

**KOFA HIGH SCHOOL SOCIAL SCIENCES DEPARTMENT**

**ECONOMICS - PERSONAL FINANCE WORKSHOPS**

**# 2 - CREATING A BUDGET**



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*Vocabulary Keys : Words that are in **bold** = are terms that appear in one of the chapters , Words that are underlined = supplemental vocabulary . Ask questions about these words if you are not familiar with them !*

**TOP THINGS TO KNOW**

1. Budgets are a necessary evil.

*They're the only practical way to get a grip on your spending so you can make sure your money is being used the way you want it to be used.*

2. Creating a budget generally requires three steps.

- *Identify how you spend money now*
- *Evaluate your current spending and set goals that take into account your financial objectives*
- *Track your spending to make sure it stays within those guidelines.*

3. If possible, use software to save grief.

*If you use a personal-finance program such as Quicken or Microsoft Money, the built-in budget-making tools can create your budget for you.*

4. Don't drive yourself nuts.

*One drawback of monitoring your spending by computer is that it encourages overzealous attention to detail. Once you determine which categories of spending can and should be cut (or expanded), concentrate on those categories and worry less about other aspects of your spending.*

5. Watch out for cash leakage.

*If withdrawals from the ATM machine evaporate from your pocket without apparent explanation, it's time to keep better records. In general, if you find yourself returning to the ATM more than once a week or so, you need to examine where that cash is going.*

6. Spending beyond your limits is dangerous.

*But if you do, you've got plenty of company. Government figures show that many households with total income of \$50,000 or less are spending more than they bring in. This doesn't make you an automatic candidate for bankruptcy -- but it's definitely a sign you need to make some serious spending cuts.*

7. *Beware of luxuries dressed up as necessities.*

*If your income doesn't cover your costs, then some of your spending is probably for luxuries -- even if you've been considering them to be filling a real need.*

8. *Tithe yourself.*

*Aim to spend no more than 90 percent of your income. That way, you'll have the other 10 percent left to save for your big-picture items.*

9. *Don't count on windfalls.*

*When projecting the amount of money you can live on, don't include dollars that you can't be sure you'll receive, such as year-end bonuses, tax refunds, or investment gains.*

10. *Beware of spending creep.*

*As your annual income climbs from raises, promotions, and smart investing, don't start spending for luxuries until you're sure that you're staying ahead of inflation. It's better to use those income increases as an excuse to save more.*

#### *THE DUBIOUS JOY OF BUDGETS*

*Most people would rather stick pins in their eyes than draw up a budget. They may have a point.*

*If you're the type of person who always has plenty of cash, knows exactly where every penny goes, and never has trouble paying bills, skip this chapter. You're either too rich or too smart to need it.*

*For the rest of us, unfortunately, making -- and sticking to -- a budget is the essential tool for ensuring that our money gets used the way we need it to. Even if you're in the happy situation of having plenty of income, the homework involved in drawing up a budget can be instructive, since you may find that you are spending more than you wish on items like music CDs, electronic gadgetry, or restaurant meals.*

*Not that drawing up a budget is a barrel of laughs. On the contrary, it's pure drudgery enlivened only by the occasional rueful hilarity triggered by staring your own foolish spending habits square in the face. In fact, one of the chief impediments to budgeting is that most people would rather not know how they really use their money. It's bad enough to learn this kind of information on your own. It's even worse when a spouse or significant other finds out, since it usually confirms his or her worst fears -- and provides new ammunition for future "discussions."*

*Take heart. However unwise you are about spending your money, others are likely to be just as foolish in their own way. Moreover, the pain of budgeting comes mostly at the beginning.*

*After you have a budget in place -- and you've fine-tuned it with a couple of months of actual spending -- tracking your expenditures becomes almost automatic. If your boss at work were to ask you for an analysis of the department's spending, you'd figure it out quickly enough. Budgeting your household should be approached in the same businesslike fashion. A variety of electronic tools can make the process easier.*

## LISTING EXPENSES

*To build a realistic budget, start by figuring out where your money goes now.*

*There are three steps to creating a budget:*

- 1. Identify how your money is currently being spent.*
- 2. Evaluate that spending to see if it meets the financial priorities you specified in Lesson 1.*
- 3. Track your ongoing spending to make sure it stays within those guidelines ( or to understand how your budget needs to be revised ).*

*Again , if you happen to use Quicken, Microsoft Money, or other such software, you're in luck. These programs generally make it easy to draw up a budget.*

*In Quicken, for example, every time you make a deposit, write a check, pay a credit card bill, or dispatch an electronic payment you are asked to assign it to a particular category, such as "salary," "clothing," "groceries," "child care," or "health insurance."*

*You can also create subcategories, dividing "auto" expenses into "fuel," "insurance," and "service." The program comes with a set of categories that handle most of the basics. You can edit the list to create categories that make better sense for your particular household.*

*The drawback, of course, is that entering and categorizing all of your income and outflow is a truly tedious chore.*

*You can reduce the tedium to some degree by judicious selection of categories. Let's say you are only worried about tracking your spending for recreation and leisure pursuits. You could create categories that cover those types of expenses, and let everything else accumulate under "miscellaneous revenue" or "miscellaneous expense."*

*The problem with that approach is that you forgo the opportunity to spot problems in other spending areas that you may not even be aware of.*

*A better solution is to track expenses using electronic banking. That way, you can download your payments and deposits directly from the bank, rather than having to enter them by hand.*

*The downloaded banking transactions generally show up without any categorization -- meaning you'll have to add the categories by hand. But if you use a credit card that is issued by a bank that permits electronic access, then the downloaded charges from your card sometimes do come with categories attached ( they aren't always right, so check them ).*

*Either way, once you've got your spending tracked by category, drawing up a report requires only a few clicks of the mouse. Even better, such programs often have an automatic budget-creation feature that scans your spending in the past in order to estimate how much you'll spend going forward.*

*If your finances aren't wired, you can still get a good handle on your spending the old-fashioned way. Start by getting all your records together from the past 12 months, including pay stubs, loan proceeds, withdrawal slips, canceled checks, and itemized credit-card statements. Then go through them and compile totals for your income and expenses in a set of categories that make sense for you.*

*At the end of this exercise, you may still have a sizable lump of spending that's undocumented -- typically, the money you withdraw in cash and then spend on day-to-day needs. If this portion of your budget seems to be getting out of hand, keep a journal for the next four weeks in which you record every nickel you spend. You can use those results to extrapolate how your cash is being spent throughout the year.*

*Now that you've got a good picture of where your money is going, you can proceed to evaluate which parts of that spending should be raised or lowered.*

### **SETTING GOALS**

*Analyze your spending habits to see where you need to make changes .*

*Once you have a budget, it's time to go through your spending and figure out where you need to cut back.*

*This is especially urgent, obviously, if you spend more than you make -- a scary position, for sure, but not uncommon. In fact, Labor Department numbers show that many families making \$50,000 or less are spending at least a few percentage points more money each year than they actually bring in.*

*That doesn't mean that they, or you, are headed for bankruptcy. But it does show that Americans are in the habit of borrowing to cover both short-term expenses, like those on credit cards, and long-term ones, such as buying cars and homes.*

*Let's just say that if your spending exceeds your income, then your top priority in constructing a budget should be to slash your spending, pronto.*

*If your household runs in the black, you may still want to reallocate some of your spending. The calculator helps identify trouble spots by highlighting categories where your annual expenses are sharply higher or lower than average for households with similar **demographics**.*

*In some cases, a divergence will be perfectly reasonable. The average family spends only a few percent of its income on education, for example. But if you've got a child in college or private school, or are taking courses yourself, your education spending will be a lot higher -- and more power to you.*

*On the other hand, if the calculator shows that you're spending twice as much as the average family on meals away from home, and there's no obvious reason why that should be so, you may want to consider eating in more often.*

*When projecting your income, don't include money that you can't be sure to receive, such as highly variable year-end bonuses, tax refunds, gains on investments, or gambling winnings. Instead, wait until the extra cash arrives, then save or invest it to produce more revenue for the future.*

*Your goal should be to reduce your spending to about 90 percent of your income, with the aim of plowing the rest of that money into the financial objectives you deem most important.*

*Once you've set your budget goals, you need to develop the habit of tracking your expenses on an ongoing basis -- something that's most easily accomplished using personal-finance software. The aim here is to make sure the spending stays within the limits you've set.*

*But there's a second aim: Very likely you will discover that some of the goals you set were unrealistic. If so, adjust them. No point in giving yourself an unreachable hurdle, but neither should it be too easy.*

*Often it takes two or three revisions before you achieve a budget that you can really stick to. If juggling the numbers leaves you wishing you could free up some extra cash, push on to the next section of this lesson for suggestions.*

## **CUTTING COSTS**

*How to pare spending to free up money for use elsewhere.*

*The most common spending problems are caused by a house that's too large, a car that's too luxurious, or a credit-card lifestyle that's too lavish for your income.*

*Whatever your situation, here are some common ways that people can reduce monthly bills.*

*Eliminate trivial but needless costs :*

*Look first for small savings -- not because they'll end your budget problems, but simply because they're easy to find and take advantage of. For example, swear off that mid-afternoon Danish or expensive premium latte. Shop for clothes and household furnishings only during sales. Keep your house warmer in summer and cooler in winter. Take on chores that you usually pay someone else to perform, such as mowing the lawn or shoveling snow. Seemingly inconsequential savings do, in fact, add up.*

*Reduce larger expenses :*

*These recommendations are decidedly more painful. If you smoke, for instance, quit. Don't buy season tickets to anything. Trade in your luxury car or sport utility vehicle for something a lot cheaper to buy, fuel, and maintain (we said this was painful).*

*On the assumption that those kinds of changes may be too wrenching, here are some other specific areas where many people can find savings:*

### Refinance your mortgage :

*If new mortgages are costing at least two percentage points less than the rate you're paying, refinancing may save you significant dollars.*

### Cut your taxes :

*Usually this means taking better advantage of itemized deductions, and it's a lot easier to do if you are either self-employed or have some income from work you do outside of a regular job. That opens up a range of new deductions -- from expenses for work-related items to a home office -- that are much harder to claim if you're an ordinary working stiff.*

*On the investment side, you can save some money by selling, and then writing off, investments that have lost money. You can use such losses to offset any gains you may have in a given year. If your losses outweigh your gains, you can deduct as much as \$3,000 of investment losses from your ordinary income each year. Those with higher incomes may also be able to save some money by shifting money out of taxable bonds into tax-free **municipal bonds**.*

### Appeal your home assessment :

*If you're a homeowner, you may even be able to cut your real estate taxes by challenging the value that the local assessor puts on your property. You have to have good evidence, of course. You should call the assessor's office first to make sure you understand the formula for determining the house's value ( the assessment listed on tax bills is often only a fraction of the real value that determines your tax ).*

*If recent home sales in your neighborhood lead you to believe that your house is worth less than its assessment and a qualified real estate agent writes an appraisal in support of your claim, then you can file a grievance with the assessor's office and possibly get your bill reduced. The cost: \$200 to \$300 for the written appraisal. If an attorney handles the appeal for you, he or she will typically charge 50 percent of the first year's tax savings.*

*The above suggestions won't work for everyone, and you may have considered some already. But since you alone are privy to the numbers in your budget, you alone know how radically you need to cut. If our suggestions don't appeal, find your own alternatives.*

### **ONE LAST CAUTION**

*Over time, your income should rise as your career progresses and you manage to save money for investing. But, also over time, inflation will raise the cost of living. A mere 3 percent annual rise in prices will double the cost of everything within 24 years. At that time, you'll need twice as much money as you do today to live as well as you do now. So don't start spending your rising income on luxuries you've been denying yourself until you're sure that you're staying ahead of inflation.*