

Common Sense Economics:
What Everyone Should Know About Wealth and Prosperity
(Gwartney, Stroup, Lee, and Ferrarini ~ St. Martin's Press, © 2010)

Small Group Discussion Questions

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Part I. Twelve Key Elements of Economics



Element 1: Incentives Matter.

1. What is the basic postulate of economics? Why is this a powerful tool that enhances our understanding of human behavior?
2. Is there a difference between self-interest and selfishness? Do people who are altruistic and charitable respond to incentives? Provide examples other than those included in the text.
3. How do incentives influence the choices of political participants - as voters and/or elected officials? What are some examples you can think of to illustrate this point?
4. Suppose you are taking a class and the teacher announces that all students will receive the same grade at the end of the term. How would this influence a students' incentive to study and master the material? If teachers want their students to learn the course material, do they have a strong incentive to establish a close relationship between performance and the grade received? Explain.

Element 2: There Is No Such Thing As a Free Lunch.

5. Why do individuals have a strong incentive to attempt to get the most out of the resources that they own? When you go to the mall, do you try to get the most value from your spending? Why or why not?
6. Sellers often advertise that a product is “free”, i.e. “buy one, get one free” or “free car wash with fill-up.” Does this mean that there is no cost of providing the “free” product? If there is a cost of providing the product, why would the seller advertise it as “free”?
7. Can the government provide goods such as housing, education, or health care “free” to its citizens? If so, how does this affect the incentive of people to consume these goods? Explain, using examples.

Element 3: Decisions Are Made at the Margin.

8. Why do economists pay so much attention to marginal benefits and marginal costs? Hint: when making decisions, do we consider the marginal benefits and costs or the total benefits and costs?
9. Use the example of pollution control in the text to explain how political decisions can (and should!) also be subject to marginal analysis. Provide another example from your own experience of a policy decision that did *not* seem to have been analyzed at the margin.
10. “People commonly ignore the implications of marginalism in their comments and votes but seldom in their personal actions.” What do you think the authors mean by this statement? Do you agree or disagree, and why? Use examples, other than those from the text, to support your answer.
11. Why is the price of diamonds so much greater than the price of water? Does marginal analysis help provide the answer?

Element 4: Trade Promotes Economic Progress.

12. Trade is based on the agreement of the trading partners. Why is this important? What does the agreement of each trading partner reflect about how the transaction affects their personal well-being?
13. Explain the law of comparative advantage and the principle of economies of scale in your own words. Explain how each of these fundamental ideas make it possible for trading partners to produce a larger output than would otherwise be attainable.
14. How do trade restrictions influence economic welfare? Does trade between parties in different countries work differently than domestic trade?

Element 5: Transaction Costs Are an Obstacle to Trade.

15. What are transaction costs? How do “middlemen” influence transaction costs? Do middlemen add value to trade, or do they merely add to the cost of obtaining the good?
16. Suppose each of the individual states of the United States levied a 10% tax on all goods “imported” from another state. How would this tax affect the gains from trade of Americans? Would Americans be better off or worse off as a result of the tax?

Element 6: Prices Bring the Choices of Buyers and Sellers into Balance.

17. If producers are supplying more of a good than consumers are willing to purchase at the current price, what will happen to the market price in the future?

18. How will a consumer decide whether to purchase a good? What determines whether a producer will supply additional units of a good?
19. When markets are open and property rights well defined, how will the value derived by consumers from the purchase of a good compare with the cost of producing the good? Why is this important?

Element 7: Profits Direct Businesses Toward Activities That Increase Wealth.

20. If we want to get the most out of our resources, do we want activities that are undertaken to be profitable? Why or why not?
21. Evaluate the statement: “Production should be for people and not for profit.” Think about the following in formulating your answer:
 - a. If production is profitable, are consumers helped or hurt?
 - b. Would consumers be helped more if production resulted in a loss?
 - c. To what extent is there a conflict between the incentives of producers and the incentives of consumers?
22. The text suggests that “even though business failures are often painful for the investors and employees involved, there is a positive side.” What is the positive side? Why do many economists stress that the role played by losses is just as important as the role of profits?

Element 8: People Earn Income by Helping Others.

23. Do you agree or disagree with the following quote: “...if you want to earn a high income, you had better figure out how to help others a great deal. To put that another way, if you are unable or unwilling to help others, your income will be low.” Is this true? Can you think of anyone with substantial earnings who does not provide a valuable good or service to others?
24. If an individual is motivated primarily by the desire to make money, will he or she have an incentive to be helpful to others? Will he or she have an incentive to develop skills that others value highly? Why or why not?

Element 9: Production of Goods and Services People Value, Not Just Jobs, Provides the Source of High Living Standards.

25. The federal government subsidizes the production of gasoline produced from ethanol even though it costs about \$1.50 more per gallon than gasoline produced from petroleum. Does this program increase the incomes of farmers supplying corn for the production of ethanol? Does it increase the average incomes and living standards of Americans? Explain.

26. Does the political process have anything like profit and loss that will consistently direct resources toward productive, and away from counterproductive, projects? Discuss.
27. What is “crony capitalism?” How does it affect the efficiency of resource use and income levels? Discuss.

Element 10: Economic Progress Comes Primarily Through Trade, Investment, Better Ways of Doing Things, and Sound Economic Institutions.

28. What are the primary sources of high per capita income? Why are the incomes of Americans so much higher today than was true 250 years ago?
29. Describe the role of the entrepreneur in a market economy. What must an individual do in order to undertake an entrepreneurial venture? Why is the role of the entrepreneur so important as a source of economic progress?
30. Do the legal institutions of a country matter? What are some of the characteristics of legal institutions that would help promote economic progress?

Element 11: The “Invisible Hand” of Market Prices Directs Buyers and Sellers Toward Activities That Promote the General Welfare.

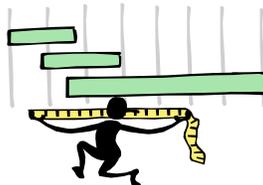
31. How can you explain that the quantities of milk, bananas, candy bars, television sets, notebook paper and thousands of other items available in your hometown are approximately equal to the quantities of these items that local consumers desire to purchase?
32. In a market economy, will there be a tendency for both resources and products to be supplied by low-cost producers? Why or why not? If we want to get the most out of the available resources, why does this matter? Explain.
33. Suppose that enrollment at your college increases sharply and as a result there is a substantial increase in the number of students looking for apartments. How will this change affect the price of apartments in the area? How will this change influence the incentive to conserve on the use of apartment space? If markets are allowed to operate, how will the future supply of apartments be affected? Explain.
34. What does the term “self-interest” mean to you? In a market economy, when individuals pursue their own self-interest, how will their actions influence the well-being of others?

Element 12: Too Often the Long-Term Consequences, or the Secondary Effects, of an Action Are Ignored.

35. Do increases in government expenditures create jobs? Why or why not?

36. Why might politicians deliberately ignore the secondary effect(s) of a policy they have initiated? Explain. What are some examples of instances where this has (or at least could have) happened?

Part II. Seven Major Sources of Economic Progress



Source 1. Legal System: The Foundation for Economic Progress Is a Legal System That Protects Privately Owned Property and Enforces Contracts in an Evenhanded Manner.

1. What three things does private ownership allow the owner to do?
2. Do the owners of private property have an incentive to maintain and develop their property in ways that are highly valued by others? Why or why not?
3. What is a “doomsday forecast”? Why have such forecasts been wrong in the past? How is this related to the private ownership of resources?
4. Two centuries ago there were more buffalo than cattle in the United States. Even though millions of cattle are killed for beef consumption each year, the cattle population continues to grow while the buffalo are virtually extinct. Why?
5. Does private ownership encourage selfish behavior? Does it encourage owners to consider the views of others when they make choices about how to use their privately owned resources? Discuss.

Source 2. Competitive Markets: Competition Promotes the Efficient Use of Resources and Provides a Continuous Stimulus for Innovative Improvements.

6. What makes a market competitive? How do firms compete with one another? What determines whether small firms, medium-sized firms, or large firms will dominate in a competitive market? Explain, using real-world examples.
7. Do business firms operating in competitive markets have a strong incentive to serve the interest of consumers? Are “good intentions” necessary if individuals are going to engage in actions that are helpful to others? Discuss.
8. What is “creative destruction”? How does this idea help to make the case that competition is NOT “pro-business”, as is often suggested in popular parlance?

Source 3. Limits on Government Regulation: Regulatory Policies That Reduce Trade Also Retard Economic Progress.

9. Is government regulation necessary in order to assure that a large firm like Wal-Mart will serve the interest of consumers? Why or why not?
10. “When property rights are well defined and markets competitive, competition will regulate the actions of buyers and sellers. Additional regulation by the government is unnecessary and unlikely to be helpful.” Indicate why you either agree or disagree with this statement.
11. Should government approval be required for entry into a market or the introduction of a new product? Why or why not?
12. Will regulations that require employers to get permission from government officials before dismissing workers reduce the rate of unemployment? Why or why not?
13. “The market price makes it possible for buyers and sellers to communicate with each other. When the government imposes price controls and sets the price of various items, it restricts the ability of buyers and sellers to send messages to each other.” Discuss the meaning and importance of this statement.

Source 4. An Efficient Capital Market: To Realize Its Potential, a Nation Must Have a Mechanism That Channels Capital into Wealth-Creating Projects.

14. When investment is allocated by political decision-makers, are new innovative ideas likely to be supported? Are unproductive investments likely to be terminated? Explain, using both real-world and text-based examples.
15. “...mistaken investments are a necessary price that must be paid for fruitful innovations in new technologies and products.” Indicate why you either agree or disagree with this statement.
16. What makes an investment project productive? If an economy is going to grow, why is the allocation of investment capital into projects that create wealth crucially important?
17. For more than four decades, investment in the former Soviet Union and Eastern European countries was allocated by central planners. Even though the investment rates of these countries were high, general living standards grew slowly. Is this surprising?

18. Why were lenders willing to extend mortgages to people with a poor credit history? Did government policy contribute to the availability of such loans? Explain
19. What impact did Fannie Mae and Freddie Mac have on the run up in housing prices during 2002-2006, the erosion of mortgage lending standards, the eventual increase in the mortgage default rate, and the severe recession of 2008-2009?
20. What are some of the secondary effects that will result when investment is allocated by political decision-makers? How will this influence the productivity of the projects that will be undertaken?

Source 5. Monetary Stability: A Stable Monetary Policy Is Essential for the Control of Inflation, Efficient Allocation of Investment, and Achievement of Economic Stability.

21. “Money is to an economy what language is to communication.” What does this statement mean?
22. How do economists measure inflation? What is the major cause of inflation? Cite evidence to support your answer.
23. If a country has a high and volatile rate of inflation, will domestic investors find this environment attractive? Will foreign investors find it attractive? How will the country’s investment rate be affected?
24. Shifts in monetary policy generally exert an impact on the level of economic activity with time lags that are variable and often lengthy. How will these time lags influence the ability of monetary policy-makers to follow a course that will minimize economic instability? Explain your response.

Source 6. Low Tax Rates: People Will Produce More When They Are Permitted to Keep More of What They Earn.

25. Do you think taxes influence the choices of people? Why do economists believe that marginal tax rates exert a strong impact on the incentive of individuals to earn additional income?
26. Explain the ways in which high marginal tax rates reduce both productivity and the gains from trade.
27. How will individuals and families adjust their behavior when marginal tax rates are increased to high levels? Give examples.

28. How were marginal tax rates altered during the Great Depression? Did these tax changes help promote recovery or did they increase the length and severity of the depression? If policy-makers have good intentions, will the impact of their policies be positive? Discuss.

Source 7. Free Trade: A Nation Progresses by Selling Goods and Services That It Can Produce at a Relatively Low Cost and Buying Those That Would Be Costly to Produce Domestically.

29. Why do Americans buy things from foreigners? What are the characteristics of the things we buy from others?
30. Why are foreigners willing to sell goods and services to Americans? What will foreigners do with the dollars they acquire from the sale of goods and services to Americans?
31. Would higher import restrictions “save” American jobs and expand U.S. employment? Would subsidies to U.S. firms that export goods abroad increase domestic employment? Would the income levels of Americans be higher if we imported less and exported more? Explain.
32. Why do the authors contend that “...it is production of value that really matters, not jobs”? How does this relate to the current debate about the impact of “outsourcing”?
33. “The United States would gain substantially if it unilaterally phased out all of its trade restrictions over, for example, a ten-year period.” Do you agree or disagree with this statement? Explain your answer.

Concluding Thoughts

34. Discuss the importance of the following as sources of economic growth and prosperity: A) natural resources, B) density of population, C) democracy, and D) economic freedom.

Part III. Economic Progress and the Role of Government



Government 1. Government Promotes Economic Progress by Protecting the Rights of Individuals and Supplying a Few Goods That Are Difficult to Provide Through Markets.

1. Is it necessary for government to have a “monopoly on the legitimate use of force”? Why or why not?
2. “Well defined and enforced property rights will help promote peaceful interactions among people” Is this statement true? Discuss.
3. How does the U.S. Constitution limit the economic powers of the federal government? Provide examples of policies in existence today that you believe violate the spirit (or text) of these limitations. Why have such policies been adopted? What incentives exist to modify or remove such policies?

Government 2. Allocation Through Political Voting Is Fundamentally Different from Market Allocation, and Economic Analysis Indicates That the Latter Is More Consistent with Economic Progress.

4. “When government bureaus or enterprises are financed or subsidized by coerced payments (taxes), there is no assurance that people who use the goods or services value them more than their costs.” Is this a potential problem? Discuss.
5. “Government action is based on majority rule, whereas market action is based on mutual consent. The market allows for proportional representation of minorities, but minorities must yield to the views of the majority when activities are undertaken through government.” What does this statement mean? Is it true? Explain, using examples.
6. In a market economy, if a business or consumer makes bad choices, who bears the consequences? If a political majority makes bad choices, who bears the consequences? How does the incentive structure in the two systems affect the likelihood that people will make poorly informed choices and undertake counterproductive projects? Discuss.

7. “The United States is rich because it is a democratic nation.” Is this statement true? Does economics indicate that democracy will make people rich if resources are not allocated primarily through markets? Discuss.

Government 3. The Costs of Government Are Not Only Taxes.

8. Do politicians have an incentive to conceal the cost of taxes? Why or why not?
9. “The personal income and payroll taxes are already too high. I think business should shoulder a larger share of the tax burden.” Have you ever heard a politician make a statement like this? Does the statement reflect sound economics? Why or why not?
10. Do you believe the statements of politicians are more likely to be true than those of business entrepreneurs? Why or why not?

Government 4. Unless Restrained by Constitutional Rules, Special-Interest Groups Will Use The Democratic Political Process to Fleece Taxpayers and Consumers.

11. Why do politicians so often support special interest groups?
12. From the viewpoint of economic efficiency, does representative democracy do a good job of handling special-interest issues? Why or why not? If the power of special interests was reduced through the adoption of a supermajority voting rule, for example, would economic efficiency improve? How would contributions to political campaigns be affected?
13. Do you think special interest groups have too much political power? If so, what do you think should be done about it?

Government 5. Unless Restrained by Constitutional Rules, Legislators Will Run Budget Deficits and Spend Excessively.

14. Do elected political officials like to spend on projects that benefit their constituents? Do they like to levy taxes on their constituents? How does this incentive structure affect the attractiveness of budget deficits?
15. “Predictably, politicians will talk about controlling spending but at the same time push for spending programs that benefit favored constituents and well organized voting blocks.” Do you agree or disagree with this statement?
16. Does the federal government face a serious problem of budget deficits and outstanding debt in the decade ahead? Why or why not?

17. What is meant by the “unfunded liabilities” of the Social Security and Medicare programs? How will these liabilities influence future budget deficits? Explain.
18. How might the political rules be changed in a manner that would reduce the tendency of the federal government to spend more than it taxes?

Government 6. Government Slows Economic Progress When It Becomes Heavily Involved in Providing Favors to Some at the Expense of Others.

19. “In this era of the unconstrained state, income transfers from taxpayers to well-organized groups and voting blocs have become the business of modern politics.” Explain why you either agree or disagree with this statement.
20. As more firms, products, and sectors are subsidized, businesses will spend more time trying to get the subsidies. What impact will this have on both the businesses and the products they produce? How will this affect the economy’s output and income levels?
21. What is rent-seeking? When the government is heavily involved in taxing some in order to provide subsidies and income transfers to others, how will the level of rent-seeking be affected?
22. What percentage of Americans does not pay any personal income tax? How large are income transfers and subsidies as a share of the federal budget? When the government is heavily involved in taxing a minority of voters in order to provide transfers and subsidies to a large share of voters, what impact will this have on political democracy? Discuss.

Government 7. The Net Gain to Those Receiving Government Transfers Is Less, and Often Substantially Less, Than the Amount They Receive.

23. Why is much of the gain of transfer recipients often eroded by the change in the structure of the incentives accompanying the transfers? Do transfer payments sometimes encourage recipients to make “bad decisions”?
24. “If you subsidize something, you will get more of it.” Is this statement true? What does the statement imply about the relationship between government spending on anti-poverty programs and the poverty rate?
25. What are some of the secondary effects of government anti-poverty programs? Give some examples. Does government anti-poverty spending crowd out private charitable activities?

26. What are three things a young person could do that would substantially reduce the likelihood they would spend much time in poverty? Is this message being clearly communicated to younger people? Discuss.

Government 8. Central Planning Replaces Markets with Politics, Which Wastes Resources and Retards Economic Progress.

27. Are central planners able to allocate resources into activities that will be highly valued by the citizenry? Will efficient use of resources be a priority for central planners? Why or why not?
28. “When property rights are well-defined and competition present, economic activities organized through markets will be based on agreement among the parties and resources will generally be channeled into projects that increase the wealth of the citizenry. On the other hand, when economic activity is organized through the political process, the majority will often impose its will on minorities and resources will often be channeled into projects that reduce wealth.” Evaluate this statement. Indicate why you either agree or disagree with it.

Government 9. Competition Is Just As Important in Government As in Markets.

29. What is the meaning of competition? How is competition among governments similar to competition among private firms? How is it different?
30. What conditions are necessary for competition among government units? When competition is present among governments, how do citizen-taxpayers indicate their preferences to political decision-makers?
31. “...poor performance and failure to achieve objectives are often used as arguments for increased funding in the public sector.” Do you agree or disagree? Use examples to strengthen your case.

Government 10. Constitutional Rules That Bring the Political Process and Sound Economics into Harmony Will Promote Economic Progress.

32. Identify and describe the components of the Economic Bill of Rights, as proposed by the authors. State whether you agree or disagree with each element, and provide an example of a current action that would be prohibited if this Bill of Rights were adopted.
33. Do you believe that the Bill of Rights suggested in the text would promote economic prosperity and stability? Explain.

Part IV. Twelve Key Elements of Practical Personal Finance



Element 1. Discover Your Comparative Advantage.

1. The authors state, "...financial insecurity is primarily the result of the choices we make rather than the incomes we earn." Do you agree or disagree? Explain, using examples from your personal life.
2. Why is it important for you to specialize in areas where you have a comparative advantage? How can you discover key areas where you have a comparative advantage?
3. Explain the meaning of the following quote: "The worst thing you can do is convince yourself, or be convinced by others, that you are somehow a victim and therefore unable to become wealthy through your own effort and initiative." Do you agree or disagree? Give some examples to support your view.

Element 2. Be Entrepreneurial. In a Market Economy, People Get Ahead by Helping Others and Discovering Better Ways of Doing Things.

4. How can you "be entrepreneurial" without ever becoming an entrepreneur in the traditional sense (i.e., opening up your own business)? Give an example of a time when you have been entrepreneurial, or an opportunity where you could be entrepreneurial in the near future.
5. Do successful entrepreneurs share common characteristics? If so, what are they? What role do formal education and wealth play in entrepreneurship? Is either a necessity for successful entrepreneurship?
6. Is it important for employees, as well as business decision-makers, to "think entrepreneurially"? Why or why not?

Element 3. Use Budgeting to Help You Save Regularly and Spend Your Money More Effectively.

7. Do you currently have a budget? What is the purpose of a budget?
8. Do you agree or disagree with the following statement: "...almost all of our spending decisions are discretionary, rather than based on true need."

9. *Can* everyone spend less than they earn? Can *you*? Do you think it would be possible for you to save 10 percent of your income? What are some examples of expenses you might be able to eliminate?

Element 4. Don't Finance Anything for Longer Than Its Useful Life.

10. What does it mean to finance something for longer than its useful life? How does doing so force you to “pay in the future both for your past pleasure *and* your current desires”? Have you ever done this? How can you avoid doing so in the future?

Element 5. Two Ways to Get More Out of Your Money: Avoid Credit-Card Debt and Consider Purchasing Used Items.

11. What does an unused balance (a balance that is less than your credit limit on the card) represent? Is it like money in your bank account? Why or why not?
12. Explain the following statement: “...those who try to increase their consumption using credit-card debt end up having less consumption and less money than those who avoid credit-card debt and save instead.”
13. Why is the interest rate on credit cards so high? Is it unfair for banks to charge, for example, a 7 percent prime interest rate to some customers and at the same time charge others 15 percent to 18 percent on outstanding credit card balances? Why or why not?
14. What types of items will generally result in substantial savings when purchased “used”? Give examples.

Element 6. Begin Paying Into a “Real-World” Savings Account Every Month.

15. What are some synonyms for what the authors call a “real-world” savings account?
16. Consider the following statement: “The surprising element relates to the nature and timing of the events, not to their occurrence.” Why does it make sense to save for such “surprises”? Provide some examples from your own life in which a “real-world” savings account would have (or did!) come in handy.
17. Do you think most Americans save for the expenses of unexpected, but nonetheless, predictable events?

Element 7. Put the Power of Compound Interest to Work for You.

18. Can people with average incomes become quite wealthy? Do they have to be lucky in order to do so?
19. What is your reaction to the example of Roger, who is deciding whether to start smoking? Is there a message about the costliness of seemingly small expenditures? Does the example reflect the power of compound interest?
20. Albert Einstein is purported to have stated, “The most difficult thing in the world to understand is the power of compound interest.” What do you think he meant by this statement?

Element 8. Diversify – Don’t Put All Your Eggs in One Basket.

21. What is the difference between a stock (equity) and a bond? Is it risky for the ordinary investor to undertake stock market investments? Are equity investments more risky than bonds?
22. What do the authors mean when they refer to “double jeopardy”? How does their advice differ from what you might expect to receive from your employer? Would this advice have made any difference to employees of companies like Enron and Bear Stearns, who lost both their jobs and a substantial value of their retirement assets when their employers ran into difficulties? Does this segment in any way alter your feelings about these employees’ misfortunes? Explain.

Element 9. Indexed Equity Funds Can Help You Beat the Experts Without Taking Excessive Risk.

23. How difficult is it to tell whether a specific business will do well in the future? Are “experts” able to determine whether the price of a stock will rise or fall in the future? Why or why not?
24. How does the “random walk theory” help to explain the authors’ enthusiasm for (indexed) equity mutual funds?
25. Can an ordinary person who does not want to spend a lot of time studying the stock market or analyzing specific businesses expect to earn an attractive return in the stock market? If so, how?

Element 10. Invest in Stocks for Long-Run Objectives, but As the Need for Money Approaches, Increase the Proportion of Bonds.

26. If an investor pays a fixed amount each month or quarter into an indexed equity mutual fund, what generally happens to the variability in the average annual rate of return as the investor pays into the fund over a longer and longer period of time?
27. How do the investment goals of people generally change over the course of their life? How do these changes influence the attractiveness of investment alternatives (for example, stocks relative to bonds)? Use examples of real-world investments as you discuss how individuals might alter their investment portfolio as they age.
28. Will people moving into the retirement phase of their life often find TIPS to be an attractive investment alternative? Why?

Element 11. Beware of Investment Schemes Promising High Returns with Little or No Risk.

29. Why is investment characterized by a principal-agent problem? Can it ever be eliminated? Explain.
30. It is usually costly for a firm to obtain its financing from small investors rather than from a bank or investment company. Why? Why should you be wary of such investments?
31. If someone offers you an unbelievable investment option that promises to make you wealthy in a relatively short period of time, what should you do?

Element 12. Teach Your Children How to Earn Money and Spend It Wisely.

32. When parents provide their children with most everything they want, what message is this sending? Is this a good way to help them learn sound personal finance?
33. “People spend money they earn more wisely than funds that are given to them.” Indicate why you either agree or disagree with this statement. Use some examples to make your case.