Ten Principles of Economics

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Learning Objectives

After learning this chapter you will be able to:

- Explain the ten principles of economics.
- Explain why there is trade-off in the economy.
- Discuss the relationship between inflation and unemployment.
- Explain the principles of marginal cost and marginal benefit.

Introduction

The ten principles of economics may be categorised into three broad headings:

A. How People Take Decisions;

B. How People Interact; and

C. How the Economy as a Whole Works.

Ten Principles of Economics

The ten principles of economics may be explained as:

A. How People Take Decisions

There are four principles in this category. They are:

Principle 1: Trade-offs

Economics is full of trade-offs. At every steps in decisions making we have to choose between the two alternatives. For example, student of economics has to allocate number of hours of his study to each subject. If he studies economics for one hour, he is left with one less hour for other subjects. So, he has to allocate his resource (that is time, which is limited) according to his preferences.

Consumers have limited incomes, which can be spent on wide variety of goods and services, or saved for the future. When they consume more, they are left with less income in their hands.

Workers also face constraints and make trade-offs. First, people must decide whether to enter in job and earn money or go for education to get high pay scale jobs. Second, workers face trade-offs in choice of employment. For example, while some people choose to work in a large corporation to get more money with less job security and some go for earning less money but ensures their job security. Finally, workers must sometimes decide how many hours per week they wish to work, thereby trading off labour for leisure.

When people are grouped into society, they face different kinds of trade-offs. For example, trade-offs between clean environment and employment. Employment requires exploitation of natural resources because establishment of industries generates employment. Establishment of industries will pollute environment. Thus, while pollution regulations give us good health and clean environment but at the cost of unemployment.

Another trade-off society faces between efficiency and equity. **Efficiency** means society that society is getting the maximum benefit from its scarce resources. Equity means that those benefits are distributed fairly among society's members.[1] Efficiency refers to the size of the economic pie and equity refers to how the pie is divided. When government policies aredesigned, more often than not these two goals conflict with each other[2].

Resources are efficiently allocated in free market and people are getting what they want from the market. But the problem is that market does not know emotions; poor people suffer and rich people become more rich. As a result government intervene in the market for proper distribution of resources from rich to the poor. It reduces the reward for working hard people; as a result, people work less and produce fewer goods and services. In other words, when the government tries to cut the economic pie into more equal slices, the pie gets smaller.

These trade off begets positive economics and normative economics for example, when government imposes minimum wage regulations, which leads to higher wages for some but less opportunity of employment for others. Society must decide if the trade off between the higher wages and less opportunity of employment is acceptable. To answer this question, society must make value judgment that is the subject matter of positive economics.

Though there is trade-off; decisions have to be taken up. Society should not stop protecting the environment just because environmental regulations reduce our material standard of living. The poor should not be ignored just because helping them distorts work incentives. Trade-offs is important in the sense that it provide us many options to choose over.

Principle 2: Opportunity Cost

Opportunity cost also arises because people face trade-offs. For example, what to produce or consume with the limited resources? They have to compare the cost and benefit of their alternative courses of action. The opportunity cost of any item is the cost of sacrificing. For example, if we want to produce two commodities viz; X and Y. The opportunity cost of production of commodity X is the sacrifice production of commodity Y.

Principle 3: Marginal Benefits and Marginal Costs

Economists normally assume that people are rational human being. Rational people often make decision by comparing marginal benefits and marginal costs. Marginal decision helps us solving puzzling economic phenomena: Here is a classic question: Why are diamonds more valuable than water? Human needs water to survive, while diamonds are unnecessary; but people pay more for diamond and less for water. People pay more for diamond and less for water because the additional utility gained from the last gallon of water is less than the utility gained from the last carat of diamond. This is because a rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost.

Principle 4: Incentives Encourage People to Work

Incentive means something that induces a person to work. One economist went so far as to. suggest that the entire field could be simply summarized:"People respond to incentives. The rest is commentary." Public policy makers should never forget this principle because policy of incentives change the cost or benefit that people face, and, therefore alter their behaviour.

B. How People Interact

Principle 5: Trade Make Everyone Better Off

Trade allows each person to specialize in the activity he or she does best. As a result, trade increase the level of output, which can be shared in between the trading nations. By trading with others, people can buy a greater variety of goods and services at lower costs.

Principle 6: Market Mechanism or Price Mechanism or Free-Enterprise Economy

Market economy is that economy which allocates resources through the decentralised decisions of many firms and households as they interact in market for goods and services. In a free enterprise economy, the price mechanism performs two closely related types of rationing. First it restricts the total level of consumption to the available output. Second, it restricts the current level of consumption so the commodity will last for the entire time period over which its supply is fixed. This is possible because price mechanism is governed by the forces of demand and supply in the market[3]. With the forces of demand and supply market allocates resources efficiently.

Principle 7: Government Intervention

One purpose of studying economics is to refine your views regarding the role and policy of government. Adam smith's invisible hand can work only if the government enforces the rules and maintains the institutions that are key to the market economy. Most important, markets work only if property rights are enforced. An industrialist won't establish industry if he expects his industry to be stolen or damaged; a restaurant won't serve meals unless it is assured that customers will pay before they leave. We all depend on government. Market fails to distribute resources to those who are not able to produce or pay money for the produce. Government intervenes in the market to ensure fair and equity in distribution of resources. Government usually modifies the functioning of the price mechanism by taking from the rich (through taxation) and redistributing to the poor (through rationing shops, subsidies, and welfare programme). They also raise taxes in order to provide for certain "public: goods like education, law and order, roads, and defence.

C. How the Economy as a Whole Works

Principle 8: Productivity Determines Living Standards

The fundamental relationship between the productivity and the living standards is simple but its implications are far reaching. This relationship has profound implications for public policy. To think about how policy affects living standards, the key question is how it will affect our ability to produce goods and services. To boost productivity, policy makers must ensure that people are well educated, skilled, and have the tools needed to produce goods and services, and have access to the best available technology. Large differences in living standards among countries are attributed to the differences in the country's productivity – that is the amount of goods and services produced from each hour of a worker's time.

Principle 9: Growth of Money Leads to Inflation

In Germany in January 1921, a daily newspaper costs 0.30 marks. Within two years, in November 1922, the same newspaper costs 70,000,000 marks. All other prices in the economy rose by similar amounts. This episode is one of history's most spectacular examples of inflation, an increase in the overall level of prices in the economy. What causes inflation in the economy? In almost all cases of large or persistent inflation, the culprit is growth in the quantity of money. The

The quantity theory of money states the when velocity of circulation of money remains (V) stable. A change in the quantity of money (M) will cause nominal national product (PQ) to change by approximately the same percentage. The PQ represents average level of prices and Q represents quantity of output (i.e., real national product or real national income). Their analysis was based o the equation:

$$MV = PQ \qquad 1.1$$

In the long-run (over periods of years and decades), classical economists advocate that real output (Q) tends to move towards full employment, capacity level. Therefore, long-run effect ofa change in M is on P, not on Q. Most notably, a rapid increase in the quantity of money causes a rapid inflation. In the United States of America, the high inflation of the 1970s was associated with the rapid growth in the quantity of money, and the low inflation of 1990s was associated with the slow growth in the quantity of money. Similarly, in Germany in the early 1920s when prices were on average tripling every month, the quantiy of money was also tripling every month

Principle 10: Short-Run trade-off Between Inflation and Unemployment

Many economists believe that in the short run trade-off between inflation take place because in the short run increased demand cannot be met with the increased supply. The supply of output capital remains fixed in the short-run. This simply means that, over a period of a year or two, many economic policies push inflation and unemployment in opposite directions. This short-run trade off plays a key role in the analysis of a business cycle. Policy makers can avoid the short-run trade-off between inflation and unemployment by using fiscal and monetary policy instruments.

Important Points to Remember

- Economics is full of trade-offs. At every steps in decisions making we have to choose between the two alternatives.
- Incentive means something that induces a person to work. One economist went so far asto. suggest that the entire field could be simply summarized:"People respond to incentives. The rest is commentary."
- Trade increases the level of output, which can be shared in between the trading nations. By trading with others, people can buy a greater variety of goods and services at lower costs.
- Adam smith's invisible hand can work only if the government enforces the rules and maintains the institutions that are keys to the market economy. Most important, markets work only if property rights are enforced.
- To boost productivity, policy makers must ensure that people are well educated, skilled, and have the tools needed to produce goods and services, and have access to the best available technology.
- Large differences in living standards among countries are attributed to the differences in the country's productivity – that is the amount of goods and services produced from each hour of a worker's time.
- The quantity theory of money states the when velocity of circulation of money remains (V) stable. A change in the quantity of money (M) will cause nominal national product (PQ) to change by approximately the same percentage.

Check Your Progress

1. Explain the ten principles of economics.
2. Explain why there is trade-off in the economy.

3. Discuss the relationship between inflation and unemployment.
4. Explain the principles of marginal cost and marginal benefit.

References

1. Mankiw, N. Gregory, Principles of Economics, 2003, Worth Publishers.