

The seven core principles of economics essay sample

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Economics is the social science that deals with the production, distribution, and consumption of goods and services and with the theory and management of economies or economic systems. All economists agree on one thing, the economy is large and it is unpredictable. However, throughout the years economists have developed some simple but widely applicable principles that are useful when trying to understand decisions that are made by everyday people to the workings of highly complex markets. There are Seven Core Principles of Economics. These principles are: Scarcity Principle, Cost-Benefit Principle, Principle of Unequal Costs, Principle of Comparative Advantage, Principle of Increasing Opportunity Cost, Equilibrium Principle, and Efficiency Principle. Being familiar with these seven core principles is vital in your understanding on how economics operates.

Scarcity PrincipleThe Scarcity Principle basically states having one good thing usually means having less of another. It is one of the most basic principles of economics. Although we have boundless needs and wants, the resources available to us are limited, there's just not enough good to go around. It basically states that there is a cost to consumption, people have unlimited wants but we have limited resources. If not for scarcity, then, there would be no need to concern ourselves with how best to manage resources. Everyone is faced with everyday decisions that involve scarcity. It doesn't matter if you are Bill Gates or a homeless man living on the streets. When we make decisions about anything, scarcity is usually taken into consideration whether we realize it or not. Gates has enough money to buy more houses, cars, boats, vacations, and basically any consumer good he

wants but there will always be only twenty-four hours in a day. For Bill Gates time is most scarce for him.

In economic reasoning, scarcity is a relative concept, not an absolute one. When most people think of scarcity they usually think it means not abundant. However, in economics something is scarce when it has more than one valuable use. It is obvious to a thirsty person lost in the desert that water is scarce. But water that appears plentiful in a large lake or river is scarce nonetheless because it has many different uses including crop irrigation, the production of electricity, a venue for shipping lanes, fish habitat, and many forms of recreation. Even though there is plenty of water the many alternative uses of it makes it scarce. Another example of scarcity would be Petroleum in Japan, a country without its own oil fields and without oil reserves.

Petroleum is considered scarce because it has many valuable uses in Japan. But what about petroleum in Saudi Arabia? Saudi Arabia is a country with many oil fields and oil reserves. Petroleum is still considered scarce because it still has many valuable uses in Saudi Arabia, and it can be sold to other people in other countries so it has several valuable uses making it scarce. Scarcity can be a powerful thing. It can force you to make difficult choices. It can force you to go without. It can force you to pay more than you wanted to. It can force you to look elsewhere for the thing you want. The next time you discover that something you want isn't available, remember the idea of scarcity.

Cost-Benefit Principle The Cost-Benefit Principle is taking no action unless its marginal benefit is at least as great as its marginal cost. Marginal benefit is the increase in total benefit that results from carrying out one additional unit of the activity. Marginal cost is the increase in total cost that results from carrying out one additional unit of activity. A cost is what you give up when you decide to do something and a benefit is something that satisfies your wants. Basically The Cost-Benefit Principle states an individual, firm, or a society should take an action if, and only if, the extra benefits from taking the action are at least as great as the costs. This creates an economic surplus which is the benefit of taking any action minus the cost of that action.

The concept of cost-benefit sounds simple enough but to apply it you have to decide how to measure relative costs and benefits which can become tricky. Different people may feel differently about the value of different things. A classic example is whether or not you should walk downtown to save \$100 on a \$500 dollar guitar. The benefit here is saving \$100. The cost being the time it takes for you to walk downtown and what else you could be doing in that time. If you feel that your time is worth \$100 then you make the trip downtown. If you feel your time is not worth a \$100 then you do not make the trip. However if you decide to make the trip then you should make that same trip to save \$100 even if you are buying a \$3,000 painting. It is important to ignore proportions and focus on absolute dollar amounts.

As long as the marginal benefit of an activity exceeds the marginal cost, people are better off doing more of it. But as soon as the marginal cost

exceeds the marginal benefit, they suddenly become better off doing less of that specific activity. This can be used when deciding how many employees a company should have. To produce the profit-maximizing level of output and hire the optimal number of workers, and other resources, producers must compare the marginal benefits and marginal costs of producing a little more with the marginal benefits and marginal costs of producing a little less. You can decide how many workers to hire for a profit-maximizing car company by comparing the cost of hiring each additional worker to the additional revenues derived from hiring each additional worker. At some point the profit for the company reaches a maximum and it becomes less profitable to hire more workers.

For example hiring three employees per day would result in a revenue of \$91 and a cost of \$76 which would result in a profit of \$15. Hiring four employees per day would result in a revenue of \$105 and a cost of \$88 resulting in a profit of \$17. Hiring five employees per day would result in a revenue of \$115.50 and a cost of \$100 which would result in a profit of only \$15.50. It is in the company's best interest to go with four employees since that is where profit maximizes. People tend to use the cost-benefit principle without even realizing it. It is known that people who follow the Cost-Benefit will fulfill their goals better than those people who do not follow this simple principle.

The Principle of Unequal Costs The principle of unequal costs explains that some costs matter in making decisions while other costs do not. Costs that do not matter or are beyond recovery at the moment a decision must be made are known as sunk costs. Sunk costs should be ignored when making

decisions because they're sunk. A worn out piece of equipment bought several years ago is a sunk cost because the cost of buying it cannot be reversed. A sunk cost means that you can never recover that cost. You've already spent it, and there's nothing you can do to get it back, so it is misleading to consider it. Think about it like this, you're the CEO of Ford. You spend \$100, 000 on researching a new kind of engine for a sports car. So, a year later you have this engine design. However, by this point, your sales estimates for trucks are much better than for sports cars. You have to decide whether to make this new sports car model, or use your facilities to make more trucks. The \$100, 000 shouldn't come into it, because no matter whether you choose sports cars or trucks, you can't get that money back, it's gone. It's wrong to say " well, I've spent \$100, 000 on sports car research so I should make those cars or it's a waste."

You should base your decision on which will make more money for you in the future . The \$100, 000 you spent is gone forever no matter what you choose to do, so deciding to make sports cars just because of that sunk cost is basically throwing more money into a hole. Sunk costs are not relevant in decision making once they have been incurred. What matters is the marginal cost of a decision, or the change in, extra additional costs that may come about. Another example can be eating at a buffet. If you pay \$5 for a buffet you are only paying for the first plate. After the first plate you're not getting as much out of it and since you feel like you're getting a good deal you keep going up for more plates of food even though your need for food has been satisfied already.

When making decisions it is important to focus on marginal costs and benefits. As I mentioned in the Cost-Benefit Principle, marginal costs and benefits are the increase in total costs and benefits that result from carrying out one additional unit of activity. Focusing on marginal costs gives you the truest value of your decisions.

The Principle of Comparative Advantage Comparative advantage is the ability of an individual or group to carry out an economic activity, such as production, at a lower cost and more efficiently than another entity.

Everyone does best when each concentrates on the activity for which he or she is relatively most productive. Comparative advantage was first described by Robert Torrens in 1815 in an essay on the Corn Laws. He concluded that it was to England's advantage to trade various goods with Poland in return for grain, even though it might be possible to produce that grain more cheaply in England than Poland. Comparative Advantage basically says the economy is best served when people do what they're best at doing, even if they are better at doing some other things than others. When talking about comparative advantage it is important not to confuse it with absolute advantage. Absolute advantage is simply a measurement of the maximum amount of a product that can be produced in a given time frame.

The country that can produce the most has the absolute advantage. just because someone has an absolute advantage does not mean they have a comparative advantage. Lets say Molly makes five bicycles in an hour while Pat makes three bicycles in an hour, Molly has the absolute advantage.

Comparative advantage is when ones opportunity is less to perform a certain

task. Molly makes five bicycles in an hour and ten helmets in an hour. Pat makes three bikes and seven helmets. Pat has the comparative advantage in making bicycles because he is only giving up making seven helmets while Molly would be giving up ten helmets to make bicycles even though Molly can make bicycles more efficiently than Pat. Comparative Advantage is directly related to opportunity cost. Opportunity cost is the cost of the next best alternative that must be forgone in order to pursue a certain action. Basically whatever is the second best alternative when making a decision is the opportunity cost.

A question economic naturalists like to ask regarding comparative advantage is where have all the .400 hitters gone in Major League Baseball? It's been 66 years since Ted Williams batter .406 in 1941. Specialization has played an important role in the extinction of the .400 hitter. Specialization entails focusing on a narrow area of knowledge or skill or activity. In the case of the .400 hitter specialization has hurt them. No longer does one pitcher pitch an entire game.

Now the starting pitcher is expected to go six or seven innings. After that relief pitching specialists come in. There are middle relief pitchers and closers and pitchers who specialize in getting out only righty or lefty hitters. Specialization allows even the weaker teams to be competitive and with no weaklings for hitters to pick on hitting .400 is nearly an impossible task. Specialization is a main component among countries and trading. If countries specialize in producing the goods in which they have a comparative advantage, they can trade their excess production for different goods that

have been more cheaply produced by other countries. This increases the amount of goods and services available to each country.

The Principle of Increasing Opportunity Cost
The Principle of Increasing Opportunity Costs basically states that you should use the resources with the lowest opportunity cost before turning to those with higher opportunity costs. In expanding the production of any good, first employ those resources with the lowest opportunity cost, and only afterward turn to resources with higher opportunity costs. If people specialize in producing the product in which they have a comparative advantage, a lower opportunity cost, a greater amount of output will be produced in the same time with the same number of resources. Workers learn to produce more efficiently, exploit their own best-developed skills and do not have to switch tasks with their attendant with time consuming setup costs. As more scarce resources are used to increase production of one good or service, production of another good or service falls by larger and larger amounts.

An example of increasing opportunity costs is a need to produce more food, so resources employed in clothing production must be transferred to food production. The first resources transferred from clothing to food production will likely be those that are best suited for food production. For example, the most fertile land is first transferred from raising sheep to growing food. As more resources are transferred those resources are progressively less well suited to food production. Increasing opportunity costs is a reflection of the specialized characteristics of resources. Resources are not perfectly adaptable to alternative uses. According to the law of increasing opportunity

cost the more of something we produce, the greater the opportunity cost of producing even more of it. This principle applies to all of society's production choices.

The Equilibrium PrincipleThe Equilibrium Principle states that a market in equilibrium leaves no unexploited opportunities for individuals, but may not exploit all gains achievable through collective action. Equilibrium principle is a fundamental notion in economic analysis. Basic economic models deal with the comparison of two or possibly more equilibriums. Economists think in terms of equilibriums, which are situations where no one has an incentive to change his or her behavior. Market equilibrium occurs when the quantity buyers demand at the market price is exactly the same as the quantity that sellers offer. The equilibrium price-quantity pair is the one at which the demand and supply curves intersect. The supply equals the demand. In equilibrium, market price measures both the value of the last unit sold to buyers and the cost of the resources required to produce it.

When the price of a good lies above its equilibrium value, there is an excess supply of that good. Excess supply motivates sellers to raise their prices, and price continues to fall until the equilibrium price is met. When price falls below the equilibrium, there is excess demand. With excess demand, buyers are motivated to offer higher prices and the upward pressure on prices persists until equilibrium is reached. The most important part of the Equilibrium Principle is just letting the economy go on its own. This is what the economic naturalists believe in. An increase in demand will lead to an increase in equilibrium price and quantity. A reduction in demand will lead to

a reduction in equilibrium price and quantity. An increase in supply will lead to a reduction in equilibrium price and an increase in equilibrium quantity.

A decrease in supply will lead to an increase in equilibrium price and a reduction in equilibrium quantity. When the supply and demand curves for a good reflect all significant costs and benefits associated with the production and consumption of that good, the market equilibrium will result in the largest possible economic surplus. But if people other than buyers benefit from the good, or if the people other than sellers bear costs because of it, market equilibrium need not result in the largest possible economic surplus.

The Efficiency PrincipleThe Efficiency Principle basically explains efficiency is an important social goal, because when the economic pie grows larger, everyone can have a larger slice. The greatest benefit to society of any action is achieved when the marginal benefits from the allocation of resources are equivalent to the marginal social costs of the allocation. Economic efficiency occurs when all goods and services are produced and consumed at their respective socially optimal levels. The socially optimal quantity is the quantity of a good that results in the maximum possible economic surplus from producing and consuming the good. Efficiency is an important social goal. Efficiency is important not because it is a desirable end in itself, but because it enables us to achieve all our other goals to the fullest possible extent. Whenever a market is out of equilibrium, it is always possible to generate additional economic surplus.

To gain additional economic surplus. To gain additional economic surplus is to gain more of the resources we need to do the things we want to do.

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Whenever a market is out of equilibrium it is a waste and that makes it bad. Failure to achieve efficiency means that total economic surplus is smaller than it could have been. Movements toward efficiency make the total economic pie larger, making it possible for everyone to have a larger slice. The efficiency of markets in allocating resources does not eliminate social concerns about how goods and services are distributed among different people. For example, we often lament the fact many buyers enter the market with too little income to buy even the most basic goods and services. Concern for the well-being of the poor has motivated many governments to intervene in a variety of ways to alter the outcomes of market forces.

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