks which are used in and/or facilitate the production of goods and services that satisfy human wants. The terms capital and capital resources are interchangeable.

**Command economy**. An economy in which the government directs the allocation of resources, the output of goods and services, and the distribution of the resulting output.

**Economic efficiency**. A state in which it is impossible to produce additional output of a particular good or service without decreasing the output of other goods or services.

**Economic growth**. An increase in the economy's productive capabilities due to an increase in the quantity or quality of economic resources and/or a change in technology.

**Economic problem**. Because of limited productive capabilities, there is a need to make decisions about what to produce, how to produce, and the distribution of output.

**Factors of production**. The inputs land, labor, and capital necessary for the production of goods and services. The terms factors of production and economic resources are interchangeable.

**Labor**. The mental and physical skills of individuals which are used to produce goods and services. The terms labor and human resources are interchangeable.

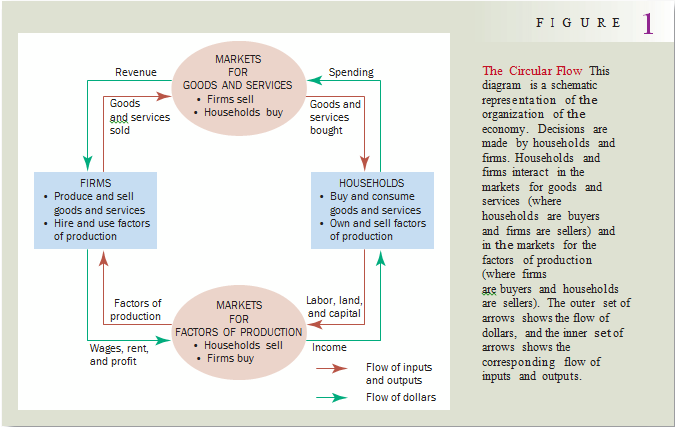
**Land**. The economy's natural resources land, trees, oil and minerals which can be used to produce goods and services. The terms land and natural resources are interchangeable.

**Market economy**. An economy in which individuals and businesses freely decide where to employ economic resources, freely decide which goods and services to produce, and freely distribute the resulting output.

**THE CIRCULAR-FLOW**

In a market economy, economic decisions are decentralized and are made by the collective wisdom of the marketplace, i.e., prices resolve the three fundamental economic questions of **what, how, and for whom.** The economy consists of millions of people engaged in many activities like buying, selling, working, hiring, manufacturing, and so on. To understand how the economy works, we must find some way to simplify our thinking about all these activities. In other words, we need a model that explains, in general terms, how the economy is organized and how participants in the economy interact with one another.

Figure 1 presents a visual model of the economy called a **circular-flow diagram**. Circular-flow diagram is a visual model of the economy that shows how dollars flow through markets among households and firms.



In this model, the economy is simplified to include only two types of decision makers firms and households. Firms produce goods and services using inputs, such as labor, land, and capital (buildings and machines). These inputs are called the ***factors of production****.* Households own the factors of production and consume all the goods and services that the firms produce.

Households and firms interact in two types of markets. In the ***markets for goods and services****,* households are buyers, and firms are sellers. In particular, households buy the output of goods and services that firms produce. In the ***markets for the factors of production****,* households are sellers, and firms are buyers. In these markets, households provide the inputs that firms use to produce goods and services. The circular-flow diagram offers a simple way of organizing the economic transactions that occur between households and firms in the economy.

The two loops of the circular-flow diagram are different but related. The inner loop represents the flows of inputs and outputs. The households sell the use of their labor, land, and capital to the firms in the markets for the factors of production. The firms then use these factors to produce goods and services, which in turn are sold to households in the markets for goods and services. The outer loop of the diagram represents the corresponding flow of dollars. The households spend money to buy goods and services from the firms. The firms use some of the revenue from these sales to pay for the factors of production, such as the wages of their workers. What’s left is the profit of the firm owners, who themselves are members of households.

What goods and services are produced is determined by the spending preferences of individuals; how these goods and services are produced depends upon the relative scarcity of the resources needed for production and the state of technology; to whom the output is distributed is determined by the income received by individuals in supplying resources to business firms.

Let’s take a tour of the circular-flow by following a dollar bill as it makes its way from person to person through the economy. Imagine that the dollar begins at a household, say, in your wallet. If you want to buy a cup of coffee, you take the dollar to one of the economy’s markets for goods and services, such as your local Starbucks coffee shop. There you spend it on your favorite drink. When the dollar moves into the Starbucks cash register, it becomes revenue for the firm. The dollar doesn’t stay at Starbucks for long, however, because the firm uses it to buy inputs in the markets for the factors of production. Starbucks might use the dollar to pay rent to its landlord for the space it occupies or to pay the wages of its workers. In either case, the dollar enters the income of some household and, once again, is back in someone’s wallet. At that point, the story of the economy’s circular-flow starts once again.