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

Reading Guides

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Part I. Twelve Key Elements of Economics

Element 1: Incentives Matter.

1. The authors state that “All of economics rests on one simple principle.” What is this principle?

2. Describe the following statement in your own words: “There is little reason to believe that a person making choices in the voting booth will behave much differently than when making choices in the shopping mall.”

3. Do incentives influence the choices of students? Do incentives influence the decisions of elected political officials? Did incentives influence choices under the socialist central planning system of the former Soviet Union? Provide examples.

4. If you respond to changes in incentives, does this indicate that you are selfish and greedy? Did Mother Teresa respond to incentives? Was she selfish and greedy?

5. If the price of a good increases because consumers want to purchase more than sellers are currently supplying, how will the higher price affect the incentive of consumers to purchase the good? How will the higher price affect the incentive of sellers to supply the good?

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

6. Why can’t we consume as much of each good or service as we would like? If we become richer in the future, do you think we will eventually be able to consume as much of everything as we would like? Why or why not?

7. What does the cost of a good or service reflect? Does it ever make sense to make a choice without considering the cost? If you choose an option without considering the cost, what does this mean?

8. Why is it costly for you to purchase and item or make choices involving the use of your time? What is the meaning of “opportunity cost”? What is the opportunity cost of purchasing a book? What is the opportunity cost of reading the book?
9. If a good is provided free of charge to individuals, how will this affect their incentive to conserve on its use?

**Element 3: Decisions Are Made at the Margin.**

10. What does it mean to make a decision “at the margin”? Consider your purchases of food in the next month. As you choose how much you will spend on food and the amount of each food item you will purchase, will these be “marginal” decisions? Why or why not?

11. A restaurant offers an “all you can eat” lunch buffet for $10. Jim has already eaten three servings, and is trying to decide whether to go back for a fourth. Describe how Jim can use marginal analysis to make his decision.

12. “Pollution is causing $100 million worth of damage to the environment and we are only spending $1 million to reduce pollution. We are clearly not spending enough on fighting pollution.” Is this statement true? Is marginal analysis needed to answer this question? Explain.

**Element 4: Trade Promotes Economic Progress.**

13. Why do people engage in trade? If one of the trading partners gains, must the others involved in the transaction lose an equal amount? Why or why not?

14. Is trade productive? Could trade be productive even if nothing new was produced? Explain.

15. What are the three major sources of gains from trade? Explain the source of the gains derived by the trading partners in each of the three cases.

16. What is the law of comparative advantage? Why does it lead to specialization, and explain how this influences the total output the trading partners are able to produce?

17. Why do you trade for things rather than produce them yourself? Would you be better off if you did not buy so many things from others? Would Americans in general be better off if they did not buy so many things from others?

18. What are economies of scale, and how are they achieved? What role can economies of scale play in increasing the gains from trade?

**Element 5: Transaction Costs Are an Obstacle to Trade.**

19. What are transaction costs? Why are they an impediment to trade?

20. “Countries that impose obstacles to exchange – either domestic or international – reduce the ability of their citizens to achieve more prosperous lives.” Indicate why you either agree or disagree with this statement.
21. What is a “middleman?” Give a couple of examples of middlemen. Do middlemen perform valuable services? Why or why not?

22. How have the following influenced the volume of trade:
   a. the internet?
   b. the interstate highway system?
   c. tariffs on goods purchased from sellers in another country?

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

23. Why does the demand curve for a good slope downward to the right? What does the downward slope reflect?

24. What is the law of supply? What does it imply about the supply curve for a good or service?

25. If the quantity of a good consumers are purchasing exceeds the quantity producers are willing to supply at the current price, what will happen to the market price in the future? Why?

26. What does the height of the demand curve for a good indicate? What does the height of the supply curve for the good indicate? What condition must be present if an exchange is going to occur?

27. In a market economy, will units of a good be produced and purchased if consumers value them more than their cost of production? Explain. If the production cost per unit of a good exceeds the value derived by consumers, will the good continue to be produced and consumed? Why or why not?

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

28. What must a firm do in order to make a profit?

29. What is the function of profits in a market economy? What is the function of losses?

30. If we want to get the most out of our resources, is the role of losses just as important as that of profits? Why or why not?

31. In a market economy, how do suppliers decide what to produce? Do they have an incentive to produce those goods and services that consumers value highly relative to their cost? Do the producers have an incentive to produce efficiently and keep costs low? Why or why not?

32. If a business is consistently making losses, should the government provide it with subsidies so it will be able to continue operating? Why or why not?
Element 8: People Earn Income by Helping Others.

33. In a market economy, what is the primary source of high earnings?

34. “High-income individuals must be exploiting others.” Is this statement true? What must one do in order to earn a high income in a market economy?

35. If one is motivated primarily by the desire to make a lot of money, will he or she still have a strong incentive to provide others with goods and services that they value? Why or why not?

36. How have the actions of Oprah Winfrey, Tom Hanks, Steve Jobs, LeBron James, and Bill Gates impacted the well-being of others? Have you been helped by any of them? Were you harmed by any of them?

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

37. What is the source of higher income levels and living standards? If there is an increase in employment, does this necessarily mean that income levels have increased? Why or why not?

38. Under the “Cash for Clunkers” program of July-November 2009, the government paid car dealers between $3500 and $4500 per vehicle to destroy approximately 700,000 used cars traded in when purchasing a new automobile. Did this program increase new car sales, output, and employment in the auto industry in 2009? What impact did it have on new car sales in 2010 and subsequent years? Did it improve the living standards of Americans? Would Americans be better off if an outbreak of crime destroyed 700,000 automobiles during the next few months? Why or why not?

39. Does government spending create jobs and expand employment? Why or why not?

40. Is there good reason to expect that projects financed or subsidized by the government will generate goods and services that are more highly valued than their cost? Why or why not? When goods and services are produced through market allocation, is there good reason to expect that they will be more highly valued than their cost? Why or why not?

41. When governments become heavily involved in subsidizing and granting favors to some businesses at the expense of others, how will this incentive structure influence the efficiency of resource use?


42. Explain how each of the following promote economic progress:
a. Investments in productive assets
b. Improvements in technology
c. Improvements in economic organization

43. “Our modern living standards are primarily a reflection of brain power, capital formation, and the quality of institutions.” What is the meaning of this statement? Is it true?

44. Entrepreneurs are people who undertake the risk of business activity with the expectation of earning profit. Why is the role of the entrepreneur vitally important as a source of economic progress? How do entrepreneurs influence the discovery and development of new products and better ways of doing things?


45. Describe Adam Smith’s “invisible hand” principle. According to this principle, how does self-interest actually work to help others (even when unintended)?

46. How do consumers decide whether or not to purchase a product? How do producers decide whether or not to produce it? What coordinates their actions and brings them into harmony?

47. Suppose you have a pizza and a Coke at a local restaurant, and then go to a movie. How many people do you think contributed to your enjoyment of these activities? What motivated them to do so?

48. Why did Friedrich Hayek believe that the information conveyed by markets was so important? What is the “summary statistic” that communicates information to buyers and sellers and helps to coordinate their actions? Would it be possible for any central planning agency to acquire the necessary information to motivate and direct resource suppliers, investors, producers, and consumers in a sensible manner? Why or why not?

49. Suppose you decide that it is in your self-interest to establish a computer repair business. Will others be better off or worse off if your business earns a profit? How will the well-being of your customers be affected?

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

50. What are secondary effects? Give several examples of secondary effects.

51. Why does failure to consider the secondary effects often result in fallacious economic reasoning?

52. In 2002, the Bush administration imposed steel import quotas that limited the entry of foreign-produced steel into the U.S. market. What were some of the secondary effects of
this policy? Did the policy expand employment as the administration argued that it would?

53. Several cities have adopted rent controls that force the price of rental housing below the market level. What are some of the secondary effects generated by these controls?
Part II. Seven Major Sources of Economic Progress


1. Explain the meaning behind the following quote from Tom Bethell: “Property sets up fences, but it also surrounds us with mirrors.”

2. Can the owners of private property do anything they want with the things they own? Why or why not? What does private ownership allow the owner to do?

3. What are the (four) reasons why the incentives provided by property rights promote economic progress? Explain why each provides the owners of assets with a strong incentive to use their resources wisely and engage in actions that benefit others as well as themselves.

4. Why is the evenhanded enforcement of contracts an important source of prosperity?

5. “Private ownership forces resource users to confront the cost of the resources they utilize. Without private ownership, it is difficult to see how the benefits of resource use could be balanced against the costs incurred.” Evaluate this statement.

6. If the ownership of a resource is insecure, how will this affect the value of the resource and the efficiency of its use? Why is legal entitlement of things like real estate, automobiles, scientific discoveries, and intellectual property important?

7. Do you think the world will soon run out of important natural resources such as oil or timber? Why or why not? If the resource is privately owned, what will happen to its price if supply should decline relative to the current use rate? How will this influence the likelihood that the supply of the resource will be exhausted?

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

8. What makes a market competitive? Why is competition important?
9. What must a firm do in order to compete effectively? Do firms operating in a competitive market have an incentive to keep cost low and produce goods that consumers value highly relative to cost? Do they have an incentive to innovate and develop improved products?

10. In a competitive market, what happens to firms that fail to provide consumers with desired goods at prices equal to or less than those available from other firms? Is this good or bad? Is there a positive side to business failure?

11. When markets are competitive, what determines whether a new innovative product will be successful?

12. What determines whether corporations, individual proprietorships, employee-owned firms, consumer cooperatives or some other form of business structure will dominate in a market? In a market economy, are firms forced to use a specific type of business structure?

13. How is the size of a firm related to the concept of economies of scale? Why do the authors of CSE assert that there is no “right answer” as to the appropriate size of a firm, but rather that competition decides?

14. Is competition “pro-business?” Do business firms generally lobby legislators requesting that they make sure that their market is open to all potential producers, or do they often ask legislators to erect barriers limiting competition from various rivals?

15. What is “creative destruction”? Historically, how has creative destruction influenced the quality of our lives? Provide some examples that reinforce your answer to this question.

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

16. How will licensing and other government regulations that make it difficult to enter markets and operate legally influence competition? How will such regulations influence gains from trade, innovation, and income levels?

17. How will regulations that make it more costly for an employer to layoff or dismiss current employees affect the unemployment rate of youthful workers and other new labor force entrants? Explain.

18. “Price controls that set the price of a good or service above the equilibrium level will reduce the volume of trade, while controls that set prices below the equilibrium level will increase the volume of trade.” Is this statement true or false?
19. What is the “informal economy”? How does regulation influence the size of the informal economy? According to Hernando de Soto, what is the impact of regulation in developing countries?

20. Why do business and labor organizations often lobby for regulations that limit competition? When more and more resources are directed toward lobbying for political favoritism, how will total output and living standards be affected?

21. “Exchange based on mutual agreement is powerful evidence that the activity is both beneficial and productive.” Is this statement true? Why or why not?

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

22. What is capital investment? Why do business firms often use machinery and other capital assets to produce goods and services?

23. If an economy is going to grow, why is the allocation of investment capital into productive projects crucially important? What determines whether a project is productive?

24. When investment is allocated by government decision-makers, what determines which projects will be undertaken? How will the political allocation of investment funds influence the likelihood that investment funds will be persistently directed toward productive projects?

25. Even though the centrally planned countries of the former Soviet bloc had high investment rates, their growth rates were relatively low? Was this surprising? Why or why not?

26. Two large government-sponsored corporations, Fannie Mae and Freddie Mac, dominated the mortgage market during 1995-2008. Why did these two firms have a competitive advantage over other lenders in the mortgage market?

27. Responding to regulations and political pressure, Fannie Mae and Freddie Mac began approving mortgages with little or no down payment and extending more loans to sub-prime borrowers in the late 1990s. What impact did this policy initially have on the demand for and price of housing? How would you expect this policy to influence the mortgage default rate with the passage of time?

28. Government allocation of mortgage credit through Fannie Mae and Freddie Mac played a central role in the erosion of mortgage credit standards, the run up in housing prices, and the eventual collapse that led to the severe recession of 2008-2009. Did the political leaders that supported Fannie Mae and Freddie Mac accept responsibility for their role in
creating the perverse incentives that generated the recession? Did they blame others for the crisis? Is this surprising?


29. What are the functions of money? Is money productive – does it help people get more out of their resources?

30. What is inflation? What is the primary cause of inflation?

31. How does money of stable value influence the volume of trade? When the inflation rate is volatile, how is the volume of trade affected? How will this influence the income levels of people?

32. When policymakers shift to a more expansionary monetary policy, what will be the initial impact of this policy on interest rates, investment, and the level of economic activity? If the expansionary monetary policy is continued over a lengthy time frame, what will be its major impact?

33. Monetary policy exerts 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 stabilize the economy? If monetary policy-makers are constantly shifting back and forth between expansionary and restrictive monetary policy, what is the likely impact on economic stability?

34. During 2002-2004, the expansionary monetary policy of the Fed pushed interest rates to historic low levels. What impact did these low interest rates have on the demand for and price of housing? As the inflation rate rose beginning in 2005, the Fed shifted to a more restrictive monetary policy that pushed interest rates upward. What impact did this policy have on the demand for and price of housing? What impact did the more restrictive policy have on the mortgage default and housing foreclosure rates during 2007?

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

35. What is meant by a marginal tax rate? Why is it so important to always consider the marginal tax rate in policy discussions?

36. How do high marginal tax rates affect the incentive of individuals to earn and invest? How will high marginal tax rates influence the personal income levels people are able to achieve?

37. “When marginal tax rates are high, tax-deductible expenditures become relatively cheap.” Explain the meaning of this statement.
38. Will higher marginal tax rates always generate more revenue for the government? Why or why not?

39. In 1932 the Republican President Hoover and the Democratic controlled Congress adopted a huge tax increase. Tax rates more than doubled and the top marginal rate was increased from 25 percent to 63 percent in one year. What impact did this tax increase have on economic activity? Is it a good idea to increase tax rates during a recession? Why or why not?

**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.**

40. Are the principles underlying the gains from international trade different than those underlying domestic trade? Why or why not?

41. Paraphrase the three reasons given by the authors explaining why free trade allows nations to produce and consume more than would otherwise be possible.

42. How does competition from foreign producers affect American consumers? How do trade barriers affect the realization of gains from specialization and economies of scale?

43. “Trade restrictions neither create nor destroy jobs; they reshuffle them.” What is meant by this statement?

44. Why will the dollar value of the items Americans buy from foreigners tend to equal the dollar value of the items Americans sell to foreigners? (Hint: what does the foreign exchange market do?)

45. Would Americans be better off if importers had to obtain permission from government officials before they could buy things from foreigners? Would politicians be better off—would they have more campaign contributions?

46. Would Americans be better off if the states imposed trade restrictions limiting the purchase or sale of goods and services to the residents of another state? Would total U.S. employment be larger? Explain.

47. In 1932, the Smoot-Hawley trade bill increased tariffs by approximately 50 percent. President Herbert Hoover, Senator Reed Smoot, Congressmen Willis Hawley, and other proponents of the bill thought the higher tariffs would “save jobs” and stimulate the economy. Were they right? What impact did the legislation have on the Great Depression?
48. What is the primary source of the political popularity of tariffs and other trade restrictions? Will politicians often be able to derive political gain from trade restrictions even if they exert an adverse impact on the economy? Why or why not?

49. “Good intentions provide little protection from the consequences of bad policy.” Do you agree or disagree with this statement? Cite examples supportive of your view.

Concluding Thoughts

50. How do institutions and policies influence income differences across countries?

51. What are the five freest economies in the world? Are countries with more economic freedom more prosperous than those that are less free?

52. When less developed countries adopt institutions more consistent with economic freedom, have they been able to grow rapidly and achieve higher income levels? Cite evidence in support of your response.
Part III. Economic Progress and the Role of Government

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?


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.
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?

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?
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 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.
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.  

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.  

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.

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

Introduction

1. Is making money the key to happiness? Is there anything wrong in taking steps that will help you earn more money? If you make more money, will you have more resources with which to pursue objectives that you think are important?

Discover Your Comparative Advantage.

2. Why is it important for individuals to specialize in those areas where they have a comparative advantage?

3. What are the major factors that determine whether you have a comparative advantage in a specific area?

4. Is it important to specialize in an area that you find interesting and fulfilling? Why or why not?

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

5. What are the four factors mentioned by the authors that underpin the success of self-employed entrepreneurs?

6. If you want to make a lot of money, why is it important for you to figure out how you can help others a great deal?

7. “Successful entrepreneurs must be good at discovering and acting upon opportunities that are often overlooked by others.” Is this statement true?

8. Is it important for employees to “think like an entrepreneur?” If employees can figure out how to make their services more valuable to employers, how will their promotion and earnings be affected? Can employees adopt many of the attributes that underlie the financial success of business entrepreneurs? Give examples.
9. If entrepreneurial activity were not rewarded financially, do you think that innovations and technological changes that improve the welfare of people would occur as rapidly? Why or why not?

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

10. What is the primary source of financial insecurity? Why are so many people with middle or even high levels of income financially insecure?

11. What is a budget? Will budgeting help you make better financial decisions and develop a strategy to achieve personal objectives? Explain how.

12. Is it important to save regularly? Why or why not?

13. Think about your current spending habits, what expenses can you either eliminate or reduce in order to save more?

14. Why is it important to start saving and investing at a young age? If you allocate 10 percent of your income each year into an investment program, how much would you have 20 years later? How much would you have 35 years later?

15. Why is delaying a savings plan until you earn more income or have more discretionary income a bad idea? What are the advantages of saving even small amounts of your income now?

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

16. Does it ever make sense to buy things on credit? If so, what type of items might the prudent person purchase on credit?

17. If you finance an asset such as a car or a machine, why is it important to pay off the debt before the asset is worn out?

18. If you pay for items that are consumed immediately or wear out quickly by placing them on your credit card, what is happening to your wealth?

Two Ways to Get More Out of Your Money: Avoid Credit-Card Debt and Consider Purchasing Used Items.
19. Why is it important to avoid using credit card debt as a method to purchase normal consumer goods?

20. If you have several outstanding debts, which ones should you pay off first? Why?

21. Can you think of some items that are “bargains” when purchased used? What are the characteristics of used items that can be purchased at attractive prices?

22. Why is it expensive to purchase a new car every year? Do you think most millionaires purchase a new car every year?

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

23. What is a “real world” savings account? Can it help you purchase some “peace of mind”?

24. List some expenses that you can expect to incur at various times in the future even though you may not know precisely when you will incur them.

25. How much should you set aside monthly in order to have sufficient funding for surprise expenditures?

26. How can you determine if your “real world” savings are adequate?

Put the Power of Compound Interest to Work for You.

27. What is compound interest? How does compound interest affect the importance of starting a saving and investment program at an early age? Explain.

28. Describe the “miracle of compound interest”. Why is the analogy to a snowball so useful?

29. If a pack of cigarettes costs $4 and a person starts smoking one pack per day at age 16, how much retirement wealth would they be giving up if they smoked until age 66? Assume they could earn a real return of 7 percent if they allocated the funds into an investment account.

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

30. What is “diversification” and how does it “put the law of large numbers to work for you”?
31. Is it attractive to invest in a home? What are some of the pitfalls to avoid when purchasing a home?

32. What is volatility? What are the two ways that diversification can help to reduce volatility?

33. When the authors state that the stock market has yielded an average real rate of return of approximately 7 percent over the last 150 years, what does this mean?

34. Historically, stocks have earned a higher rate of return than bonds. What is the primary reason why this has been the case?

35. Why do the authors recommend selling off your employer’s stock (as part of a company investment plan) as soon as you are permitted to do so? How does the term “double jeopardy” influence your answer to this question?

36. What is a stock mutual fund? Explain how it can help even small investors maintain diversity in their holdings of stock.

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

37. What is an indexed equity mutual fund? What is a managed equity mutual fund? How will the administrative costs of the two differ?

38. What is the random walk theory of stock prices? What does it indicate about the ability of “experts” to forecast accurately the future direction of stock prices?

39. When considered over lengthy time periods, such as a decade, how has the rate of return of actively managed equity funds compared with the return derived from indexed funds? Is this surprising?

40. If a mutual fund has earned a high rate of return during the last five years, is this solid evidence that it can also be expected to earn an attractive return during the next five years?

41. During the last two centuries, what has been the best method for a long-term investor to earn an attractive return and build funds for their retirement years?

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

42. Suppose an investor pays a fixed amount each month into a mutual fund indexed to a broad set of stocks such as the S & P 500. When this strategy is followed over a lengthy time period, 35 years for example, historically has the annual rate of return been
attractive? Has the variability of that return been relatively stable? How does this affect the attractiveness of this strategy for a younger person paying into a retirement investment fund?

43. What is the difference in the tax treatment of a traditional Individual Retirement Account (IRA) and a Roth IRA? If you are currently in a high tax bracket and expect to confront a lower marginal tax rate during your retirement years, which of these two options would be most attractive? Explain.

44. As a person approaches retirement or anticipates that they will want access to their funds some time during the next few years, why does it make sense for them to switch out of stocks and into bonds?

45. Over a relatively short time period, such as five years, are stocks likely to have more variability in rate of return than bonds? Why?

46. What is the major risk of investing in long-term bonds? How do changing interest rates affect bond values?

47. If the inflation rate increases sharply in the near future, what will happen to the market value of a bond you are currently holding?

48. What is a Treasury Inflation-Protected Security (TIPS)? How do TIPS differ from ordinary bonds? Which investors will find TIPS most attractive?

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

49. What is the principal-agent problem? Is this problem often present when an agent is trying to get you to invest in stocks, insurance, or a business proposition? Why should this cause you to be cautious?

50. Will it be attractive for entrepreneurs to contact and raise funds from a large number of relatively small investors? Under what circumstances are they likely to do so?

51. How can you avoid making investment decisions that, even though they sound good, may well result in the loss of all or most of your funds? What are some of the things that should cause you to be highly cautious?

52. Can you think of examples, either from someone you know or from the news, where someone lost money on an investment because they failed to recognize the risk involved? Would any of the six guidelines mentioned in the book have helped avoid a poor investment decision?

**Teach Your Children How to Earn Money and Spend It Wisely.**
53. What can parents do to help their children learn how to make wise financial decisions?

54. People tend to appreciate things they earn more than things that are given to them. Do you think this is true? How might this impact how you deal with your children?

55. Rather than simply purchasing items for a child, why will it often be better to provide the child with a fixed amount of money, allow choices about which items to purchase, and keep any funds that are not spent? How will this influence their incentive to economize?