Ten Principles of Economics

Talking about ten principles, this most commonly refers to Gregory Mankiw’s “Ten Principles of Economics”, which he has presented in his book “The Principles of Macroeconomics.”

The list is a set of principles showing the way economics works.

1. People Face Trade-offs

- When people are grouped into societies, they face different kinds of trade-offs.
- The classic trade-off is between “**guns and butter**.”
- Other modern society trade-offs are between:
  - **a clean environment and a high level of income:** while pollution regulations yield the benefit of a cleaner environment and the improved health that comes with it, they have the cost of reducing the incomes of the firms’ owners, workers, and customers.
  - **efficiency and equality**: When government policies are designed, these two goals often conflict. While achieving greater equality, these policies reduce efficiency.

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 courses of action.
- **The opportunity cost** of an item is what you give up to get that item. When making any decision, decision makers should be aware of the opportunity costs that accompany each possible action.

3. RATIONAL PEOPLE THINK AT THE MARGIN

- Rationality of individuals is one of the basic assumptions of Economics.
- 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 usually involve shades of gray.
- Economists use the term **marginal changes** to describe small incremental adjustments to an existing plan of action.
- Rational people often make decisions by comparing marginal benefits and marginal costs.

4. PEOPLE RESPOND TO INCENTIVES

- Because rational people make decisions by comparing costs and benefits, they respond to incentives.
- Public policymakers should never forget about incentives: Many policies change the costs or benefits that people face and, therefore, alter their behavior.

5. TRADE CAN MAKE EVERYONE BETTER OFF

- Trade between two countries can make each country better off.
- Trade allows each person to specialize in the activities he or she does best, whether it is farming, sewing, or home building.
- Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services.

6. MARKETS ARE USUALLY A GOOD WAY TO ORGANIZE ECONOMIC ACTIVITY

- Communist countries worked on the premise that central planners in the government were in the best position to guide economic activity.
- The theory behind central planning was that only the government could organize economic activity in a way that promoted economic well-being for the country as a whole.
- Today, most countries that once had centrally planned economies have abandoned this system and are trying to develop market economies, where decisions are taken by millions of firms and households.

- Market economies are directed by invisible hand, which uses price as an instrument.
- Prices reflect both the value of a good to society and the cost to society of making the good. Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social benefits and costs of their actions.
- As a result, prices guide these individual decisionmakers to reach outcomes that, in many cases, maximize the welfare of society as a whole.

- When the government prevents prices from adjusting naturally to supply and demand, it impedes the invisible hand’s ability to coordinate the millions of households and firms that make up the economy.
- In communist countries, prices were not determined in the marketplace but were dictated by central planners. These planners lacked the information that gets reflected in prices when prices are free to respond to market forces.

7. GOVERNMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES

- There are two broad reasons for a government to intervene in the economy: to promote efficiency and to promote equity.
- For various reasons, the invisible hand sometimes does not work.
- **Market failure** refers to a situation in which the market on its own fails to allocate resources efficiently.
- One possible cause of market failure is an externality. An externality is the impact of one person's actions on the well-being of a bystander.

- Another possible cause of market failure is market power. **Market power** refers to the ability of a single person (or small group of people) to unduly influence market prices.
- The invisible hand is even less able to ensure that economic prosperity is distributed fairly. A goal of many public policies, such as the income tax and the welfare system, is
- to achieve a more equitable distribution of economic well-being.

8. A Country's Standard of Living Depends on Its Ability to Produce Goods and Services

- Almost all variation in living standards is attributable to differences in countries' productivity—that is, the amount of goods and services produced by each unit of labor input.
- In nations where workers can produce a large quantity of goods and services per hour, most people enjoy a high standard of living; in nations where workers are less productive, most people endure a more meager existence.

- Similarly, the growth rate of a nation’s productivity determines the growth rate of its average income.
- To boost living standards, policymakers need to raise productivity by ensuring that workers are well educated, have the tools they need to produce goods and services, and have access to the best available technology.

9. Prices Rise When the Government Prints Too Much Money

- Because high inflation imposes various costs on society, keeping inflation at a low level is a goal of economic policymakers around the world.
- When a government creates large quantities of the nation’s money, the value of the money falls.

10. Society Faces a Short-Run Trade-off between Inflation and Unemployment

- Increasing the amount of money in the economy stimulates the overall level of spending and thus the demand for goods and services.
- Higher demand may over time cause firms to raise their prices, but in the meantime, it also encourages them to hire more workers and produce a larger quantity of goods and services.
- More hiring means lower unemployment.