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Making S.M.A.R.T. Financial Decisions

Estimating Spending

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To get a sense of control over your financial life, it helps to know how you're spending your money. Sure, you know what you spend when you spend it. You know when you're buying a pair of jeans or paying the utilities or getting your car repaired. But how does it all add up? Some people carefully track every expense. Some have a pretty good idea how much they're spending in different categories, such as housing, utilities, insurance, food, vacations. And others have, at best, a vague sense of where their money goes. Some people break expenses down into many detailed categories, such as dinners at restaurants, lunches at restaurants, takeout meals, lattes, cappuccinos. I'm going to suggest a simple approach to budgeting, recommended in the book, All You're Worth by Senator Elizabeth Warren and her daughter Amelia Warren Tyagi. This approach has only three budget categories-- must-haves, savings, and wants.

Must-haves are the things you need, the things you couldn't do without, and the bills you'd have to pay even if you lost your job. Savings is the money you save. And wants are everything else-- the things that you buy for fun and enjoyment and the money you give to others.

I'd like you to pause the video in a moment to estimate and write down three numbers. Write down your monthly after tax income. This is your take home pay plus any contributions to retirement savings or health insurance that come directly out of your paycheck. If your income varies from month to month, estimate your average monthly after tax income.

Two, write down how much you spent each month on must-haves. Must-haves include your mortgage or rent, utilities, insurance, car loan payments, student debt payments, alimony and child support, minimum credit card payments, gas or public transport to get to work, and basic groceries. When estimating your must-haves, be sure to include expenses that don't come up every month. For example, if you pay property taxes every six months, divide the half year property tax bill by 6 and add it to your monthly must-haves. Some must-have expenses, such as medical expenses, car repairs, and replacing broken appliances, are going to vary from year to year, and thus, be harder to estimate.

And the third number I'd like you to write down is how much money you save each month. This includes any contributions that your employer makes 401(k plan. It also includes paying down credit card balances or other debts that you had at the end of last month. Those count as savings. However, building up new credit card balances is negative savings. Now, you're just making ballpark estimates. So don't take the time to look up the numbers now. And don't worry about getting the numbers exactly right. We have a spreadsheet on the course website that you can later use to get more accurate estimates. Once you've got the three numbers, divide your must-haves by your after tax income. And divide your savings by your after tax income. All right, pause the video now. So what did you get? Are your must-have expenses close to or less than 50% of your after tax income? What fraction of your after tax income are you saving? Let's look at a simple example. Jane is spending $800 a month on rent, 150 on phone and other utilities, $100 on a car loan, $100 on gas, $100 on car insurance, $350 a month on groceries, and $200 a month on health insurance. That's a total of $1,800 a month. Jane saves 300 a month. And her after tax income is $3000 a month. Jane's must-have spending of $1,800 is 60% of her after tax income. Her savings of 300 is 10% of her after tax income. That leaves 30% of her after tax income for wants. We aren't going to ask Jane how she spends her wants. That's up to her. What do you think of these levels? Is Jane spending too much or too little on must-have expenses? Is she saving enough? Should she spend less on wants? Elizabeth Warren and Amelia Tyagi have specific recommendations that I believe make a lot of sense for a lot of people. Keep your must-have expenses at or below 50% of your after tax income. Save 20% of after tax income. And spend 30% of after tax income on wants.

Like most personal finance rules of thumb, these recommendations aren't perfect for every circumstance. And for many people, they will be goals, not a starting place. They're designed to keep you out of financial trouble and ensure that you have the money you need to live comfortably in retirement. In our example, Jane is spending 60% on must-haves. Warren and Tyagi recommend 50%. Why spend only 50% on must-haves? Isn't it better to spend your money on serious things, like rent and car payments, rather than clothes, toys, and vacations? Keeping your must-have expenses at or below 50% protects you in times of financial crisis. If you lose your job or otherwise can't work, you can temporarily stop saving and stop spending on wants, and, thus, cut back your monthly expenses by 50%. As we'll discuss in another video, a crucial part of this protection is to also have a security, or emergency, fund that you can draw on at such times.

Another reason not to spend too much on must-haves is that it doesn't leave you enough to spend on things that make you happy. 50% is a good goal. But if you're a single parent with young children or you live in a city with astronomical rents, keeping your must-have expenses down to 50% is going to be tough. Jane is saving 10% of her after tax income. Warren and Tyagi recommend 20%. Why save 20%? Because you need to save. Most Americans are saving much too little. A generation or two ago, many of us had company or government pensions that guaranteed us our retirement income. Today, most people need to save for their own retirement. Is 20% the answer for everyone? No. If you're young with a high, steady income, you may get by saving less. But 20% is a good target for most people. And those who are starting to save later in life should shoot higher. For almost everyone watching this video, a 20% savings rate is going to be a goal, not a starting place. Start saving now, as much as you can today, and work your way up to 20%.

We'll talk about strategies for saving more in the video on saving more. What about your wants spending? How do you spend your wants budget is up to you. However, if you're like a lot of people and are saving too little, you might benefit from tracking your wants spending for a month, just to see where this money is going. This isn't hard to do. Carry around a small notebook and just for a month. And every time you spend, write down what you bought and what it cost. At the end of the month, add up your month's spending, as well as 1/12 of what you spend on wants that don't come up every month, such as annual vacations and holiday presents.