NAME: ______________________________ CLASS PERIOD: __________

A Mystery of Two Families

Part 1. The Mystery

The Robinson and Murray families are alike in several ways. They earn the same family income, live in the same neighborhood, are similar in age, and have two children each. Yet the Robinsons are much wealthier than the Murrays. Why is this?

The Robinsons spend time managing their money, and they spend less money than they earn. Mr. and Mrs. Robinson have saved $250,000, which makes for a good start on their retirement fund. They also have established savings plans to help their children with college expenses. And the Robinsons are working to improve their capacity for future income. Mr. Robinson is taking evening courses to complete an advanced degree, and Mrs. Robinson is taking weekend seminars offered at no cost by her employer. Both are hoping for promotions at work.

The Murrays are always worried about money. While their house is worth the same amount of money as the Robinsons' house, the Murrays have a larger mortgage to pay off, so they pay more in interest than the Robinsons do. They drive newer cars than the Robinsons drive, and their credit-card balances keep increasing every month. They say they do not have enough time or money to improve their education. Although they could sell their house for more than they owe on their mortgage, they have no other savings. They hope their children will get scholarships to pay for college.

In short, the Robinsons are wealthier than the Murrays because they spend less than they earn and as a result they have more assets (for example, they have large balances in their savings accounts) and fewer liabilities (the Murrays have larger mortgage-interest payments, larger credit-card balances, larger auto loans, etc.). And the gap is likely to grow as time goes on, since the Robinsons are investing in their capacity for earning by improving their education, while the Murrays are not.

Part 2. An Approach to Solving the Mystery

For a better understanding of why the Robinsons are wealthier than the Murrays, despite the similarities between the two families, let's apply some basic points of economic reasoning. Our approach to economic reasoning, summarized in The Handy Dandy Guide, is based on six main ideas.

The Handy Dandy Guide

1. People choose.

This may seem obvious, but think for a minute about how many people say, in one situation or another, that they "have no choice." In fact, we ALWAYS have a choice—though sometimes, of course, the choices can be very difficult. The Robinsons choose to spend a few hours every week managing their money. They choose to set financial goals, to have a plan for their spending, to keep track of their expenses, and to adjust their spending if they go "over budget." Their goal is to save 10 percent of their income each month. They study ways to invest their savings, comparing rates of return and risks on different savings plans or other investments. The Murrays choose not to spend time managing their money. They don't communicate much about money within the family, making most spending decisions independently. And they choose not to set spending limits. They use their two credit cards frequently; without the credit cards they would find it very difficult to manage their day-to-day purchases. They do work hard at their jobs. When they are not working they enjoy relaxing or going out to dinner.

2. All choices involve costs.

Choices come with costs. Some costs are dollar costs. If you choose to buy a computer, you must pay the purchase price. But there is another kind of cost that also attaches to choices. It is called opportunity cost. For any choice you make, your opportunity cost is your next-best option: the next-best choice you could have made but did not make. For someone who buys a computer, the opportunity cost is the next-best use she could have made of the money spent on the computer. For someone who goes to a movie, the opportunity cost is the next-best use he could have made of the time and money he spent to go to the movie.

For the Robinsons, the opportunity cost of managing their money and furthering their education is having less time to relax, less time to go out to dinner, and so on. For the Murrays, the opportunity cost of relaxing and going out to dinner is that they are not managing their money or furthering their education. Making good choices involves comparing the benefits and costs of decisions. The Robinsons are wealthier and will continue to grow wealthier than the Murrays because of the choices they make.

3. People respond to incentives in predictable ways.

An incentive is a benefit or cost that influences a person's decision. One powerful incentive is money. Money is important because of the goods and services we can buy with it. It is also important because having money opens up the range of choices and opportunities people face. People work to earn money, but they also work to accomplish their goals and to have satisfying careers. By managing your money carefully, you can gain full benefits from your hard work, and you can position yourself, financially, to accomplish other goals.

People earn money by working for it, but it is also possible to earn money by making deposits in savings accounts and earning interest on those savings. The prospect of earning interest creates an incentive to save. It also creates an incentive for lenders; lenders earn money from the interest payments borrowers make as they pay off their loans.

One incentive encouraging the Robinsons to save is that, with savings, they will have more goods and services available to them in the future. They will also be able to achieve other goals, including helping others; and more choices will be open to them than they otherwise could have had. It is possible to think in the same way about the incentive for getting a good education. To get a good education, it is necessary to spend time, effort, and perhaps money on your studies; but the incentive for doing so is that, with a good education, you will be able to earn more income in the future, understand more about the world, and have more control over your life.

4. People create economic systems that influence choices and incentives.

The American economic system relies on markets, choices, and incentives. Americans are free to start a business, get an education, choose an occupation, and buy or not buy an incredible variety of goods and services. Americans may save or not save; they may rent an apartment or buy a house; they may buy a new car, a used car, or no car; and they may use credit cards or debit cards or pay cash for things they buy. Each one of these decisions comes with an opportunity cost. Every choice we make affects other opportunities, sometimes more than we realize.

For example, the Murrays have chosen to buy newer and more expensive cars than the cars the Robinsons have bought. As a result, the Murrays also pay more for insurance, taxes, maintenance, etc. All of the expenses related to the more expensive cars add up to more money that they can't use to save for other goals, such as retirement.

The Robinsons keep their cars for quite a while, and when they do replace their cars, they buy used. As a result, they keep their costs for cars and car-related expenses (insurance and taxes) down, and they therefore have more money available to save for retirement and even some fun family goals such as a vacation.

5. People gain when they trade voluntarily.

"Voluntarily" refers to doing something because you want to, not because someone forced you. Neither the Robinsons nor the Murrays are forced to buy goods and services. They are not forced to work for their employers (when you work, you trade your time and labor for money that you can use to buy goods and services). They do these things because the benefits are greater than the costs. Of course things can go wrong when people trade. If you don't gather sound information and trade carefully, you may find you don't benefit as much from the trade as you expected. The key is to determine whether the benefits will be greater than the costs. The Murrays might ask, for example, whether buying expensive cars today is a greater benefit to them than making contributions to a retirement fund and a college fund for their children.

6. People's choices have consequences for the future.

If you watch television and read newspaper and magazine advertisements, you might suppose that everyone lives for today. Most people, however, also live for tomorrow. Otherwise, why would we conserve, save, and invest? Life is not a lottery. People are affected from time to time by good luck and bad luck, but overall they shape their futures by the decisions they make—the good decisions and the bad ones. The Robinsons have acquired a measure of wealth because they save more and spend less than they earn. The Robinsons communicate within the family about their goals and spending, and this helps them to make good choices for their family. Even though the Murrays work hard, they spend as much as they earn—or more—and so they have almost no savings. They don't communicate with one another about their money; they don't set financial goals or pay much attention to their spending; and so it is hard for them to save for the future. The Robinsons' past decisions have affected their present wealth and lifestyle. For the Murrays, past and current decisions will have a great impact on their ability to live well in the future. It is important to find a balance between enjoying your money today and being able to live the way you would like to live at a later date.

Questions:

a. What is an opportunity cost?

b. Why is opportunity cost important when you make choices?

c. Why do people want to be wealthy?

d. Why do the choices we make now matter in the future?

e. What incentives encourage people to save money?

f. Why are the Robinsons wealthier than the Murrays?

NAME: ______________________________________ CLASS PERIOD: ___________

The Boring School Mystery

Most high school students believe school is boring. Yet most students graduate from high school. Why do students stay in school if school is so boring? Can the Handy Dandy Guide provide the answer to this mystery?

There are many reasons to stay in school and many reasons to drop out. For each of the following reasons, put an "S" for "stay in school" or a "D" for "drop out of school." Then use the Handy Dandy Guide to explain why more people stay in school than drop out.

1. ______ High school dropouts can get a job and thus provide more financial help for their families than their friends in high school can.

2. ______ High school graduates will have higher incomes in the future than the incomes of high school dropouts.

3. ______ High school graduates are able to go on to college.

4. ______ High school students must follow school rules, which limit freedom.

5. ______ High school dropouts can work full-time and have a better car, clothes, and social life than their friends in high school.

6. ______ Parents are happy when their children graduate from high school.

7. ______ School activities, such as sports and music, are fun for many students.

8. ______ Increased knowledge opens up increased choices and opportunities.

Questions:

a. What is the cost of staying in school?

b. What is the cost of dropping out of school?

c. What incentives encourage people to stay in school?

d. How does the American economic system encourage people to graduate from high school?

e. Is going to high school voluntary, or are young people required to go to high school?

f. Why do some students choose to drop out of school?

g. Why do most students choose to stay in high school and graduate?

h. What are the future consequences of a decision to drop out of school or stay in school?

