

Fundamentals of economics



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Explain why rising prices do not necessarily mean declining living standards

Introduction: The discussion about the living standard is very important because it represents a platform where the opponents and supporters of entrepreneurship meet face-to-face. First of all we should know about the standards of living. What does it mean? The historians of economics have given it the meaning of happiness. But it was not possible to measure the amount of happiness so they changed its meaning and attach it with real income. Real income is money which is adjusted for the cost of living, also for the achieving things such as health, education and other basic needs of living. 1 It all depends what anyone wants to spend. Some people are intended to spend loads of money and they also easily can do. We will see how rise in prices affect the living standards.

Standards of Living and Rise in prices:

There are so many elements in the standards of living. These are not only consumer goods but also there are some elements included in standards of living that cannot be purchased or are not under our control for example environmental quality and the services provided by the government. 2

Decline in living standard is not because of rise in prices. There are so many elements affecting the standards of living.

Factors not playing important role in decline:

There are so many elements offered for the decline in living standards. But some are not playing important role, these are:

1. Taxes
2. The size of the government
3. Inflation
4. High wages that make workers and product less competitive in

international markets

5. The education and skills of the labor force

6. Government Regulations

Reasons for the decline of living standards:

1. There have been a general slowdown in economic growth (the growth in the amount of goods and services produced) and in the growth of national income (the sum of all the income received in the nations). This means that the size of the income pie available to be divided among the families is growing very slowly than before.

2. There has been a change in the distribution of income. Since 1973, people with relatively low or mid level incomes have been slower growth in income than have people with higher incomes.

3. Corporations have been taking a larger share of national income as profits, compared to the size of their investments and assets and the average profit rates seen between 1952 and the mid 1980s.

The prices of goods plays important roles for spending life, it can make life easy if prices of goods and services are low and it can creates more difficulties it prices are very high. But it does not mean to decline the standards of living. Standards of living depend on many factors. We have seen the factors those are affecting the standards of living and those are not affecting. There are also many other elements such as education, quality of education, health facilities. 3

Let's see some factors in more detail:

Real income:

It can be defined as the income of the individuals or people after adjusting for inflation. It can be measured by subtracting the inflation from the nominal

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income. Mathematically it can be written as:

$$\text{Real Income} = \text{Nominal Income} - \text{Inflation}$$

Real income is a more useful indicator of well-being; it is based on the amount of goods and services that can be purchased with the income. It involves real variables as real income, real GDP and real interest rates. These real variables can be measured in physical units (standards of measurements of physical quantities)⁴.

It does not play any important role in the change of Living standards.

Nominal Income:

Nominal Income is the income that has not been adjusted against inflation and decreasing buying power. It involves nominal variables as nominal income, nominal GDP and nominal interest rates. These nominal variables are calculated in monetary units (Each Country uses a Monetary Unit of some kind some may use more than one depending on the position and nature of the economy). Although real variables and nominal variables are different with each other and they are influenced by each other. Both are separate in nature and use.

Labor:

Labor is a calculation of the work done by human beings. It is usually contrasted with such other factors of production as land and capital. There are some theories created on this concept called human capital. This refers to the skills those workers own). Other theory is Macro-Economics system theory that thinks human capital opposition in terms.

Rise in the price of labor have both a substitution effect and an output effect.

The substitution effect reduces the quantity of the labor demanded as capital ratios rises at each output. But total costs and marginal costs of output

increase. 5

Inflation:

It is defined as a sustained raise in general price levels for some set of goods and services in a given financial system over a period of time. It is measured as the percentage rate of change of a price index. There are so many inflation measures in use as there are different price indices designed to measure the different sets of prices that affect different people. Mostly common measure systems for inflation are Consumer Price index (CPI) and GDP deflator.

Inflation influences poverty mainly through its impact on real wages: the empirical evidence shows that wages increase more slowly than prices during episodes of rising inflation in Latin America. 6 CPI is used for the measurement of nominal consumer prices while GDP deflator is used for the measurement of nominal prices of goods services produced by a given country.

Changes in inflation are sometimes credited mostly to changes in the real demand or supply of goods and services, and sometimes to changes in the supply or demand for money. . If the nominal starting income was 100 and there was a 10% inflation (general rise in prices e. g.: what cost 10 now costs 11) rate. So now with 100 we can buy less and if your income is not adjusted by inflation (did not rise by 10%), our real income has dropped 10%. 7

As we have discussed deeply the factors effecting the living standards and Inflation has no affect in the change of living standard.

References: