Ten Principles of Economics

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① What Economics is All About

The management of society's resources is important because resources are scarce.

Scarcity means that society has limited resources which cannot produce all the goods and services people wish to have.

Economics is the study of how society manages its scarce resources, including:-

- How people decide how much to work, save and spend and what to buy.
- How firms decide how much to produce, how many workers to hire.
- How society decides how to divide its resources between national defense, consumer goods, protecting the environment and other needs.

The study of economics has many facets, but it is unified by several central ideas.

How people make decisions

There is no mystery to what an economy is. An economy is just a group of people dealing with one another as they go about their lives. Because the behaviour of an economy reflects the behaviour of an individuals who make up the economy. The ten principles of economics give a sense of what economics is all about.

Decision making is at the heart of economics. The first four principles discussed how individuals make decisions.

Principle 1 : People face trade-offs

There's an old saying, "There ain't no such thing as a free lunch." There is much truth to this adage. To get something that we like, we usually have to give up something else that we also like. All decisions involve trade-off. Making decision requires trading off one goal against another. When people are grouped into societies, they face different kinds of trade-offs.

Examples :

- Going to a party the night before midterm leaves less time for studying.

- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.

An important trade-off society faces is between Efficiency and Equity. Efficiency means that society is getting the maximum benefits from its limited/scarce resources. Equity means that those benefits are distributed fairly among societies members not equally. People are likely to make good decisions only if they understand the options available to them. Our study of economics, therefore, starts by acknowledging life's trade-offs.

Principle 2 : The cost of something is what you give up to get it.

Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative choices. In many cases, the cost of an choice is not as obvious as it might first appear. The opportunity cost of an item is what you give up to get that item. It is the relevant cost for decision making.

Examples :

The opportunity cost of –

- going to college for a year is not just the tution,

books and fees, but also the foregone wages.
• seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater.

When making any decision, decision makers should take into account the opportunity costs of each possible choice that they usually do.

Principle 3 : Rational people think at the Margin

Economists normally assumes that people are rational. Rational people systematically and purposefully do the best they can to achieve their objectives, given the available opportunities. Rational people know that decisions in life are rarely black and white but often involve shades of gray. Economists use the term marginal change to describe a small incremental adjustment to an existing plan of action. Rational people make decisions by comparing marginal benefits and marginal costs.

Examples :

• A student considers whether to go to college for an additional year, comparing the fees and foregone wages to the extra income he could earn with an extra year of education.

- A firm considers whether to increase output, comparing the cost of the needed labor and materials to the extra revenue.

Marginal changes are adjustments around the edges of what someone is doing. A rational decision maker takes an action if and only if the action's marginal benefit exceeds its marginal cost.

Principle 4: People Respond to Incentives

An incentive is something that induces a person to act, such as the prospect of a punishment or reward. Rational people respond to incentives because they make decisions by comparing costs and benefits. Incentives play a central role in the study of economics. Incentives are key to analyzing how markets work.

Examples:

- In response to higher cigarette taxes, teen smoking falls.
- In response to higher gas prices, sales of "hybrid" cars rise.

How People Interact

An "economy" is just a group of people interacting with each other. The first four principles discussed how individuals make decisions. The next three principles deal with how people interact with one another.

Principle 5 : Trade can make everyone better off

"Trade can make everyone better off" means that when people or countries trade with each other, they can both end up better off than if they didn't trade. Trade allows each side to focus on what they're good at and exchange with others. Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.

Countries also benefit from trade & specialization :

- get a better price abroad for goods they produce
- buy other goods more cheaply from abroad than could be produced at home.

Principle 6 : Markets are usually a good way to organize economic activity.

"Organize economic activity" means determining :

- What goods to produce
- How to produce them

- How much of each to produce
- Who gets them

A "market" is a group of buyers and sellers. In a market economy, these decisions result from the interactions of many households and firms.

Each of these households and firms interacting in markets act as if they are guided by an "invisible hand" that leads them to desirable market outcomes. One of our goals is to understand how this "invisible hand" works its magic. The "invisible hand" works through the price system:

A "Market economy" also known as a free-market economy, is an economic system in which most economic decisions and resource allocation are determined by the interaction of buyers and sellers in a competitive market. Market economies are characterized by their decentralized nature.

- The interaction of buyers and sellers determines prices of goods and services.
- Each price reflects the good's value to buyers and the cost of producing the good.
- Prices guide self-interested households and firms to make decisions, that in many cases, maximize society's economic well-being.

Principle 7: Governments can sometimes improve market outcomes.

One purpose of studying economics is to know about the proper role and scope of government policy. One reason we need government is that the invisible hand can work its magic only if the government enforces the rules and maintains the institutions that are key to a market economy. Market economies need institutions to enforce "property rights" so individuals can own and control scarce resources. We all rely on government-provided police and courts to enforce our rights over the things we produce - and the invisible hand counts on our ability to enforce those rights. There are two broad rationales for a government to interfere in the economy and change the allocation of resources that people would choose on their own: to promote efficiency and to promote equality.

"Market failure" refers to the situation when things don't work out well in a normal situation and the government might need to step in to make it better for everyone.

"Externality" is the impact of one person's actions on the well-being of an observer.

Example :

• When the production of a good pollutes the air and creates health problems for those who live near the factories, the market on its own may fail to take this cost into account.

"Market power" refers to the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.

That's the reason, why government can sometimes improve market outcomes.

How the Economy as a Whole Works

The last three principles deal with the economy as a whole.

Principle 8 : A country's standard of living depends on its ability to produce goods and services

A nation's prosperity is closely tied to its productivity. When a country can produce more efficiently, its citizens suppose to enjoy a higher standard of living. The growth rate of a nation's productivity determines the growth rate of its average income.

The relationship between productivity and living standards is simple, but its implications are far-reaching. If productivity is the primary determinant of living standards, "Productivity" means the quantity of goods and services produced from each unit of labor input.

other explanations must be less important.

Example:

- Average income in rich countries is more than ten times average income in poor countries.
- The U.S. standard of living today is about eight times larger than 100 years ago.

Principle 9: Prices rise when the Government prints too much money

Inflation occurs when the amount of money in circulation grows faster than the supply of goods and services. In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall. The faster the government creates money, the greater the inflation rate. This can lead to rising prices, consuming the purchasing power of money.

Principle 10: Society faces a short-run Trade-off between inflation and unemployment.

This principle known as the Phillips curve, suggests that policymakers might need to make trade-offs between reducing inflation and reducing unemployment in the short term. Many economic policies push inflation and unemployment in opposite directions. This short-run trade-off plays a key role in the analysis of the "Business cycle"– the irregular and largely unpredictable alteration in economic activity as measured by the production of goods and services or the number of people employed.

These principles serve as a framework for understanding how individuals and societies make economic decisions and how markets and government policies influence these choices. They are fundamental concepts in the field of economics.

Summary

- Trade-off : Making one decision leads to abondoning another decision.
- The cost of something is what you give up to get it :

As a result of taking one opportunity and abondoning another opportunity, the cost & benefit of the other opportunity is abondoned. (Cost, benefit relationship)

* Trade-off & Opportunity cost both means give up. But the difference is, in Opportunity cost, we have to think about cost and benefit. To give up one opportunity, how much cost and benefit of another opportunity do we have to give up.

- Rational people think at the margin : Logical people make decisions by mathematically calculating and thinking logically.
- People respond to Incentives : No one can be made to work for free. Work has to be done by reward or punishment which acts as an incentive.
- Trade can make everyone better-off : One kind of barter system. A country that is good at producing one good sells the good to other countries after satisfying the needs of its own country. At the same time, the country buy goods from other countries that the countries good at producing, which helps in the economic development of a country.
- Marketers are usually a good way to organize economic activity : Marketers make decisions through decentralization.

- Governments can sometimes improve market outcomes: Government intervention is sometimes necessary to maintain equity.
- A country's standard of living depends on its ability to produce goods and services: A country's standard of living depends on its output.
- Prices rise when the government prints too much money: Inflation - Increase in value of goods, decrease in value of currency.
- Society faces a short-run trade-off between inflation and unemployment: For short time, there is a positive relationship between Inflation & Unemployment.