

## LESSON EIGHT: TAXES AND INFLATION

# FINANCIAL FORCES YOU CAN'T AVOID

### *Lesson 8: Taxes and Inflation*

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## Taxes and Inflation - Financial Forces You Can't Avoid

With all the other important issues facing you today, like learning how to drive, taking exams, and planning for college, concepts like taxes and inflation can seem a million miles away. In this lesson, you'll learn how these financial forces will affect your lives in the future. We will explore different real-life scenarios and discover how taxes and inflation can affect income, home ownership, wealth accumulation and retirement.

- Students will learn a basic overview of what taxes are and why you must pay them
- We'll talk about inflation, how it works, and its effect on everyday items

**What is inflation?:** Inflation is the overall increase in the prices of goods and services over time. For example, if one store increases prices for video games, but another store offers a lower price, this is not inflation. However, if all stores that carry video games increase their prices, this is considered a general increase in average prices and can be classified as inflation.

The value of a dollar is not static; it changes over time. For example, in 1950 a loaf of bread might have cost \$0.15 and now it may cost about \$2.50. If you had \$500 in 1950 and you have \$500 now, your purchasing power with the same amount of money has dramatically decreased due to inflation.

**How Does Inflation Affect Me?:** Think about how inflation will affect your own life. You may not realize it now, but money you have now will have less purchasing power in the future. Inflation may affect you sooner than they think. While we can't predict exactly how much inflation will rise in the future, historically the rate has increased by 2–3% each year.

Pretend that you received \$1,000 as a gift to use for expenses when you go to college. Assuming a 3% yearly inflation rate, what will that gift be worth in today's dollars five years from now? Answer: it will be worth \$858.73 in today's dollars. Three percent might not seem like a lot, but year after year – that number really adds up! How do you think inflation influences savings and wealth accumulation? Do you think it will make a difference in your spending or savings choices?

**Paying Uncle Sam:** Can you think of any other “financial forces” that may affect your wealth potential? Yup – that's right – TAXES! Whether you realize it or not, you have all paid taxes before. Even though you might not have paid income tax, if you've purchased a book, shoes, or even school supplies, you have paid sales tax.

Income tax is a certain percentage of your income that is paid to federal and some state governments. The exact percentage is based on how much money you make. Sales tax is an additional charge on the items you buy that is paid to your state or local government, however not all states have sales tax. Other common taxes include property tax (taxes paid on your home), Social Security and Medicare (taxes taken out of your paycheck to fund government retirement and health care programs, respectively). Most taxes are used to invest money back into federal, state and local government efforts. For example, taxes help to pay for road repairs, education and police forces.

How do you think taxes will affect your life? How does knowing that a certain portion of your income goes to taxes affect spending, saving and career choices? Let's calculate some ways that taxes can impact your income.

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## INVESTMENT ACTIVITY

**What does inflation really mean?** Let's assume you were given \$500 at the start of each year below. Assume an inflation rate of 3% each year. Then calculate the difference in buying power that amount of money represents in 2017. The buying power in today's dollars = current value x (1 – inflation rate) ^years.

Year	Starting Value	Buying Power in 2017
1990	\$500	
2000	\$500	
2010	\$500	
2015	\$500	

What happened to the numbers on your chart? Why did they change the way they did? What does this say about the value of a dollar and inflation?

**The Effects of Taxes on Your Income:** We all have to pay taxes to help fund government programs. But how will they affect your financial future? Read the scenario below and do the math to find out.

**Scenario:** Courtney is a senior in college and just started her first job as a sales associate. At her new job, she expects to make about \$24,000 per year. She is excited to receive her first paycheck, which is given every two weeks. Courtney learns that 15% of her gross pay will be withheld for federal income tax, 4% for state income tax and 6% for Social Security and Medicare taxes. Help Courtney figure out what her take home, or net pay, is and how much she will pay in taxes each paycheck.

1. How much money will Courtney pay in taxes each paycheck?
  - a. Federal:
  - b. State:
  - c. Social Security and Medicare:
2. What is Courtney's net pay?
3. Based on your knowledge of taxes, to which programs, services and accounts do you think the money withheld from Courtney's paycheck will go?