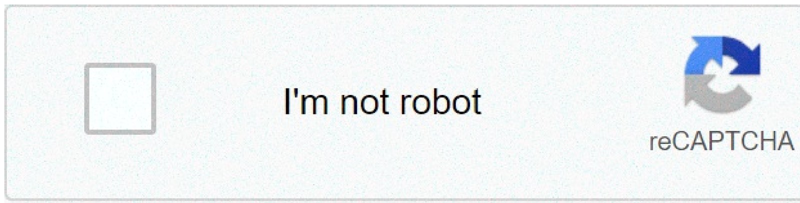

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10 principles of economics with examples

When talking about a list of economic principles, this most commonly refers to Gregory Mankiw's "Ten Principles of Economics." The list is a set of principles about the way economics should work. The 10 principles are divided into three categories: decisions people make, the work of the economy as a whole and people interactions. This refers to the concept of making compromises. A person may have to give something up to get something else they want more. For example, say you are offered a chocolate bar or a lollipop. You have to choose to give up one to get the other. The second economic principle emphasizes the cost of whatever it is you gave up. For example, you took the lollipop, which has an economic profit, what you gain from the choice, of $.85. But you had to give up the chocolate, which had an economic profit of $.45. So you actually only gained $.40 for your choice. But if you didn't have a choice and were only offered the lollipop, you wouldn't have given anything up and would have gained an economic profit of $.85. This principle can be a little difficult to grasp. Marginal thinking is to make small adjustments. For example, a movie theater offers matinee prices. The theater knows fewer people see movies in the afternoon. The standard ticket price of the movie is $10 and at that price the theater will sell two tickets for a matinee show. But by offering a $6 matinee price, the theater ended up selling five tickets. By selling the tickets at a 40 percent discount, the theater actually made $10 more. People respond to different incentives in good or bad ways, but the point is that we respond. A bar might offer a buy one, get one free drink. The good side of the incentive is free drinks, the bad side might be a college student who forgoes studying to drink. Either way, the response to the incentive was there. It is important to clarify that trades include using money to pay for something. Say someone is skilled at giving massages. You get the massage, relying on this person, and then trade your money as a payment. Markets are defined simply as a place where people make an agreement, settle on a price and then communicate that to the world at large. The food market, for example, has farmers making an agreement to sell at a set price and then supermarkets communicate that by selling the food to the public. The government may get involved if the market efficiency isn't working or if the market is failing to distribute. This failure is often caused by externality, which means that the product impacts more than just the direct buyers and sellers. For example, cars benefit drivers, but emissions are also a health concern for people. Simply put, this principle is productivity. The richer the country, the higher the level of productivity. This principle refers to inflation. Prices go up to reflect the amount of money being printed. While the more money makes people think they're wealthier, inflation causes prices to go up and that money loses some of its value. Also referred to as the Phillips Curve, this principle says that you can't keep unemployment low and inflation under control at the same time and, therefore, create a tradeoff. Understanding economics isn't necessarily vital to managing a budget, but it can certainly help you get a leg up in business. If you understand the ways in which businesses make money – the real principle of economics behind them – you're much more likely to know when it's time to ramp up production or slow things down. There are five basic principles of economics that explain the way our world handles money and decides which investments are worthwhile and which ones aren't: opportunity cost, marginal principle, law of diminishing returns, principle of voluntary returns and real/nominal principle. While the marginal principle definition might explain the very fundamentals of turning a profit, the real/nominal principle can teach you how to understand the actual worth of a dollar. You might not think you're the type of person who needs to use and understand each principle of economics, but the truth is you're probably using them every day without even realizing it. For example, even students use the five major principles of economics to analyze which courses are worth taking for the money. The average employee will use the real/nominal principle to prioritize home repairs. Anyone who's ever bought something in a store has used the principle of voluntary returns (unless, of course, they broke something in the store and were forced to buy it). Before we get into any marginal principle examples, opportunity cost is one of the most basic economic concepts on the map. It's something we understand without ever even thinking about it. Basically, the world has unlimited wants but very limited means, so there's always a choice that has to be made. We give up one thing to have another but must calculate the value and cost to find which option will be most fruitful. Take this example: The world has a limited beef supply. There's only so much cattle that farmers can raise in any given year, but where that beef goes is totally up in the air. It can be turned into ground beef and mass-marketed in supermarkets. It can be put in Slim Jims and other beef jerky products. It can be transformed into beef broth and canned for Campbell's or sent to a local butcher. Only so many of those products can be made because there's only so much beef, so how do you decide how much of it gets made into beef jerky verses transformed into broth? A market system (see: supply and demand) is a simple answer. In short, the marginal principle definition is very basic and what we deal with every single day when running a business. You increase the level of an activity as long as its marginal benefit exceeds its marginal cost. In other words, it wouldn't be a very wise business decision to spend more money than you're taking in if you don't have an overarching plan for profitability. You might spend three years in the hole with startup costs and rely heavily on investors, but no one's going to be willing to invest if they don't see a pathway to turning a profit. Here's a very basic marginal principle example: Say you run a doughnut shop. The flour, sugar, eggs and butter you put into the doughnuts cost around $.10 per doughnut. You sell each doughnut for $1.50. That's a huge profit, so it might seem like the marginal benefits do outweigh the costs. Unfortunately, your store has poor Yelp ratings and you barely have any customers. Your rent starts to pile up, and even though your doughnuts themselves are profitable, the marginal benefit does not end up exceeding the costs. You ultimately shutter your business. That's the marginal principle definition in its most basic form. Another marginal principle example? A store may choose to keep expanding their business as long as they see increased revenue. When a store like, say, Sears or Toys R Us sees that revenue has started to drastically shrink, they will, in turn, scale down or close altogether. The law of diminishing returns also goes by a couple of other names. You might know it simply as diminishing returns or the principle of diminishing marginal productivity. This principle of economics shows that if one output of production is increased while keeping the others fixed, production will see an overall increase, but the rate of the increase gradually decreases. Let's take this simple example: A factory with a certain number of workers will find the perfect amount of workers to make the assembly line run the smoothest and generate the most products. This magic number results in the highest return. If you add more workers into the mix, you might actually see a long-term decrease in profits. There's only so many products a conveyor belt can turn out, regardless of who's on staff. Without purchasing more machinery, the costs to hire these workers might actually decrease your overall revenue if you're already at the prime production level possible with the equipment you have. The law of diminishing returns is something every business considers when they're ramping up and planning to expand, and it's often the same reason we hear about layoffs and restructuring within companies that may still be profitable but aren't showing as much profit as anticipated. The number of sales must justify the cost of raw materials, payroll and other manufacturing costs. The principle of voluntary returns is a principle of economics that promotes a free exchange of goods and services between buyers and sellers in a marketplace. This particular principle is used highly in international trade. For example, each country has products they specialize in. Taiwan is a huge manufacturer of microchips. American companies buy these chips to make computers. These computers can then be sold back to Taiwanese consumers. Basically, we import the products we don't specialize in and sell off the ones we do. Sometimes, those things are deeply intertwined. The key part of this principle is that this exchange is voluntary. You get the best rate and both parties are happy with the exchange. The real/nominal principle is one of the fundamentals of economics. Basically, it states that people aren't interested in the face (nominal) value of money. They're interested in the actual (real) value of money. The real value is how much goods money can buy and the key to understanding how much money is actually worth in the scheme of real society. This is specifically important when factoring in exchange rates and inflation or the value in regard to other goods. For example, if a car costs $10,000, that could also pay for a year of rent. If an insurance policy costs $500 per month, that money could also be spent on gas and maintenance. Our society thrives on the five basic economic principles – whether you're weighing the value of a mortgage, buying a new car or simply selling some old clothes on Etsy. The more you understand the way our economy works, the better you can get ahead of the curve and make the best financial choices for you.

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