Personal Financial Literacy

ESSENTIAL QUESTIONS

- How can financial institutions help you increase and better manage your money?
- What are the different types of business organizations?
- How can you take control of your own money?

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There's More Online about personal financial literacy.

CHAPTER 19

FAFSA: Free Application for Federal Student Aid

The process of applying:

The FAFSA is available between January and June of each year, but certain kinds of federal financial aid are on a first come, first served basis. The FAFSA form can be completed online at http://www.fafsa.gov--- or a paper version can be downloaded and mailed. Also, some high school financial aid offices have software for completing the application.

Who is eligibile for federal financial aid?

STUDENT APPLICANT

- -High School Diploma or GED
- -Acceptance into a degree or certificate program
- -Registration with Selective Service
- -Valid SS#
- -Statement of non-default
- -U.S. Citizenship
- -Maintin Academic Progress

1 PIN

Get a PIN from the FAFSA Web site

4

Gather financial/banking information on income, assets and investments for the student applicant and parents

5

Gather student applicant's and parents' tax information and documents

What does federal financial aid pay for?

Federal student financial aid can be used to pay various expenses related to attending school. These expenses could include:

- Tuition & Fees
- Room & Board
- Books & Supplies
- Transportation
- Computers
- Child Care

FAFSA is the application for grants, loans and work-study funds from the federal government, as well as certain state, institution-based and private financial aid. The information provided by the applicant enables financial aid officers to determine how much of which kind of assistance students can receive.

2

DL#
SS#

Gather necessary documents (including social security numbers and driver's license numbers)

3

Prepare a list of colleges or universities that will receive FAFSA information

6

Complete the FAFSA form: go to http://www.fafsa.gov

7

Attend College!

Other Financial Options:

SALE

grants
(which don't require repayment unless you leave school)

loans
(money lent by the government)

work-study
(students earn money to pay for their education through job programs)

States, colleges, and private organizations also offer forms of financial aid. Check their information to see what types of aid is available, how to qualify, and the proper method for applying.

THINK ABOUT IT!

Understanding *List the items needed to complete the FAFSA. How would you explain the application process to someone else?*

Interact with these digital assets and others in lesson 1

- ✓ INTERACTIVE CHART
  Building Your Budget
- ✓ INTERACTIVE CHART
  Simple vs. Compound interest
- ✓ INTERACTIVE CHART
  Credit Basics
- ✓ SELF-CHECK QUIZ

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TRY IT YOURSELF ONLINE

LESSON 1

Financial Institutions and Your Money

Reading Help Desk

Academic Vocabulary

- risk

Content Vocabulary

- financial institution
- savings
- interest
- interest rate
- Federal Reserve System (Fed)
- Federal Deposit Insurance Corporation (FDIC)
- credit unions
- demand deposit account (DDA)
- creditors
- collateral
- secured
- unsecured

TAKING NOTES:

Key Ideas and Details

ACTIVITY Use a graphic organizer like the one below to explain the differences among savings accounts.

Type of Account	Risk	Amount of Interest	Deposit Requirements

ESSENTIAL QUESTION

How can financial institutions help you increase and better manage your money?

When you turned sixteen, your parents promised that you could get an after-school job to start earning your own money. You have worked at this job, getting regular paychecks for three months. You plan to use the money you earn from this job to buy a used car, but your salary is not high enough to save enough money by the target date of the start of your junior year in high school.

Which of the following methods do you think is the best way to put your money to work for you?

1. Keep all of your money in a shoebox in your closet. Promise yourself that you won't spend any money on other things until you reach your goal.
2. Put your money in a bank savings account. It'll earn some interest and you can withdraw what you need at any point.
3. Place your earnings in a certificate of deposit account. It'll raise higher interest, but you will be limited in the flexibility of withdrawing funds.

Budgeting

GUIDING QUESTION *What is the value of learning how to properly budget your money?*

Nearly everything you do is influenced by money—where you live, how you get around, what you do with your free time, and whether and what kind of job you have. When managed well, money makes your life easier. When managed poorly, it can cause great stress and create significant obstacles. Getting control of what you spend—or budgeting—will prevent a downward spiral into debt that may take decades to overcome.

Many people have no idea what happens to their money. It just seems to "disappear." Here's how to find out where *your* money goes:

1. List the bills you pay every month (cell phone, Internet access, and car insurance, for example).
2. For one month, list everything you buy, including the price you paid—no matter how little an item costs.

At the end of the month, group everything on your list into categories: Food, Transportation, Entertainment, and Personal Care. Now you can see where your money goes.

Here's how to get a handle on your spending: Write down your income and your expenses into a chart like **Figure 19.1**. Look at each expense in column 2 and think of ways to reduce that payment. Enter the smaller amount in column 3—your New Budget. Total the expenses in column 3 to see if your New Budget matches your income.

You've probably heard again and again about the importance of making wise decisions. This is especially true when you make financial decisions. The wisest financial decision you will ever make is to start a budget now and save a percentage of all money you receive—including cash in birthday cards as well as the pay from your part-time job. The second-wisest decision is to deposit what you save into a financial institution.

financial institution group that channels savings to investors; includes banks, insurance companies, savings and loan associations, credit unions

savings the dollars that become available for investors to use when others save

✓ **READING PROGRESS CHECK**

Explaining Why is it important to live on a budget?

Financial Institutions

GUIDING QUESTION ***How do financial institutions affect your own budget?***

A **financial institution** is an organization that channels **savings** to investors. How does this process work? Essentially, financial institutions make money by "selling" money. You deposit money into an account. In return, the financial institution pays you a certain percentage of that money for keeping it in an account. That payment to you is called **interest**. The financial institution then loans a portion of your original deposit to other people. Those borrowers pay back their loans plus interest (at a higher percentage) to the bank, which keeps the profit.

The amount of interest depends on the **interest rate**, a percentage a bank will pay to depositors or charge to borrowers. Interest rates are determined by the central bank of each country. The **Federal Reserve System (Fed)** acts as our central bank in setting the *discount rate*, which is the interest rate that influences all other interest rates charged by financial institutions.

Commercial Banks

Commercial banks are the most common and safest financial institutions. In addition to accepting deposits and lending or transferring funds, commercial banks help their customers manage day-to-day transaction needs such as paying bills, withdrawing cash, and paying for purchases via debit cards or by check. Many commercial banks have

FIGURE 19.1 networks *TRY IT YOURSELF* ONLINE

BUILDING YOUR **BUDGET**

Building Your Budget

Part-time job:	$_____
Monthly allowance:	$_____
Total income:	$_____

Spending Category	Current Expenses	New Budget
Food: School lunches Restaurants & take-out Snacks		
Transportation: Car payment Insurance Gasoline Maintenance (estimate)		
Entertainment: Movies Music Games Sports and hobbies		
Personal care: Clothes Shoes Haircuts Accessories Cosmetics		
Savings (10–30% of income)		
Utilities: Phones Internet access		
Medical/dental		
Donations to charity		
Miscellaneous		
Total		

Building a budget involves categorizing your income and expenses carefully in order to track how your money is spent. Then you can understand how to accurately plan for the future.

▲ **CRITICAL THINKING**

Economic Analysis Are there any parts of your budget where you spend more money than you expected? How could you reduce spending in those areas?

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You shouldn't worry about depositing your hard-earned money in the bank. What makes commercial banks safe? The money that you deposit in a single bank is insured for up to $250,000 by an independent agency of the federal government called the Federal Deposit Insurance Corporation (FDIC). The FDIC was created during the Great Depression after so many people lost their bank savings due to bank runs.

CRITICAL THINKING

Economic Analysis Why would insuring deposits be beneficial to banks as well as depositors?

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online services, and some charge fees for services such as Automated Teller Machines (ATMs). What makes commercial banks safe? The money deposited in a single bank—up to $250,000—is insured (or guaranteed) through an independent agency of the federal government called the **Federal Deposit Insurance Corporation (FDIC)**.

Credit Unions

Credit unions typically are not-for-profit banks that have been organized for a specific group of people. State employees, school districts, or big companies, for example, might have their own credit union. The benefit of a credit union is that its goal is to share its profits with members (customers) by offering perks such as lower fees and lower interest rates on loans. Because of government laws regarding nonprofit organizations and income tax exemption, credit unions often can offer certain benefits that larger banks cannot.

Nonbank Financial Institutions

Some financial institutions do not accept deposits, yet still channel savings to borrowers. *Finance companies*, for example, make loans directly to consumers who want to pay for large items—such as vehicles or appliances—on an installment plan. *Life insurance companies* also lend their surplus funds. *Investment banks* buy and sell stocks and bonds, also known as "securities." At one time, investment banks and commercial banks existed together in the same bank. After the stock market crash of 1929, Congress passed the Glass-Steagall Act to separate them.

✓ **READING PROGRESS CHECK**

Summarizing What is the goal of financial institutions?

You as a Depositor

GUIDING QUESTION *What is the value of learning to save your money at an early age?*

It is true that you have the right to keep your savings in a box under your bed. If someone steals it or if your house catches on fire, however, your money is gone forever. It is safer to deposit your savings in a bank. Earning interest on savings carries no **risk** and requires no extra effort on your part beyond making the deposits. Having a savings account also improves your credit rating, which is vital if you want to borrow money in the future. In addition, your savings are your only safety net in financial emergencies.

Why Start Saving NOW?

Saved money grows, and with an early start you can amass huge amounts of money over time. How? Through a very important concept: compounding. This process results in your interest earning interest.

As you can see from **Figure 19.2**, compound interest is different than simple interest. For example, if you deposited $10,000 and earned *simple* interest of 5%, you would earn $500 a year for a total of $1,500 interest in 3 years.

In contrast, if you deposited $10,000 and earned *compound* interest of 5% annually, you would earn $500 the first year. But in the second year, you would earn interest not on $10,000 but on $10,500—your original deposit *plus* the first

interest payment made for the use of borrowed

interest rate the price of credit to a borrower

Federal Reserve System (Fed) privately owned, publicly controlled, central bank of the United States

Federal Deposit Insurance Corporation (FDIC) the U.S. government institution that provides deposit insurance on the depositor's account

credit union nonprofit service cooperative that accepts deposits, makes loans, and provides other financial services

risk a situation in which the outcome is not certain, but the probabilities can be estimated

FIGURE 19.2

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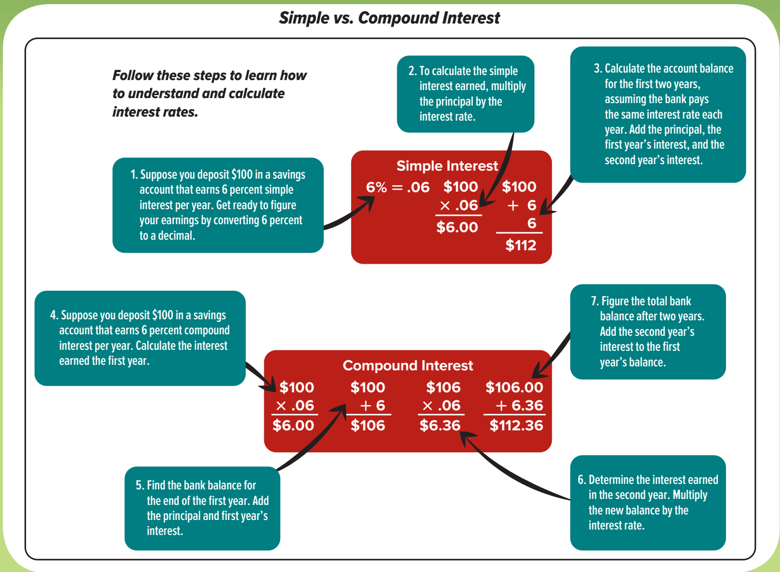
SIMPLE VS. COMPOUND INTEREST



Interest rates come in two different varieties: simple and compound. Even if the interest rate itself is the same, simple interest will affect your savings differently than compound interest.

CRITICAL THINKING

Economic Analysis Which rate would you prefer to save with? Which rate would you rather have for a loan?

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year's interest—which would total $525. In the third year, you would earn interest on $11,025, which is $551.25. With compound interest, then, your initial $10,000 would grow to $11,576.26 in three years, instead of $11,500 with simple interest. That may seem like a minor difference, but it can become a major difference as your balance grows over the years.

Interest for some accounts is compounded more often than annually. Some accounts are compounded semi-annually, quarterly, monthly, daily, or even continuously. The more frequently an account is compounded, the more interest you earn.

And the longer you leave your money in an account, the better compounding works—especially in an account with frequent compounding. For example, if you left $10,000 in an account for 10 years, with interest compounded *quarterly*, you'd have almost $16,500—without ever adding another cent!

Opening an Account

People choose a particular bank for various reasons. Some decide to go to the bank their parents use, or they might choose a bank because it's convenient or has a good reputation. Some banks offer better service or lower fees than others. Whatever bank you choose, there are a number of questions you can ask to make sure the bank is right for you.

- **Does it require a minimum balance?** Some banks charge you a fee if you do not keep a certain dollar amount in your account; other banks do not.
- **What are the fees?** It's good to know up front what services you will and won't be charged for.
- **What interest rates does the bank offer?** Even though the Fed determines the initial interest rate, banks have the ability to offer a particular range for various accounts.

You might already have a bank account that someone opened jointly for you (for your education, for example), but you must be age 18 to open an account of your own. Other items you will need to open an account at a bank include:

- a photo ID,
- proof of address (this can be on your driver's license; a utility bill with your name and address is also acceptable),
- your Social Security card,
- money to deposit.

Savings Vehicles and Risks vs. Returns

As its name suggests, a savings account is intended to be a place where customers can save their money and earn interest. Banks offer different types of savings accounts on the basis of how much money you keep in your account (your *balance*), the number of times you deposit or withdraw funds (your *transactions*), and the length of time you keep the money in the account. Your goals should determine which savings methods you choose.

- **Passbook Account** The most common savings account is sometimes called a "passbook account," named after the booklet that originally came with it. This type of account usually allows a low minimum balance, and it is ideal for "emergency funds" because you have fast access to cash. Savings accounts typically have a fixed interest rate, which means the rate will not change. But these fixed rates are usually low because savings accounts have no risk. Therefore, you also need to utilize other accounts—including investments—to receive enough interest to offset the taxes you'll pay on any interest earned, and to remain ahead of the inflation rate.
- **Money Market Deposit Account** This type of account is similar to a savings account in that it is safe (FDIC-insured), with easy but infrequent withdrawals. These accounts pay slightly higher interest because they have various deposit requirements, usually requiring a higher minimum balance. The interest rate on money market deposit accounts can change on the basis of the markets.
- **Money Market Mutual Fund** These accounts are relatively low risk because deposits are invested in a pool in short-term financial vehicles. Terms—or the amount of time you cannot withdraw your deposit—are from 90 days to 13 months. Interest rates on these accounts are comparable to money market deposit accounts.
- **Certificate of Deposit (CD)** This type of account has higher interest rates than a traditional savings account. Depositors "purchase" a CD of a certain amount ($100, $1,000, $5,000, $10,000, etc.) with a fixed rate (3.5%, 5%, etc.) with a set time period (1 year, 18 months, etc.). Making an early withdrawal before the "maturity date" can result in a penalty charge.

TYPES OF SAVINGS ACCOUNTS

There are many different types of savings methods available to depositors. Each method has its own set of advantages and disadvantages.

CRITICAL THINKING

Economic Analysis You have saved up $1000, and now you wish to use a savings account to earn interest. Consider what your needs and discuss what options you have for your money.

Art Vandalay/Getty Images

FIGURE 19.3

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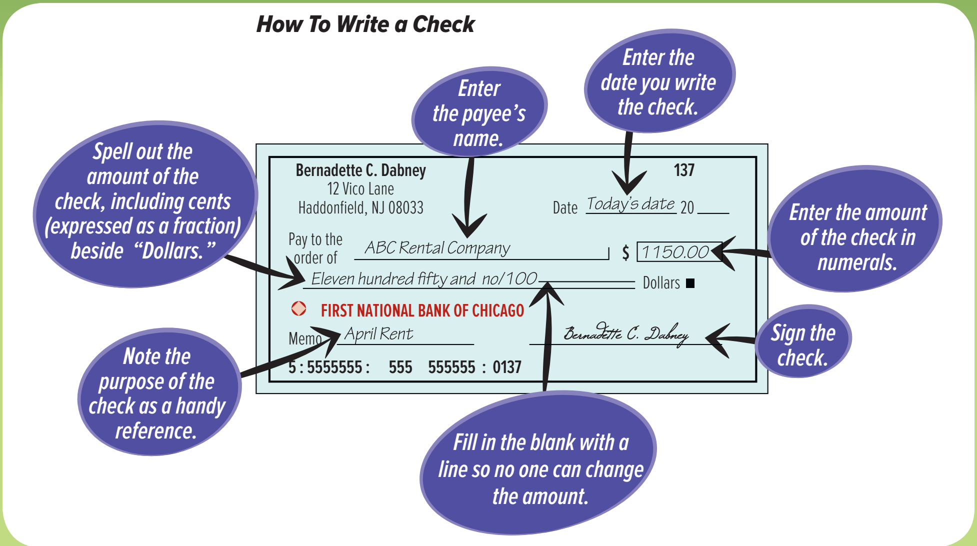
HOW TO **WRITE A CHECK**



One of the many ways you can access the money in your checking account is by writing a check, and it is easy once you know how. This figure shows you how to fill out a check.

CRITICAL THINKING

Evaluating Why might you use a check rather than pay with another method?

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Checking Accounts

A checking account is a **demand deposit account (DDA)**. This kind of account allows customers the easiest access to their money for daily and monthly use. Customers can access their money by walking into the bank and filling out a deposit or withdrawal slip, by writing a check, or by using a debit card. If the account earns any interest at all, it is usually minimal because the balance can change so much.

Demand deposit accounts (DDAs) account whose funds can be removed by writing a check and without having to gain prior approval from the depository institution

Ways to deposit money into your checking account include:

1. Go to the bank, endorse checks (personal checks or paychecks) by signing your name to the back of them, fill out a deposit slip, and hand to a teller.
2. Put endorsed checks and a deposit slip into an ATM. Tellers will make the deposit during banking hours.
3. Transfer funds from a savings or other account to your checking account online.

Ways to access the money in your checking account include:

1. Withdraw cash from an ATM.
2. Use a debit card at a store.
3. Write a paper check (or read numbers from a paper check to a vendor over the phone). (See **Figure 19.3**)
4. Go to the bank, fill out a withdrawal slip, and receive cash from a teller.
5. Pay bills with a bill-paying service through your bank online.

Keep a personal record of every transaction you make—deposits, checks written, and ATM withdrawals. Each month, your bank sends you a *statement*, which is a record of all of the transactions (deposits and withdrawals) you have made in a month. Many banks also allow you to view your activity online through their Web site.

Included in your monthly bank statement is a form that allows you to "reconcile" your account each month. This means that you compare your own personal records with those of the bank to make sure there are no errors. If you find a discrepancy, contact your bank's customer service right away to determine the problem. If you fail to report a discrepancy on your statement within 60 days, you could be held responsible.

It is important to pay attention to your account balance. If you write a check for more than the amount you have in your account, you will have "insufficient funds," also called "bouncing a check." This can happen if you write a number of checks and lose track of your balance. Bouncing checks can be very costly. Vendors to whom you write a bad check will charge you a fee on top of the amount you already owe them. And your own bank will also charge you a fee.

If your debit card is lost or stolen, report it to your financial institution immediately and check to see whether there has been any unauthorized activity on your account. If any unauthorized purchases are made within two business days after your card is stolen, you are held responsible only for $50.

✓ **READING PROGRESS CHECK**

Explaining Why is it important to start saving now?

You as a Borrower

GUIDING QUESTION ***What should you understand about the rules of borrowing money from financial institutions?***

Our society depends more and more on credit, or borrowing, to pay for purchases, which is why it is important to establish and then maintain good credit. Paying cash for everything does not make you a good credit risk. To prove you're responsible enough to get credit, you have to establish a credit history and a credit score. About 15% of a credit score is based on how long you've had credit, so it's important to establish credit as soon as possible.

Are you Creditworthy?

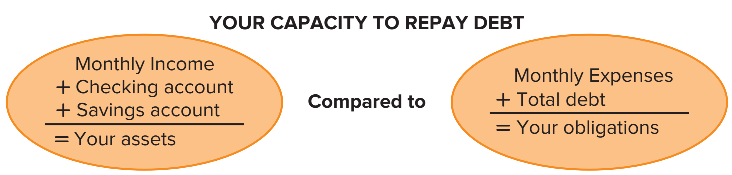
creditors persons or institutions to whom money is owed

Creditors decide whether to lend you money and how much interest to charge by looking at three things:

1. **Can you pay them back?** Add your monthly income to your bank account balances to find your total assets. Then total your monthly expenses, including debts or obligations. Compare the two to see if you're able to take on more debt.

FIGURE 19.4 networks TRY IT YOURSELF ONLINE

CAPACITY TO REPAY DEBT



Before you can begin to effectively and reliably repay debts, you need to assess your assets and compare them to your obligations. Repayment of debts can begin when your assets are greater than your obligations.

◀ **CRITICAL THINKING**

Economic Analysis If your monthly expenses were to increase without an increase in your assets, what effect could it have on your ability to effectively and reliably repay debt?

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2. **Do you have a good credit rating?** Lenders want to know if you've repaid previous debts on time.
3. **Do you have collateral?** **Collateral** is used mostly to buy homes or cars. If you don't make the payments, the lender takes back the house or car.

collateral something of value that a borrower lets the lender claim if a loan is not repaid

Credit Cards

When you use a credit card, you're borrowing money from a creditor that must be paid back—*plus interest*. Lenders make their profits on the interest their customers owe. Unlike a friend who loans you money and would prefer to have it all back at once, credit card companies set a low "minimum monthly payment" amount. The longer it takes you to pay off your balance, the more they are able to charge you. This is good for the lender, but ultimately detrimental to you.

Recall that you can earn money on your savings through compounding interest. Most savings accounts earn a low percentage (1% to 3%). In contrast, lenders charge compounding interest that is much higher (15% to 25%). That means if you run up a balance of $1,000 on a credit card and pay only the minimum payment each month (around $25.00), it will take you 22 years to pay off the credit card, and you will end up paying $3,000 total, which is three times the amount you initially borrowed.

Not all banks and credit cards are the same. If you have good credit, you can negotiate a lower interest rate, or annual percentage rate (APR). Be careful that it's not just an "introductory rate," which increases after a certain period of time. Credit card companies often set up information tables on campuses to attract college students. These can be great opportunities to establish your credit, but be sure you ask about the interest rate. If it is too high, keep shopping for a lower APR.

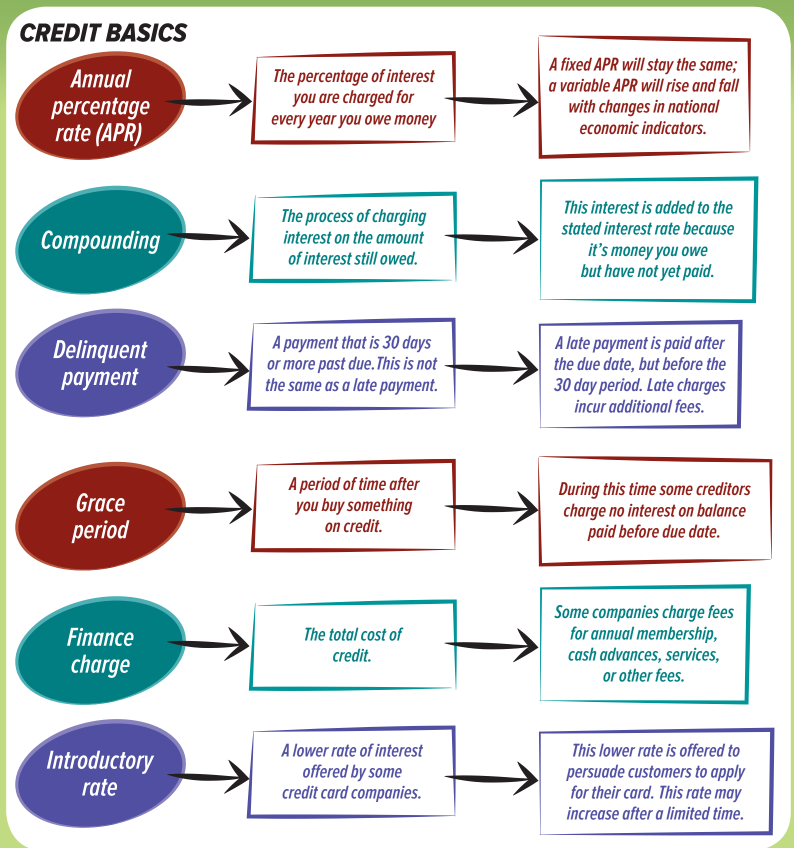
Every month, you'll get a statement listing everything you bought with your credit card the previous month, the payments you made, and the balance. Be sure to pay your credit card bill on time. And do not fall into the credit card trap of paying only the minimum payment.

Building Credit and Your Credit Score

Every time you buy something with a credit card or pay a bill, your activity is being recorded by a credit bureau, which issues each person a credit rating. Companies and banks that loan money can access that credit rating and use it to determine how likely you are to repay a loan.

FIGURE 19.5 networks TRY IT YOURSELF ONLINE

CREDIT BASICS



Some of the most common problems in managing your finances correctly comes from not understanding how credit works. Mastering the basics of credit can prevent many financial headaches.

▲ **CRITICAL THINKING**

Economic Analysis Why is it important to pay your credit card on time?

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There are three major credit reporting companies (also called *credit bureaus*) that are responsible for assigning a credit score. They are Equifax, Experian, and TransUnion. These companies track each person's credit history, or whether you've paid previous debts on time. Your credit score is a number between 300 and 900. The higher the number, the better your credit and the lower the interest rate you'll be charged for borrowing.

So how do you build credit and improve your credit score? Here are several ways:

secured loan loan that is backed up by collateral

unsecured loan loan guaranteed only by a promise to repay it

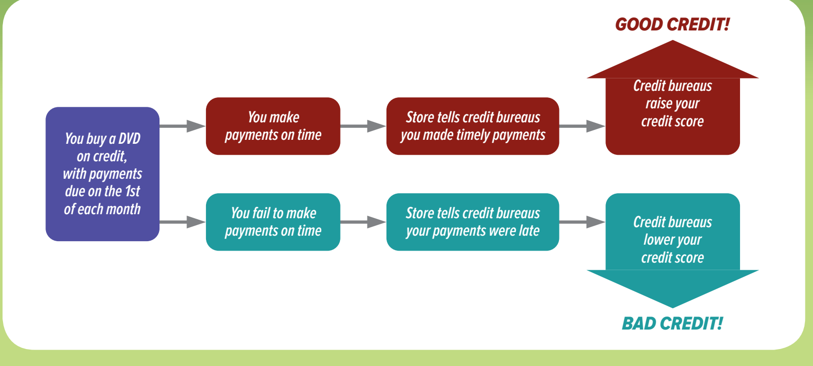
- Open an account in a bank or credit union, which builds a relationship with the financial institution.
- Apply for a **secured** credit card at the bank or credit union. You'll have to make a deposit—usually about $300—and you'll get a credit card you can use to make purchases up to the amount you deposited. Buy something each month with the card and be sure to make the monthly payments on time. After about a year, if you've paid off the balance, you can get your deposit back and switch your secured credit card to an **unsecured** one. Unsecured cards are not limited to the balance of your account.
- Apply for a retail store credit card. The store will probably ask for your current bank credit card number and expiration date. Buy something on credit at the store and make the payments on time. Retail credit cards are easier to obtain than a major credit card, such as Visa® or MasterCard®, because the borrowing limits are much lower on retail cards. But retail credit cards often have much higher interest rates, so it is important to pay off your balance each month.
- Get a job and keep it. There is a section on your credit report that identifies your employment history. Potential creditors look at this information and determine whether you are a good candidate for credit if you have been at the same job for a while and your income has increased steadily.
- Be sure to pay service providers (cell phone, Internet, electric company, etc.) on time. The history of your payments to them often appears on credit reports—especially if you pay late.

Responsibilities and Obligations of Borrowing Money

When you borrow, you are contractually obligated to the lender. It is your responsibility to understand the details of any document before you sign it,

FIGURE 19.6 networks TRY IT YOURSELF ONLINE

HOW DO **YOU SCORE?**



One of the keys to qualifying for financial loans is a good credit score. How do you earn good credit? By showing a pattern of reliable finances. Examine the art to understand the right way and the wrong way to handle your credit rating.

CRITICAL THINKING

Economic Analysis Why is it important to earn a good credit rating?

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as you will be bound by law to the terms laid out in the contract. Be sure to read the fine print on all contracts.

Failure to meet the terms of a loan can lead to legal action, including taking you to court. Lenders can "garnish your wages," meaning your employer will pay the creditor out of your future paychecks. If the loan is for a piece of property, such as a home or a car, the creditor can *repossess* them, or take them from you.

Declaring Bankruptcy

If you have trouble repaying a loan, there are things you can do to get help. Contact your creditor right away. Many creditors are willing to work with you if you lose your job. Credit counselors and other services also are available. There may come a time when income cannot keep up with the accumulation of monthly bills. A person can "declare" bankruptcy by filing a petition with the courts. Some people view bankruptcy as a "clean slate," but it stays on a credit record for a long time and can make moving forward very challenging. It should be the option of last resort.

The rules of bankruptcy vary from state to state. There are two main parties in a bankruptcy, the *debtor* (the party who owes) and the *creditor* (the party that is owed). Most bankruptcy cases involve one debtor (or two if married) and multiple creditors.

Several types of bankruptcies exist. The circumstances determine which "chapter" of the Bankruptcy Code a person should file under. Most personal bankruptcies are one of the following:

- **Chapter 7** is the most common form of bankruptcy. A trustee from the court is appointed to evaluate the debtor's assets and use them to pay a portion of the debt. Money owed on student loans, child support, and taxes will not be dismissed, however. Those with lower incomes and few assets typically choose this option.
- **Chapter 13** bankruptcy allows the debtor to keep some or all of his or her property. A trustee is appointed to create an appropriate repayment plan with lowered payments. The court collects future payments from the debtor to pass onto creditors.

After the debtor has completed the requirements spelled out by the court, he or she is relieved of the debt previously accumulated.

✓ **READING PROGRESS CHECK**

Summarizing Why is a good credit score important?

LESSON 1 REVIEW

Reviewing Vocabulary

1. ***Defining*** Explain the differences between a secured credit card and an unsecured credit card.

Using Your Notes

2. ***Summarizing*** Use your notes to explain the methods available for depositing money into a personal checking account.

Answering the Guiding Questions

3. ***Explaining*** What is the value of learning how to properly budget your money?
4. ***Discussing*** How do financial institutions affect your own budget?
5. ***Describing*** What is the value of learning to save your money at an early age?
6. ***Prioritizing*** What should you understand about the rules of borrowing money from financial institutions?

Writing About Economics

7. ***Informative/Explanatory*** Write a two-page essay explaining the concept of bankruptcy. When does bankruptcy occur? What benefits does bankruptcy provide to the person or institution? What risks does declaring bankruptcy bring?

Interact with these digital assets and others in lesson 2

- ✓ INTERACTIVE IMAGE Rasing Capital
- ✓ INTERACTIVE CHART Common Investments
- ✓ INTERACTIVE CHART Reading Stock Market Reports
- ✓ SELF-CHECK QUIZ

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TRY IT YOURSELF ONLINE

LESSON 2

Business Organizations and Your Money

Reading Help Desk

Content Vocabulary

- capital formation
- sole proprietorship
- unlimited liability
- limited life
- partnership
- limited partnership
- corporation
- stockholder
- stocks
- dividend
- preferred stock
- common stock
- portfolio diversification
- mutual fund
- stockbroker
- maturity
- municipal bond
- Treasury bill
- Treasury note
- Treasury bond
- savings bond
- Individual Retirement Accounts (IRA)

TAKING NOTES:

Key Ideas and Details

ACTIVITY Use the graphic organizer below to describe the advantages and disadvantages of the financial assets listed.

Financial asset	Advantages	Disadvantages
Preferred stock		
Common stock		
Mutual fund		
Corporate bonds		
Municipal bonds		
Treasury instruments		

ESSENTIAL QUESTION

What are the different types of business organizations?

It's never too early to start thinking about retirement. By disciplining yourself to set aside some of your salary from each paycheck, you can begin saving money and using interest to build up money that you will need later in life when you aren't working for a salary any longer.

Explain the differences between a traditional Individual Retirement Account (IRA) and a Roth IRA.

Business Organization and Ownership

GUIDING QUESTION *How do the different types of business organizations change the amount of financial risk assumed by the individual investor?*

Capital formation is a term used by economists to describe the transfer of money from individuals or households to businesses and government through investments and loans. Capital formation depends on savings and borrowing, and the smooth flow of these funds through the financial system benefits everyone. How so? Financial institutions turn the collective savings of all their customers into investments that result in more jobs, which result in more goods and services being produced. Rising employment also increases demand for more goods and services. Countries with good capital formation experience economic growth.

Capital formation helps many of the nearly 600,000 new businesses in the United States get started each year. For many people—and perhaps you in the future—owning a business is a way to fulfill a lifelong passion. For others it is a way to have more control over their professional goals, the people they work with, and personal life balance. Just as there are different motivations for starting a business, there are different ways to organize a business.

Sole Proprietorships

A **sole proprietorship** is a business owned by one person. It is the most common form of business organization. To get started, the owner needs to obtain all of the required permits, registrations, and licenses, which vary depending on the state and the kind of business. The U.S. Small Business Administration (SBA) Web site has a listing of these requirements.

Sole proprietorships are easy and often inexpensive to set up, and they have the lowest tax rate of the different types of businesses. All of the decisions are made by one person, who gets all of the profits.

Sole proprietorships are easy and often inexpensive to set up, and they have the lowest tax rate of the different types of businesses. All of the decisions are made by one person, who gets all of the profits.

Sole proprietorships also experience disadvantages. Because the business is not separate from the individual who owns it, he or she holds **unlimited liability** for debt and other obligations. It may be difficult to raise money from investors. Sole proprietorships also have **limited life**.

Partnerships

A **partnership** is a business owned by two or more people. Together they divide all profits, and they are responsible for all debts. To get started, the partners sign an agreement as to how they will run the business. A partnership must register with the state, establish a business name, and register with the Internal Revenue Service (IRS) to obtain a tax ID number. The partners also must obtain required permits, registrations, and licenses. Many law offices or doctors' practices are partnerships.

Essentially three types of partnerships exist:

- **General Partnership** In this type of partnership, management of the business, liability, and profits are split equally among partners.
- **Joint Venture** This type of partnership is like a general partnership, but it is typically set up for a single project or for a limited time span.
- **Limited Partnership** This type of partnership allows for certain partners to have less input—less money invested or fewer decision making powers, for example—in exchange for less profit. The percentages of profits are decided in advance and documented in a legal agreement.

Partnerships hold certain advantages. They are relatively easy to form. They utilize the resources and strengths of the partners, and additional partners who have specialized skills may be added.

Disadvantages of partnerships mirror the struggles common whenever people work together. There may be disputes over the direction of the company, day-to-day duties, and the amount of effort. In addition, all partners are liable for the mistakes of the other partners.

Corporations

A **corporation** is a business that is legally separate from its owners. It is made up of **stockholders** (shareholders) who invest money and, in return, receive profits that the corporation earns. Setting up a corporation requires a number of complicated and costly legal prerequisites. Corporations must register with the state, establish a business name, and register with the IRS to obtain a tax ID number. They must acquire permits, registrations, and licenses. Shareholders create a *board of directors*, a group of people who oversee the management of the corporation.

Advantages of a corporation are many. It provides limited liability, meaning that the corporation itself, not its owners, is fully responsible for its obligations. Shareholders are not responsible for the debts of a corporation, and they file their personal taxes separately. Ownership of a corporation can change easily from person to person and outlive the original shareholders. Corporations can raise money for the business, including offering stock, which can be a way to recruit high-quality employees.

capital formation the transfer of money from households to businesses and government through investments and loans

sole proprietorship unincorporated business owned and run by a single person who has rights to all profits and unlimited liability for all debts of the firm; most common form of business organization in the United States

unlimited liability requirement that an owner is personally and fully responsible for all losses and debts of a business; applies to proprietorships, general partnerships

limited life situation in which a firm legally ceases to exist when an owner dies, quits, or a new owner is added; applies to sole proprietorships and partnerships

partnership unincorporated business owned and operated by two or more people who share the profits and have unlimited liability for the debts and obligations of the firm

limited partnership form of partnership where one or more partners are not active in the daily running of the business, and whose liability for the partnership's debt is restricted to the amount invested in the business

Partnerships and sole proprietorships have several means of raising capital, including start-up loans, SBA loans, and lines of credit.

▲ CRITICAL THINKING

Economic Analysis What is a start-up loan typically used for?

Disadvantages also exist, however. Start-up costs can be very high. Because corporations require more regulation, recordkeeping and other obligations can be burdensome and time consuming.

✓ READING PROGRESS CHECK

Evaluating Why is limited liability advantageous for a business organization?

Raising Capital

GUIDING QUESTION ***How can small business owners find ways to raise the investment capital they need to start a business?***

All business organizations face a similar need: obtaining capital to develop their business. As you will see, corporations have several options unavailable to sole proprietorships and partnerships.

Small Business Loans

Small businesses such as sole proprietorships and partnerships may obtain *start-up loans* to establish their businesses. These funds typically are used to purchase property and inventory, or to pay start-up fees. Another type of loan for small business owners is a *Small Business Administration loan*. These are funded by the U.S. Small Business Association and administered through participating banks. *Lines of Credit* are loans designed to help with cash flow during slow periods or negative growth. They allow a business to draw from a set amount of funds without having to go through the loan application process over and over again.

Corporate Capital

There are four general ways for corporations to raise capital: selling bonds, issuing stocks, borrowing directly from financial institutions, and converting profits.

- **Selling Bonds** Bonds are like loans from individuals. A corporation offers bonds for sale, and then pays installments of interest to the bondholders. Eventually, the bond itself is repaid. Bondholders do not have any say in how the company is run, yet investors like bonds because they are not very risky; corporations must pay bondholders even if the company has not made a profit. Corporations like bonds because the interest rate is lower than that of a bank loan. The interest paid to bondholders is also tax deductible for the corporation.
- **Issuing Stocks** **Stocks** are also like loans from individuals. Unlike bondholders, purchasers of stock receive **dividends** representing a portion of corporate profits. There are generally two types of stock. Purchasers of **preferred stock** receive dividends after bondholders are paid but have no say in how the company is run. Purchasers of **common stock** earn dividends last but are allowed a certain say in how a company is run. For instance, they are allowed to vote for the board of directors who manage the corporation.
- **Borrowing Directly** Businesses can get loans from banks or other lenders. The interest rates typically are higher than those for bonds and stocks.
- **Converting Profits** Some corporations use all of their profits to pay their shareholders. Other corporations, called "growth companies," put their profits toward expanding the business in new directions or investing in research that relates to their industry.

✓ READING PROGRESS CHECK

Comparing In general, how is a bond different from a stock?

corporation form of business organization recognized by law as a separate legal entity with all the rights and responsibilities of an individual, including the right to buy and sell property, enter into legal contracts, and to sue and be sued

stockholder person who owns a share or shares of stock in a corporation; same as shareholder

stock certificate of ownership in a corporation; common or preferred stock

dividend check paid to stockholders, usually quarterly, representing portion of corporate profits

You as an Investor

GUIDING QUESTION ***Why is the role of an investor an important part of the economy?***

Investing is not just for the rich. A little extra is all it takes to begin using your money to make more money. All investments, however, involve two unknowns: the possibility of making money—the return—and the risk of losing it. In deciding to invest, you are always balancing these two factors.

Investment Risks vs. Returns

There are two types of financial risk involved when investing:

- **Undiversifiable risk** is also called "systematic" or "market risk." This type of risk affects all companies. Situations like inflation, interest rates, political instability, natural disasters, exchange rates, and wars are examples of undiversifiable risks.
- **Diversifiable risk** is also called "unsystematic." This type of risk is specific to each company or industry. A company being poorly managed, a factory burning down, or new technology replacing another technology are examples of diversifiable risks.

The riskiest investments usually provide the highest returns. The best way to reduce risk is to practice **portfolio diversification**, which means investing in a wide range of assets that would not all be affected in the same way. This is especially wise advice when dealing with stock market investments.

Investing in Stocks

As you learned earlier, stocks are shares of a company's assets and are considered a good long-term investment. However, stocks are also the investments with the largest amount of risk. A company might suffer any number of setbacks, and you could lose some or all of the money you invested. To reduce risk, many people buy a collection of stocks called a **mutual fund**. This is a pool of money from

preferred stock form of stock without vote, in which stockholders get their investments back before common stockholders

common stock most common form of corporate ownership, with one vote per share for stockholders

portfolio diversification strategy of holding different investments to protect against risk

mutual fund company that sells stock in itself and uses the proceeds to buy stocks and bonds issued by other companies

FIGURE 19.7 networks *TRY IT YOURSELF* ONLINE

COMMON INVESTMENTS

COMMON INVESTMENTS

Stocks	Stock mutual funds	Bonds	Bond mutual funds
Advantage: *High earnings potential*	***Advantage:*** *Some risk, but less than buying stock individually; Professional investment manager*	***Advantage:*** *Good earnings potential;* ***Federal:*** *no default risk;* ***Municipal:*** *low risk, no federal tax;* ***Corporate:*** *moderate risk*	***Advantage:*** *Professional investment manager; less risk than individual bonds*
Disadvantage: *High risk; need broker to buy and sell*	***Disadvantage:*** *Need fund company or broker to buy and sell; minimum investment usually $1,000 or more*	***Disadvantage:*** *Federal tax on federal and corporate bond interest*	***Disadvantage:*** *Need broker to buy and sell*

Corporations have more opportunities than sole proprietorships and partnerships to raise capital through these different investment methods. Each one has advantages and disadvantages.

CRITICAL THINKING

Economic Analysis What form of investment method described in this chart carries the highest risk?

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stockbroker person who buys or sells securities for investors

many people and invested together in a variety of stocks and bonds. It is administered by an investment manager.

To purchase stock, you need to establish an account with a **stockbroker**, either in person or online. There are "full-service" brokers who offer investment advice but also charge higher fees or work on "commission," receiving a percentage of what you earn. Online brokers are becoming more and more popular. They also charge fees, but the fees can be less than those of full-service brokers. Before setting up an account and making any transactions, it is important that you do your research about the broker and know what fees are charged.

To set up an account, you must be 18 years old, or you can set up a custodial account with your parents. Similar to setting up a checking account, you need two sets of identification, a Social Security number, a W-9 form, and the initial deposit.

Tell your broker your short-term and long-term goals, which will affect the risks and returns on your investments. If you want to select your own stocks, be sure to do your homework: What does the company produce? How profitable is it? What is its earnings history? How has its stock fared recently and over the past year? Join an investment club to help you answer these questions—and to learn what questions to ask.

Patience is the key to successful stock investing. The stock market (where stocks are bought and sold) may go up and down, but the return on stocks over the past 50 years has been consistently higher than for other types of investments.

Investing in Corporate and Government Bonds

maturity life of a bond, length of time funds are borrowed

municipal bonds a type of investment, often tax exempt, issued by state and local governments; known as munis

Like stocks, bond transactions can be completed through full-service brokers as well as online brokers. Recall that corporations offer bonds to raise capital for developing or expanding a business. Governments, too, sell bonds. They offer the bonds to raise money for particular projects, such as building bridges.

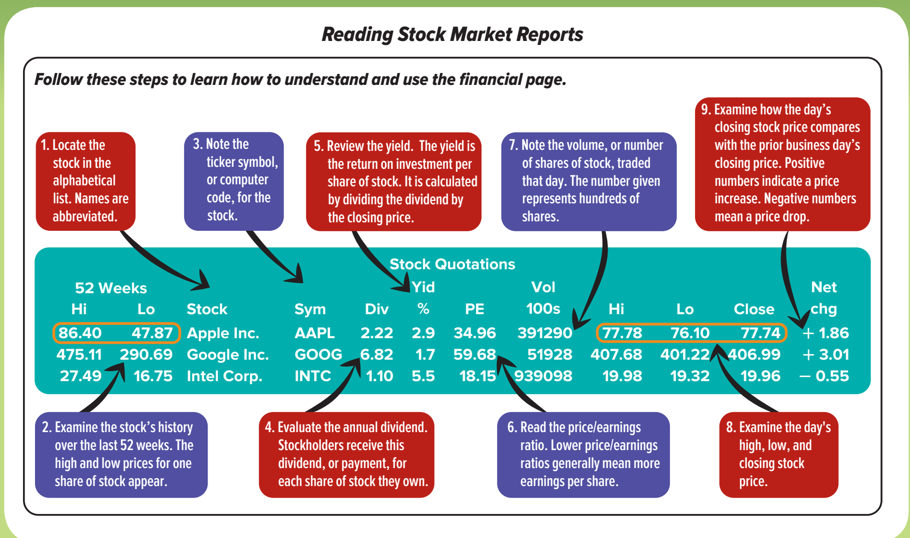
In general, as a bondholder you will receive scheduled interest payments as well as the repayment of your loan at a specified time in the future—the bond **maturity** date. Maturity dates vary widely, however.

State and local governments sell **municipal bonds** known as munis. *Treasury instruments* are loans you make to the federal government. They include

FIGURE 19.8

networks TRY IT YOURSELF ONLINE

READING STOCK MARKET REPORTS



When picking which companies you want to invest in, it is important to research the performance of those companies. Stock market reports can help you figure out what companies make for good investments.

◀ **CRITICAL THINKING**

Economic Analysis Which stock reported the biggest change for the day reported? Which stock traded the largest volume of stocks for the day reported?

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Treasury bills (T-bills), **Treasury notes** (T-notes), **Treasury bonds**, (T-bonds), Treasury Inflation-Protected Securities (TIPS), and several series of **savings bonds**. They have various interest rates and maturity dates. These types of federal bonds offer different payment plans depending upon the maturity date. Because they are issued and backed by the government, treasury instruments offer low risk. They can be bought directly from the government online, or through banks or brokers. Minimum investments for most are $100–$10,000, but some savings bond minimums are much lower.

Companies such as Standard & Poor's and Moody's rate bonds on their level of risk. Most bonds are considered less risky than stocks, and government bonds are less risky than corporate bonds. In addition, the interest payments on munis are tax-exempt, whereas the interest payments from corporate bonds are taxed.

Treasury bills United States government obligation with a maturity of a few days to 52 weeks

Treasury notes United States government obligation with a maturity of 2 to 10 years

Treasury bonds United States government bond with maturity of 30 years

savings bonds low-denomination, non-transferable bond issued by the federal government, usually through payroll savings plans

Individual Retirement Account (IRA) retirement account in the form of a long-term time deposit, with annual contributions not taxed until withdrawn during retirement

Investing in "Yourself" with IRAs

Individual Retirement Accounts (IRAs) can be considered both investments and savings. They are savings accounts because you deposit money into them, which you do not access until you reach retirement. They are investments because you (or financial advisors) select the stocks and bonds into which you want your deposits directed. Again, do your homework before you invest your IRA funds. When you're young, you can choose riskier assets to get a higher return because if you lose your investment, you still have many years to recoup your losses. As you near retirement age, you want to transfer your deposits into safer assets.

Some employers offer IRAs. Banks also offer IRAs for those who don't have access to employer-sponsored accounts or who want to save independently for retirement. There are many different types of IRAs. The most common are Traditional and Roth. The differences are in how you pay taxes on the deposits.

- **Traditional IRA** In a traditional IRA, you can make yearly contributions (deposits) into the account up to a certain limit determined by the government. These contributions are not taxed when they are deposited, but you have to pay tax on the whole amount (as income) when you withdraw the funds upon retirement. In theory, by then might be in a lower tax bracket and won't pay as much in taxes.
- **Roth IRA** The Roth IRA was created as part of the Taxpayer Relief Act of 1997. With this type of account, you have taxes taken out before you make deposits so you do not have to pay taxes when you withdraw the money at retirement.

✓ READING PROGRESS CHECK

Summarizing How can you make buying stocks less risky?

LESSON 2 REVIEW

Reviewing Vocabulary

1. ***Defining*** What is a sole proprietorship?

Using Your Notes

2. ***Summarizing*** Use your notes to compare and contrast the different types of Treasury instruments that can be used to invest in government.

Answering the Guiding Questions

3. ***Explaining*** How do the different types of business organizations change the amount of financial risk assumed by the individual investor?
4. ***Examining*** How can small business owners find ways to raise investment capital they need to start a business?
5. ***Describing*** Why is the role of an investor an important part of the economy?

Writing About Economics

6. ***Informative/Explanatory*** Write a two-page essay explaining the advantages that a corporation has over a small business. What vehicles for investment does a corporation have access to that a small business does not? At the same time, what risks and challenges does a corporation take on that a small business does not?

Interact with these digital assets and others in lesson 3

- ✓ INTERACTIVE GRAPH
  Unemployment and Earnings
- ✓ INTERACTIVE CHART
  Types of Car Insurance
- ✓ INTERACTIVE IMAGE
  Achieving Your College Goals
- ✓ SELF-CHECK QUIZ

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LESSON 3
Personal Money Decisions

Reading Help Desk

Content Vocabulary

- **defaulted**
- **premiums**
- **deductible**

TAKING NOTES:

Key Ideas and Details

ACTIVITY Use the graphic organizer below to describe various methods available for pay for college.

Method	Description

ESSENTIAL QUESTION

How can you take control of your own money?

It is unavoidable that we must spend the money we earn. But learning how to spend it carefully and effectively is the important trick that you should learn. One of your biggest expenses is paying for your own place to live.

What are the financial benefits of buying a home?

Funding Your Education

GUIDING QUESTION *Why are there so many different methods available to help you fund more education?*

You graduate from high school. Then what? Although the workplace has changed over the years, one fact remains constant: what you learn determines what you earn. Workers with bachelor's degrees have greater lifelong earning power than do workers with only a high school diploma, and are less likely to be unemployed.

Financial Aid

Many families cannot afford to pay cash for students to go to college. Instead, they acquire loans and other financial aid. To be considered for financial aid—including low-interest loans, grants, and work-study programs—you must complete a FAFSA form. FAFSA stands for the Free Application for Federal Student Aid. It is the form created by the U.S. Department of Education and managed by the Office of Federal Student Aid. It is used by nearly every college and university to determine eligibility of financial aid and how much you or your family must contribute. Around 14 million FAFSA forms are submitted each year and account for about $80 billion in financial aid. Deadlines vary from college to college, but the form should be filled out in January, as soon as you and your parents receive all tax information from the previous year.

To qualify for financial aid, you must:

- Be a U.S. citizen
- Have a valid Social Security number
- Have a high school diploma or GED

- Be registered with the U.S. Selective Service (if you are a male 18 to 25 years old)
- Promise to use federal aid only for educational purposes
- Not owe refunds on any federal student grants
- Not have **defaulted** on any student loans
- Not have been found guilty of the sale or possession of illegal drugs

Documents you need to complete the FAFSA form:

- Most recent income tax return (or your parents' tax return if you are a dependent)
- Current bank statements
- Investment records
- Records of any untaxed income
- Driver's license
- Social Security number
- Alien registration or permanent resident card (if not a citizen)

Student Loans

About half of all financial aid is in the form of loans, which must be repaid—with interest. For most student loans, you must start paying them back nine months after you graduate from college. A few of the most common federal student loans include:

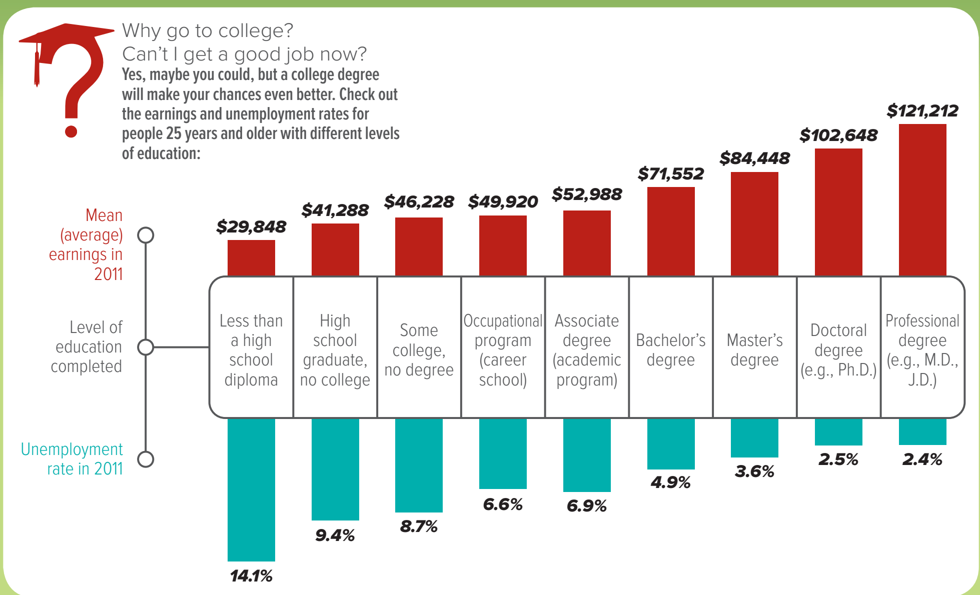
- **Direct Subsidized Loan**
- **Direct Unsubsidized Loan**
- **Direct PLUS Loan (Parent Loans for Undergraduate Students)**
- **Direct Consolidation Loan**
- **Federal Perkins Loan Program**

Go to studentaid.ed.gov to learn how to apply for federal student loans. The advantages to student loans offered by the federal government are lower interest

defaulted act of not repaying borrowed money

FIGURE 19.9 networks TRY IT YOURSELF ONLINE

UNEMPLOYMENT AND EARNINGS



While education can be expensive, it is an investment that can pay off. Statistics show that education has a marked impact on both earnings and employment.

CRITICAL THINKING

Economic Analysis Why do you think the unemployment rate decreases as education increases?

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rates and flexible repayment plans. Private loans are available from banks and other financial institutions. And some colleges sponsor loans. Interest rates are generally higher for these loans than for federal loans.

Scholarships and Grants

Unlike loans, scholarships and grants are outright gifts that you do not pay back. Both vary in the requirements, dollar amount, and expectations of the recipient. There are key differences between the two, however. A grant is tax exempt and not always related to academics. It is often given on the basis of financial need alone. Scholarships almost always are related to academic scores. They are typically more selective and competitive.

Your high school, your parents' employers, your state government, local companies, and even some nonprofit organizations offer grants and scholarships. Go online to research what is available, and begin reading about the requirements necessary for you to apply. Many applications ask you to submit a short essay about yourself and why you believe you deserve the grant or scholarship.

Work-Study Programs

Work-study programs are part-time employment at the university you attend. The benefits of these types of jobs are that the employers typically are more understanding of your college life and are more likely to consider your class schedule when assigning work hours.

There are two general types of work-study programs:

- **Federal Work-Study (FWS)** The FWS is based on financial need. Jobs can be either on campus (in one of the administrative offices, for example) or off campus. Jobs that are off campus are typically in community service in fields related to your major. You can sign up for these programs by filling out a FAFSA form and checking a box asking for interest in student employment. The employer will pay up to 50% of your wages, and the government will pay the rest. The amount of money you earn cannot exceed your financial aid award. Average work hours are 10–15 a week.
- **Non-Federal Work-Study (non-FWS)** This type of work-study is not based on financial need. Most schools offer student employment

FEDERAL WORK STUDY

Federal Work Study is based on financial need. You may request this type of work while completing the FAFSA form and checking a box asking for interest in student employment. You may be employed in administrative offices or libraries on campus, or in the local community off campus. Average work hours are 10-15 a week.

▶ **CRITICAL THINKING**

Economic Analysis Which work-study program is based on financial need?

ACHIEVING YOUR COLLEGE GOALS

There are many ways to acquire the money needed to pay for a college education. Scholarships, tuition-free schools, work-study programs, and many forms of financial aid are possibilities. Earning a college degree can mean significant improvements in job options and earnings potential.

CRITICAL THINKING

Economic Analysis Research some of the options available to you to help pay for education, and then write up a paragraph on the results.

opportunities in places like the dining halls, library, and offices of various academic departments. These jobs offer more convenience and flexibility than do off-campus jobs.

Nontraditional Methods of Paying for College

There are ways to obtain college credits before you enroll in a university. In addition, some other avenues may pay for most if not all of your college education.

- **Take an Advanced Placement (AP) course.** These are college-level courses you can take in most high schools. Every spring, AP students may sign up for the AP exam for certain courses and receive college credits by scoring high on the exams.
- **Sign up for the College-Level Examination Program® (CLEP).** Like AP exams, the CLEP consists of standardized tests that determine your knowledge of subjects at a college level. You may obtain college credits if you pass a test for a particular course. Passing several tests could save you a year or more in college tuition.
- **Apply for employer reimbursement.** As part of workplace benefits, some employers offer tuition reimbursement to their employees. This process requires the worker to pay upfront for college classes, but then he or she is paid back later by the company. The employer may require proof of good grades for one to receive the reimbursement.
- **Join the military.** Each of the Armed Forces offers a number of ways to pay for college.
- **Attend a tuition-free school.** Although the number of schools that do not charge tuition is small, they do exist. Many have strict requirements.
- **Enroll in a Public Service Loan-Forgiveness Program after graduation.** This program allows borrowers to work off their loans after college by getting hired as public service employees. Some examples of public service programs are the National Health Service Corps, National Association of Public Interest Law, Peace Corps, AmeriCorps, and Volunteers in Service to America.

✓ READING PROGRESS CHECK

Identifying What is the first step you should take when applying for financial aid for college?

Housing

GUIDING QUESTION ***What information do you need to be aware of when preparing to rent housing?***

After paying for college, buying a house will probably be one of your biggest expenses. It makes sense that you should put some serious thought into the details. One of the first decisions is whether you will rent or buy.

Costs and Benefits of Renting

Moving into an apartment can be exciting. Finding and renting one takes work, however. Before you begin searching for an apartment, first consider these items:

- **How much should you pay?** In general, what you spend each month on rent should equal what you earn in one week. For example, if you earn $300 a week, you should consider having a roommate or two who can help make up the difference on an apartment that rents for $800 a month.
- **Add other expenses.** Some apartments include utilities (gas, electric, water) as part of the rent payment, but many do not. In addition to your monthly rent, you may be responsible for monthly utility bills, including cable, phone, and renters insurance.
- **Consider location and amenities.** There are many factors to consider about location: how close the apartment is to your job, school, family, and friends. Also consider whether the landlord, or property owner, provides security and amenities (laundry, storage, access to a pool or gym). Ask about the pet policy and perhaps handicap accessibility.
- **Save for the security deposit and first and last months' rent.** Many landlords require that you pay a security deposit, which is a set amount of money paid up front that goes toward any repairs for damages you might cause. If you cause no damage, you will get your deposit back. Many property owners also ask for the first and last months' rent.
- **Read the lease carefully before signing.** This is the legal contract that all landlords require before you move in. It lays out the terms of your rental agreement. Particularly note the length of the lease. If you sign a one-year lease and then lose your job after 10 months, you are still

RENTING

Renting provides many benefits. The money you save on not paying property tax and perhaps utilities can be saved or invested. You do not have to perform maintenance or upkeep on the property. It is also easier to move because you only have to get out of a lease. But renters cannot invest in the equity of a home. Also, a landlord can raise the rent on your next lease or balk at making repairs.

▼ CRITICAL THINKING

Economic Analysis How much should you save before renting?

Glow Images

responsible for two months' rent. Some leases are for 18 months or two years, while some are month-to-month. The landlord cannot raise your rent within the term of the lease.

- **Select the right roommates.** If you plan to share an apartment with others, make sure they can afford the rent. They should sign the lease to ensure legal responsibility, and understand that everyone is responsible for paying their share of the rent until the lease is up. It is also a good idea to have house rules about chores, parties, overnight guests, and so on.
- **Understand your rights and responsibilities.** Even though a rental is where you live, it belongs to the property owner. Both of you have particular rights and responsibilities. Landlords are responsible for keeping the property structurally safe and sanitary. Prospective landlords are allowed to check your references (the names of people who know you and can vouch for you), your employment history, and credit history. They are allowed to enter your apartment to make repairs and to show the apartment to prospective renters if you are moving out. They are not allowed to discriminate on the basis of race, nationality, religion, gender, or disability. You are responsible for paying your rent on time, not causing damage to the property, being considerate of your neighbors, and following any other terms that are spelled out in the lease.

Renting provides many benefits. The money you save on not paying property tax and perhaps utilities can be saved or invested. You do not have to perform maintenance or upkeep on the property. And if your circumstances change (you find a better job in another state, for example), it is easier to move because you don't have to worry about selling a house, only trying to negotiate out of a lease.

Renting also has several negative aspects. By renting, you are not investing in the equity, or value, of a piece of property. You have less control over your living situation. Because the property does not belong to you, you are limited in remodeling. A landlord can raise the rent on your next lease or balk at making repairs. Although you have rights that protect you, you may need to hire an attorney to assert them.

Costs and Benefits of Buying a House

Owning a house is a good investment but a big commitment. There are different types of properties to choose from when you're looking to purchase: single family homes, condominiums (condos), or cooperatives (owning a share of a building).

A loan undertaken for the purchase of a home is called a mortgage. In general, your monthly mortgage payment—including property tax and homeowners insurance—should be about 30 percent or less of your gross monthly income. Making sure you understand the basics of your mortgage is important. Types of mortgages include:

- **Fixed Rate Mortgage** On these loans, the interest rates don't change, and the mortgage is issued typically for either 15 or 30 years. The advantage is that your monthly payments stay the same.
- **Adjustable Rate Mortgage (ARM)** The interest rates on an ARM vary over time. Although there are greater risks, some people prefer these interest rates because it is typical for the first few years to have lower rates.
- **Hybrid** This type of mortgage combines features of both a fixed rate and an adjustable rate.

Buying a home provides many benefits. In general, houses are a good investment because their values go up. Sometimes they go down, as they did during the collapse of the "housing bubble" of 2007, but houses overall are worth considerably more than they were 50 years ago. Buying a home also helps you

HOME OWNERSHIP

Houses are a good investment because their values generally go up. Buying a home also helps you build equity, which can be used to borrow money for other large purchases when you are ready. Home owners also receive tax deductions each year.
Home ownership also has several negative aspects. It is a huge financial responsibility. Houses also require a great deal of upkeep, which may be time-consuming and add more expense. And if home owners want to move, the process of selling a house is time-consuming and complicated.

CRITICAL THINKING

Economic Analysis What is the difference between a fixed-rate mortgage and an adjustable-rate mortgage?

John Lund/Blend Images/Getty Images

build equity, which can be used to borrow money for other large purchases when you are ready. In addition, you receive tax deductions. The interest you pay on your mortgage and your property tax can be applied to your income tax return. And finally, you can make whatever renovations, alterations, or maintenance to your property you wish (as long as it's legal).

Home ownership also has several negative aspects. First, it is a huge financial responsibility. There are many costs beyond the mortgage. Application and appraisal fees, inspections, real estate agent commissions, and title insurance are some of them. Don't forget property taxes and homeowner's insurance. Second, houses require a great deal of upkeep, which may be time-consuming. There might be rules about maintaining your property if you live in a neighborhood with a homeowner's association. And finally, you have less mobility. If you want to move, the process of selling your house is much more involved than giving notice to a landlord.

Transition from Renting to Buying

When you're ready to consider home ownership, there are ways to prepare yourself to go from renting to buying.

- **Start saving money.** Having money for a down payment lowers the amount you'll need to borrow.
- **Establish good credit.** Recall that good credit lowers your interest rates.
- **Research the market.** Knowing what you want, what's available, and how much you can afford will help you make the right choice at the right time.
- **Consider roommates.** Buying a house could become more affordable if you had an extra room that a friend might be interested in renting until you become more financially stable.

✓ READING PROGRESS CHECK

Explaining What are the costs and benefits of renting? How might these be different if you owned a home?

Insurance

GUIDING QUESTION *Why do we purchase insurance?*

Insurance is like a life raft—you don't want to need it, but you're glad it's there in an emergency. You pay an insurance company monthly or quarterly **premiums** for a policy detailing what items are covered and under what conditions. Then if something bad happens—such as a traffic accident, an illness, or an apartment fire—the insurance company will pay a portion or the entirety of what is covered in your policy.

premiums monthly, quarterly, semiannual, or annual price paid for an insurance policy

Many policies include a **deductible**, or an amount you pay before the insurance company pays. Deductibles are ways for insurance companies and customers to negotiate the premium. For example, if you have car insurance with a $1,000 deductible and you're involved in a collision, you will have to pay the first $1,000 to fix the car. The insurance company will pay the rest, up to the amount of insurance you've purchased. If you had chosen a $500 deductible, you'd pay only the first $500, but your premiums would be higher.

deductible an amount you pay before the insurance company pays

Health Insurance

Health insurance pays for hospitalization, visits to the doctor, surgery, exams, and preventative care such as physicals. Many businesses offer to pay for some of the cost of insurance for their employees and their families. By doing so, the business can get a discounted rate for being a part of a group. Some policies include co-pays (a small payment) for services such as doctor visits. Insurance companies allow children to be included on their parents' health insurance to the age of 26.

If you are not covered on a parents' policy or through your employment, you must purchase health insurance. You can do this through any private insurance company, but you may also purchase insurance from the Health Insurance Marketplace at www.healthcare.gov. You may decide to choose a policy with a low monthly premium. In exchange, you will accept a higher deductible, taking the chance that nothing will harm your health.

Auto Insurance

You have the option of buying various types of auto insurance—see **Figure 19.10**. At minimum, you must purchase basic liability insurance, which covers damage you might do to others. It is illegal in most states to drive without it. But having a policy that also covers you and your car is a good idea, too. If you are hurt in an accident you caused, and you don't have enough coverage, you could be required by law to pay for damages out of your own pocket.

Property Insurance

What would it cost to replace everything you own: computer, TV, clothes, furniture? It it's more than you can afford, you should insure your possessions against theft, fire, and other dangers. Renters insurance covers the contents of rented property. Homeowners insurance covers belongings as well as damage to the home itself. Both types cover injury to visitors. Separate insurance is needed for flood or earthquake damage.

Other Insurance

Insurance companies offer a variety of different types of insurance policies to meet the specific needs of their customers. The most popular types of coverage include:

- **Disability** This insurance partially replaces income for those who can't work due to an illness or injury.

FIGURE 19.10

networks TRY IT YOURSELF ONLINE

TYPES OF CAR INSURANCE

TYPES OF CAR INSURANCE

Collision: *Damage to your car, regardless of who caused the accident.*

Comprehensive: *Damage to your car not caused by an accident, such as theft, vandalism, and natural disasters.*

Liability: *Bodily injury and property damage to others, plus legal costs. State laws determine how much coverage you must have.*

Medical: *Medical expenses for everyone injured, regardless of fault.*

Personal injury protection: *Medical expenses for the insured driver, regardless of fault.*

Uninsured motorist: *Damage to your car in an accident caused by a driver with no liability insurance.*

Underinsured motorist: *Damage to your car in an accident caused by someone with insufficient liability insurance.*

Rental reimbursement: *Car rental if your vehicle cannot be driven after an accident.*

At minimum, car operators must purchase basic liability insurance, which covers damage you might do to others. It is illegal in most states to drive without it. Purchasing a car insurance policy that also covers you and car repairs is also a smart use of your money. If you are hurt in an accident you caused, and you don't have enough coverage, what you would be required by law to pay for damages could really hurt your personal finances.

▲ CRITICAL THINKING

Economic Analysis What types of car insurance would you consider for yourself? Explain your answer.

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- **Long-term Care** This insurance pays expenses for the care of those living in nursing homes or similar facilities.
- **Life** This type of insurance provides financial support to the loved ones of a person who dies. Some types of life insurance offer lending or retirement income features.

Shopping for Insurance

Comparison shop among different insurance companies. Low premiums are usually the goal, but this may mean less coverage than you want. Always read the fine print before signing a policy. Maintain a good credit rating—an insurance company may give you a better rate. Ask about and take advantage of discounts for which you might qualify, such as "good student," "nonsmoker," and "good driver." Consider buying several types of insurance—car and rental, for example—from the same company to qualify for a multiple-policy discount.

✓ READING PROGRESS CHECK

Drawing Conclusions What is the trade-off for a low deductible?

Charitable Giving

GUIDING QUESTION *What are some benefits of giving to charitable organizations?*

Remember the budget you created at the beginning of *Personal Financial Literacy*? There was a line in it allotted for charitable giving. A charity is an organization

Research shows that people that give to charity or who participate in volunteer activities show consistent high levels of self-esteem and generally feel good about themselves. Also, charitable giving can be deducted from taxes.

Blend Images/Ariel Skelley/Getty Images

that has been created for the purpose of helping others, usually a specific group of people who share a common circumstance. Charitable giving is also called *philanthropy*. Some of the most popular charitable organizations are the Red Cross, Susan G. Komen®, and the American Cancer Society®.

People give to charity for a number of reasons. For many, they have a personal connection to the organization's mission—a family member has a condition that is supported by a charity, for example. Others want to make a difference in the world. Still others give because contributions are tax deductible, or can be claimed on an income tax return.

Research shows that those who regularly contribute to a charitable organization have higher self-esteem and developed social skills. You may think that you don't have much to give, but you can always start with acts that don't require money. Volunteer your time. Contact Habitat for Humanity to see if you can help in your area, for example. Donating toys and clothing is also a good way to give back to the community. Find a nonprofit organization that interests you, and phone or email its headquarters for ideas to help.

✓ **READING PROGRESS CHECK**

Explaining What can you do if you have no money to donate to a charitable organization?

LESSON 3 REVIEW

Reviewing Vocabulary

1. ***Defining*** What does it mean to default on a loan?

Using Your Notes

2. ***Summarizing*** Use your notes to compare and contrast the differences between a Federal Work-Study program and a non-Federal Work-Study program.

Answering the Guiding Questions

3. ***Explaining*** Why are there so many different methods available to help you fund more education?

4. ***Examining*** What information do you need to be aware of when preparing to rent housing?

5. ***Describing*** Why do we purchase insurance?

6. ***Evaluating*** What are some benefits of giving to charitable organizations?

Writing About Economics

7. ***Informative/Explanatory*** Write a two-page essay describing the role of charitable organizations in the capitalist economy. Also, what benefits both financial and non-financial can an individual receive through charitable giving?

STUDY GUIDE

LESSON 1

- **Open an account in a bank or credit union** → Build a relationship with a financial institution
- **Apply for a secured credit card** → It is linked to the bank or credit union → small small purchases and pay off the balance each month
- **Apply for a retail credit card** → These are easier to get than a regular card. → Pay off the balanc each month to begin rebuilding credit score
- **Get a job and keep it** → Steady employment improves your creditworthiness
- **Pay service provider on time** → a history of late payments for phone, electric, and other regular bills lowers credit scores

LESSON 2

General Partnership
- management of the business, liability, and profits are equally split between partners

Joint Venture
- similar to a general partnership
- set up as a single project or for a limited time span

Limited Partnership
- allows certain partners to have less input

LESSON 3

Non Traditional Methods of Paying for College
- Take an Advanced Placement (AP) course
- Sign up for the College-Level Examination Program (CLEP)
- Apply for employer reimbursement
- Join the military
- Attend tuition-free school
- Enroll in a Public Service Loan-Forgiveness Program after graduation

CHAPTER 19 Assessment

Directions: Answer the questions below. Make sure you read carefully and answer all parts of the questions.

Lesson Review

Lesson 1

1. How does one begin a savings program?
2. Why is it important for you to reconcile your checking account each month?
3. What are your responsibilities as a borrower?
4. How is a credit card finance charge different from its annual percentage rate (APR)?

Lesson 2

5. How do savings form the basis of capital formation?
6. What are four ways for corporations to raise capital?
7. What do you need to do to start investing in stocks?
8. Why are munis attractive to many investors?
9. What is the difference between a traditional IRA and a Roth IRA?

Lesson 3

10. In what three ways might the federal government award you after you fill out the FAFSA?
11. As a renter, what are your rights and responsibilities?
12. Explain the advantages and disadvantages of both fixed rate and adjustable rate mortgages.
13. Describe how insurance works.
14. What are the costs and benefits of charitable giving?

Critical Thinking

15. ***Calculating Interest*** If your bank pays 5.5 percent interest on savings deposits, what is the simple interest paid in the third year on an initial $100 deposit? What is the total amount in the account after three years? What is the amount after three years if the interest was compounded annually?
16. ***Making Decisions*** List your short-term savings goals, such as saving to buy a new cell phone. Explain the typical ways in which you can save for such a purchase. Then list your long-term savings goals, such as saving for a house or retirement. Explain how you can achieve these goals. What is the major difference between the two ways of savings?

Need Extra Help?

If You've Missed Question	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Go to page	560	563	564	565	568	570	571	571	573	575	578	580	581	582	560	559

Assessment

Directions: Answer the questions below. Make sure you read carefully and answer all parts of the questions.

17 ***Comparing*** Imagine that you need both a car loan and a home mortgage. Use a chart like the one below to help decide which type of lending institution would be most appropriate for each loan.

Financial Institution	Services	Car or Home Loan?

18 ***Considering Advantages and Disadvantages*** In deciding whether to pay cash or use credit for a purchase, what the costs involved and the benefits of each choice?

19 ***Synthesizing*** Suppose you are applying for a mortgage. The mortgage payment will be $900, whereas your monthly take-home income is $2,400. Should the lender grant you the mortgage? Why or why not?

Building Financial Literacy

20 ***Decision Making*** How do you build credit and improve your credit score?

21 ***Planning*** Obtain various credit card applications from several retail stores and gas stations. Analyze the applications and prepare a database that organizes the answers to the following questions:

- What questions asked on each application are virtually the same?
- What questions asked on the gas station applications are different from those asked on the retail store applications?
- What are the differences in finance charges and APR?

22 ***Identifying Alternatives*** Suppose that you have $100,000 in savings. Create a chart like the one below to list the investments you might make and what percentage of the $100,000 you would invest in each. In the last column, explain how your choices will achieve investment diversification.

Investment Type	% of Funds	Diversifi-cation

23 ***Making Comparisons*** Search the Internet for information on car insurance in your area. Write a summary about the companies that sell insurance and analyze the factors they use in determining what to charge for drivers in your age group.

Need Extra Help?

If You've Missed Question	17	18	19	20	21	22	23
Go to page	559	565	578	564	565	562	582