LSS Financial Counseling

# Cornerstone One:

## Budgeting to Create Savings

Four Cornerstones
of Financial Wellness

# Table of Contents

## Introduction

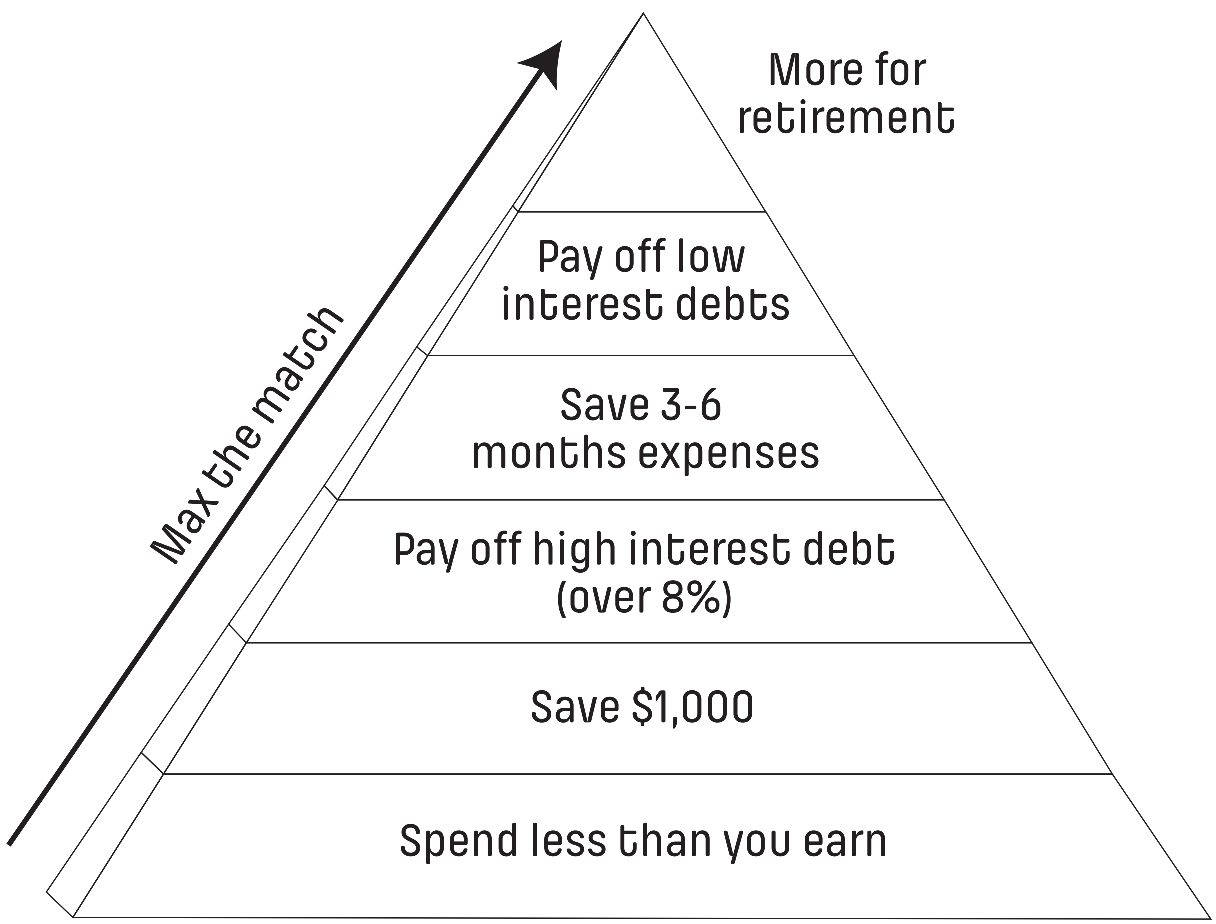
The goals for this section are to:

- **Calculate total monthly income.**
- **List ongoing living expenses.**
- **Plan for periodic expenses.**
- **Find opportunities to set aside money for savings and emergencies.**

The ability to achieve these goals assumes that one's income will be enough to make things affordable. Unfortunately, that is not always the case, and we want to acknowledge that there are disparities and systemic issues that make affordable housing and earning a living wage more difficult to obtain in certain communities. Plainly put, one cannot simply budget to get out of poverty, and one cannot assume that a person in poverty is not budgeting.

Using these budgeting tools is one of the ways we can assist others in feeling more in control of their finances. This information is a personal step that one can take, paired with community advocacy for equitable opportunities that will help establish a strong foundation of financial wellness for all.

The Pyramid of Financial Wellness



## Start with Income

There are many different ways to manage your money throughout the month and they all start with knowing how much money there is to spend. Spending plans, or budgets, work best when a plan is made only for money that has already been earned and paid; especially for those just starting out. This is true for salaried employees, and especially for workers that are paid hourly, whose hours vary, who earn tips, are contract workers, work a second job, or are self-employed. These days most of us have some amount of income that is variable, if not all of it.

What income should be included? All of it. First, start with reliable income amounts:

- Any job in which the paychecks are similar every time.
- SNAP benefits, daycare subsidies, Social Security benefits or other types of assistance paid to you (see tracker below[1]).

Once steady income is written down – if there is any – write down variable income as it is earned. If variable income is all there is, wait until it is actually earned before writing it down:

- Tips earned each shift, then add them up for the week.
- Child support only when it comes in.
- Commissions and/or overtime hours.
- Self-employed – don't count an invoice as income until the check is cashed and cleared.

This is a different way of looking at things – common advice insists that people budget with projections and averages. This is fine for those who are paid the same amount every week, every two weeks or twice a month. But when your income is unpredictable, projections and averages just don't work for a real, workable spending plan.

**Important Terms:**

- **Gross Income:** The money you earn before taxes and deductions.
- **Net Income:** What you have left after taxes and deductions.
- **Deductions:** Items taken out from your paycheck other than taxes: health insurance, dental insurance, flex spending contributions and 401k/403b contributions.
- **Pre-tax:** Deductions from your paycheck that are taken from your gross pay before your taxes are calculated. They reduce your taxable income.

**SCAM ALERT:** There are options available through certain employers that allow workers to pay a fee to get their pay early either on a daily or weekly basis. While the fee seems low, it adds up over time and can reduce your net income even further. Consider direct deposit for the fastest free way to get paid.

| Income Tracker | WEEK 1 | WEEK 2 | WEEK 3 | WEEK 4 | WEEK 5 |
|---|---|---|---|---|---|
| Job 1 | | | | | |
| Job 2 | | | | | |
| Child support | | | | | |
| Other income | | | | | |
| SNAP | | | | | |
| MFIP/TANF | | | | | |
| Disability income | | | | | |
| Other government benefits* | | | | | |
| **Total weekly income** | | | | | |
| **Total income for this month** | | | | | |

1 Format borrowed from CFPB's "Your Money, Your Goals"

## Saving is Essential

"Pay Yourself First" is a motto that is taught often and followed by many. The advice is to start small and increase the amount as you feel more confident. Having emergency savings is hugely beneficial. According to a 2016 study by the Urban Institute[2]:

> "Families with a savings cushion as little as $250 to $749 are less likely to be evicted, miss a housing or utility payment, or receive public benefits after a job loss, health issue, or large income drop. Higher savings levels are associated with even lower hardship and benefit receipt. **Savings are at least as important as income: low-income families with savings of $2,000 to $4,999 are more financially resilient than middle-income families without savings**."

You can save at any income level, and you may already be extremely creative at finding ways to save.

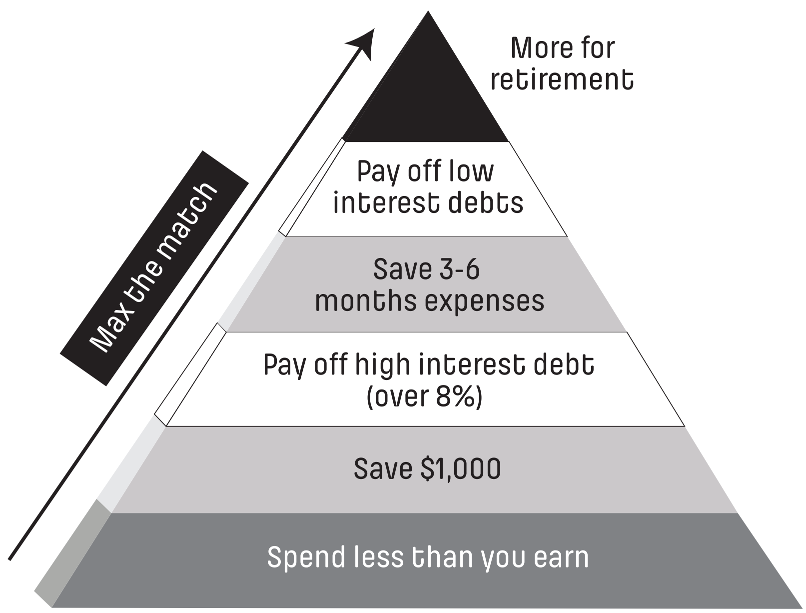
Use the pyramid to help you save:

- **Layer One:** A put-and-take account for periodic expenses (a part of the budget). This helps avoid using debt.

- **Layer Two:** An emergency savings account for the unexpected.

- **Layer Three:** Retirement savings (e.g., 401K, Roth or Traditional IRA) and/or long-term goals like homeownership or a small business.

  This layer is discussed in Cornerstone Two.




**Here are five ways to make savings a habit**:

1. Set up automatic monthly transfers from your checking into savings account.
2. See if your direct deposit can be split into two accounts – most to checking, some to savings.
3. Once you pay off a loan, keep paying that amount to your savings account instead of the creditor.
4. Save all your loose change and deposit it into savings. Most banks and credit unions have coin-counting machines you can use for free if you have an account.
5. Put all extra money (bonuses, tax refunds, gift money and rebates) into savings.

Bonus: Set aside a small amount when you achieve your savings goal for something fun or meaningful. Celebrate your successes along the way!

2 Urban Institute study

## Put-and-Take Account: Planning for Periodic Expenses

There are certain expenses, called **periodic expenses**, that need to be planned for, but do not happen on a monthly basis. Creating a "put-and-take account" either by tracking on paper or setting aside money in a separate bank account can help you stay organized and prepared.

The put-and-take account helps avoid using debt for ongoing living expenses as much as possible. These funds are needed at specific and planned times. This is different from emergency savings as they help with whatever surprises that may come up.

Some examples of periodic expenses vs. emergency savings categories may include:

**Periodic Expenses:**

- Quarterly utility bills (water, garbage, etc.).
- Car, home or renters insurance (if every 6 mo.).
- Car maintenance (tires, brakes, oil changes, etc.).
- Gifts: holidays, birthdays, etc.
- Travel/Vacation.

**Emergency Savings:**

- Medical bills.
- Loss or reduction of income.
- Replacements of home appliances.
- Major car repair.

To plan for periodic expenses, estimate the amount that you will need to set aside.

Next, calculate the monthly amount:

Amount divided by # of months = monthly periodic expense amount
**Example:** $900 needed yearly divided by 12 = $75 monthly periodic expense

**Exercise:** Calculate the monthly amount that would be set aside for each periodic expense.

| | | |
|---|---|---|
| Garbage bill | $75 every 3 months | |
| Car insurance | $600 every 6 months | |
| Car maintenance | $300 yearly | |
| Gifts: holidays, birthdays, etc. | $600 yearly | |
| Travel to see family | $1,000 yearly | |

Finally, put these expenses into your budget. You can do it separately or use one line, whatever fits your planning the best. If it is not affordable to set aside the funds to cover all the periodic needs, then you'll want to prioritize the ones you need to pay first.

## Living Expenses

Once income and essential savings are determined, living expenses need to be identified. Living expenses can be easily broken down into four categories: Essentials, Security, Debt and Lifestyle.

**Essentials**

Items that are necessary to live with health, safety and dignity.

Rent/mortgage, utilities, food, internet/phone, transportation (plus associated costs), daycare, clothing, health ins., and medical needs.

**Security**

Costs to cushion financial downturns and emergency savings.

Put-and-take account, monthly savings for emergency acct., extra retirement savings (not from paycheck) and life and/or disability insurance.

**Debt**

Payments owed to others.

Student loans, credit cards, payday loans, car loan, family loans, medical bills and collection accounts.

**Lifestyle**

Items that are choices in life (also known as discretionary spending).

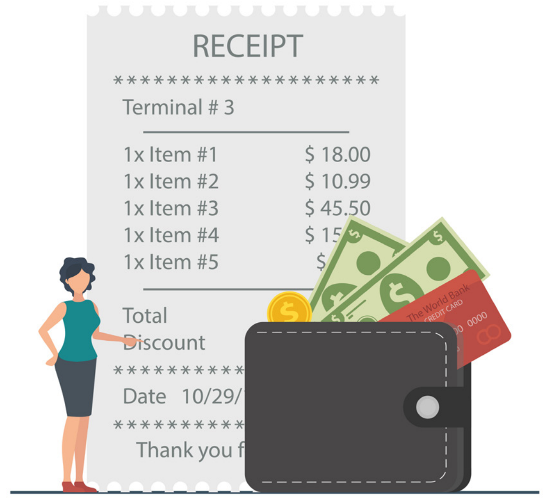
Sports, music lessons, cable, pets, hobbies, entertainment, charitable giving, etc. (This list is not exhaustive!)

**Note on Debt:** We will discuss how to pay debts in Cornerstone Two. For now, it's important to know that they need to be listed in any spending plan.

Most people know how much their regular bills and debt payments are. Some know what they save or spend on Security. When it comes to other expenses, details can get a little murky because some expenses are not the same every month. Inconsistent expenses show up under Essentials as groceries, gas, clothing and sometimes utility bills, and in the Lifestyle category.

## Track Your Spending

**Determine Inconsistent Expenses:** Tracking can be done by looking back at bank or credit card statements (if available) and identifying items that fall under the different categories listed above. Or, with a paper and pencil, write down everything spent (outside of bills) each day or at the end of the week. Some people like to use Excel to make a spending plan and track spending. There are also many apps that make creating a spending plan and tracking spending easy!




**A Word on Budgeting Apps:** There are great phone and online apps that can help you with planning. Research them to find one that meets your needs. Budgeting apps can range from super simple (where you put in all your information every time) to a whole lifestyle change (setting goals, monitoring spending and connecting with other people). Just be careful when adding personal information like your Social Security Number, address and account numbers. Some are free, but then might have ads and/or use your data for research and marketing. Some do charge a fee, so you'll need to be aware of how to end your subscription if needed.

### Payday Planner

**Pay Date** ________________________________

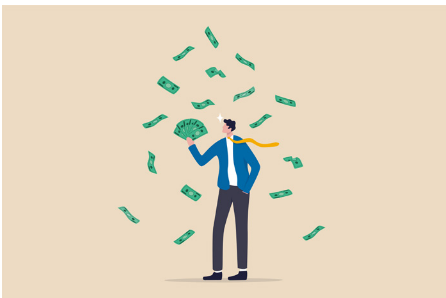
**Total Take Home Pay Amount $**__________

| Due Date | Item | Cost | Amount Remaining |
|---|---|---|---|
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |
| ______ | ________________ | ____________ | __________ |

Repeat every payday

## The Spending Plan: Pulling It All Together

We've discussed the most important parts of a spending plan, but how do you pull it all together? First, it's important to make a **written plan**. The plan starts with income: how much money is available to spend from the start of the plan until the end (in the beginning this is until the next pay period or until the next amount of income comes in). Next, plan out what bills and expenses need to be covered until more income comes in. Finally, track variable spending so that overspending can be avoided.



**Exercise:** Create a Spending Plan

Items you will need:

1. Most recent paystub.
2. Bills.
3. Bank and/or credit card statements.

### What to Do If You're Spending More Than You Earn:

1. List all Essential expenses.
2. List all Debts.
3. List any bills/debts that are past due and the past due amount.
4. Prioritize Essentials first, then Security, then Debts. Temporarily cut out all Lifestyle expenses as you are able.
5. Prioritize past due bills and work out catch-up plans. Once one bill is caught up, add the extra payment to the next bill that is behind until all are caught up.
6. Slowly add back in priority Lifestyle expenses – those things that add extra value to life.

## Brain Tricks to Make Things Stick

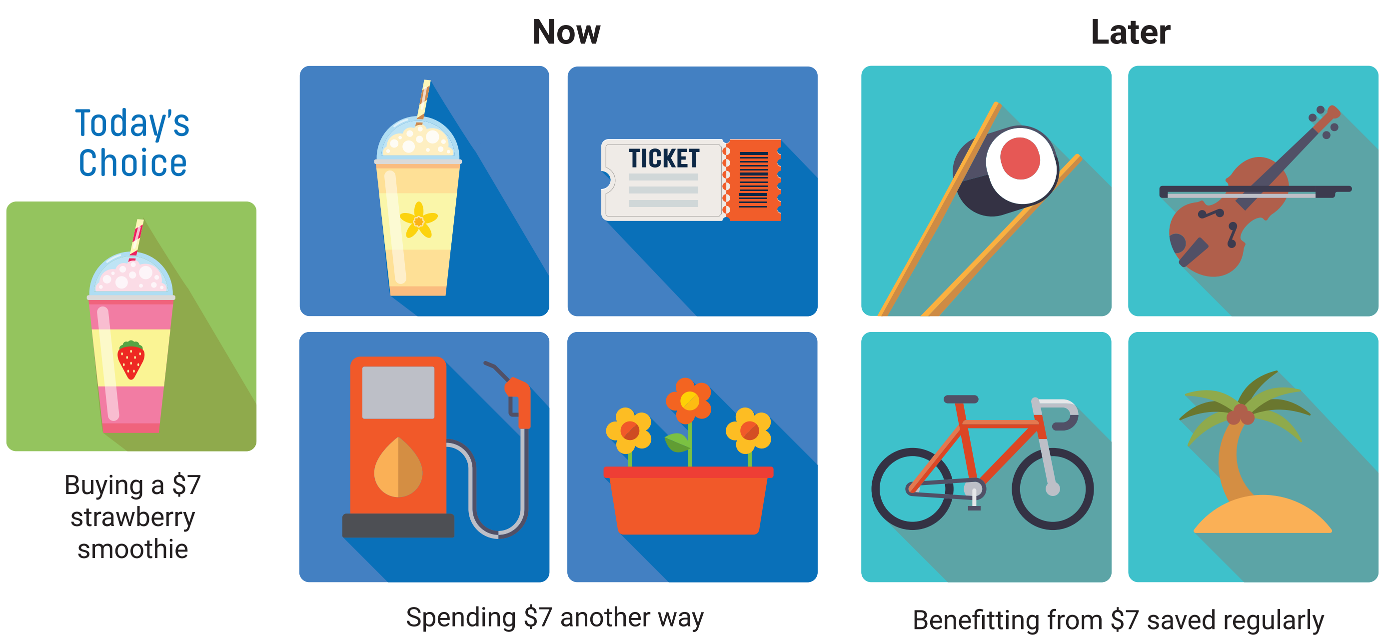
Creating a written spending plan is the easy part to managing money. The difficult part is sticking to the plan. Here are three ways that can help adjust the way we think about money.

**Recognize Opportunity Costs**
At its core, the concept of opportunity costs is the idea that the $20 (or $5, $50 or $1,000) spent on one thing will not be available to spend on another thing today, tomorrow or in the future. Simply put, it's about making a choice between one purchase or another, or none at all. Learning to use the logic behind opportunity costs can help control spending and bring more satisfaction from the money that is spent.

If every choice to purchase or spend time doing something means there is something else that can't be purchased or done later, then it's important to be aware of the benefits and consequences.

Ask yourself, **"What am I giving up if I spend this money now?"** At times it may be impossible to know. Other times, a purchase will still be made. Then, ask this great follow up question, **"Will this purchase move me towards or away from what I really want?"**

### Every Decision Involves Trade-Offs




Graphic inspired by the Federal Reserve Bank of St. Louis.

## Brain Tricks to Make Things Stick

### Loss Aversion Bias

When you lose something, your brain registers the pain of that loss much higher than it would register pleasure from any gain. This creates a loss aversion, and humans do all they can to avoid this pain from loss. Choosing cash or plastic when purchasing items can make a big difference in how much you spend. When things are purchased with cash, the loss of that cash is registered as a negative in the brain, even when the item was very much desired. When a credit or debit card (or phone) is pulled out to pay for a purchase, nothing is being lost, so the brain only registers the pleasure from the gain of whatever was purchased.


Numerous studies have shown that people spend more when using a credit card than if they paid with cash. A Massachusetts Institute of Technology (MIT) study showed that the increase in spending could be as much as 100%. Retailers make it easier and easier to spend money because they know that it will work. Why is that so? It's thanks to our "lizard brain." *See the link below for the definition*.[3]

Use this information to your advantage. Switching to cash is one of the best ways to limit spending. When cash is the only option, it's impossible to spend more than what is available. It's not always practical though, so when you use a credit or debit card or make online purchases, include the pain of losing money as part of your process. Track or take note of the amount spent either in a budgeting app or by simply writing it down. The important thing is to help your brain register the pain of the purchase closer to the time of purchase.

3 https://en.wikipedia.org/wiki/Triune_brain

## Anchoring Bias

Anchoring is the idea that we have a bias towards the first bit of information we receive. It's like a short-cut in the decision-making process. It can both work for and against good decision making and affects many areas of our lives, specifically with finances:

- How much we are willing to pay for something (*see the side bar below*).
- What we are willing to accept as pay from employers, and what they are willing to pay us.

To avoid anchoring, build good decision-making skills with three steps:

1. **Research**

   Gather as much information as possible about the value of the purchase. How much do most people spend on it? Does it last? Were people happy with their purchases? Where is the best price?

   For jobs, research your position, employer, and the average pay in your area.

2. **Establish a Price Range**

   Using your research completed in step one, determine an appropriate amount based on facts, not just emotions or opinions.

   **Example:** For vehicles, the Kelly Blue Book[4] or NADA Guides[5] can be used.

   For salary ranges, information can be found at State Departments of Economic Development and/or the U.S. Bureau of Labor Statistics.[6]

3. **Set a Personal Anchor**

   This can help you set limits and stick to them based on:

   - What is affordable in the budget.
   - What you think is fair pay.
   - Any other factors that influence the decision being made.

### What Would You Do for a New Car?

In the book *Dollars and Sense*, authors Dan Ariely and Jeff Kreisler describe an experiment where they went to a Toyota dealership and asked people what they would give up if they purchased a new car. Almost no one had an answer.

Think about that – they were spending tens of thousands of dollars and never considered what else they could do or buy, or what they would have to give up getting a new car.

Obtaining a loan makes the opportunity costs seem less, but imagine paying for a car in cash. Would you still spend as much, or would you spend less?

Consider a new vehicle driven 15,000 miles a year. It averages $8,469 in costs to maintain with payment, insurance, gas, maintenance, tabs, etc. That's $706 each month! Now ask yourself: What could I do with $706 if it wasn't going towards having a brand-new vehicle?

4 https://www.kbb.com/
5 https://www.nadaguides.com/
6 https://www.bls.gov/ncs/ocs/home.htm

## The Basics of Income Taxes

**Five Key Tax Terms:**

1. **Withholding:** This determines how much is taken out of your check each payday for state and federal taxes. It is calculated by using information provided on your W-4 form with your employer. Use the IRS calculator to figure out if you are withholding enough or too much: irs.gov/individuals/tax-withholding-estimator.

2. **Filing Status:** Your filing status determines how much you can claim for a standard deduction, which credits and deductions you may be eligible for, and which tax bracket you ultimately end up in. There are five status options: Single, Married filing jointly, Married filing separately, Qualifying Widow/er and Head of Household.

3. **Tax Deductions:** These reduce the amount of income you must pay tax on. Unlike a tax credit, they are not dollar-for-dollar, but reduce your taxable income at a level equal to the percentage of your marginal tax rate. The rules and eligibility can change from year-to-year, so be aware.
   - **Payroll Deductions:** Reduce your taxable income immediately. Examples: pre-tax medical and dental insurance premiums, retirement account contributions and FSA or HSA contributions.
   - **Standard Deductions:** Reduce your income later when you file your taxes. As of 2020, it is $12,000 for single people and $24,000 for married couples.

   **Example:** Let's say you're in the 22% tax bracket (see example below). A $1,000 tax deduction will save you $220 in taxes (0.22 × $1,000 = $220).

4. **Tax Brackets:** Brackets are where many misunderstandings of tax rates occur. Your income is taxed at different rates at different levels rather than your entire income being taxed at a single rate.

   **Example:** Let's say your taxable income is $52,000 and your filing status is Single. Here is how that income will get taxed (based on 2021 tax brackets):
   - The first $9,875 is taxed at 10% ($987.50).
   - The next $40,125 is taxed at 12% ($4,815).
   - The last $2,000 is taxed at 22% ($440).

   **Total Tax Owed:**
   $6,242.50 approx.

   The **marginal tax rate** is the rate of the last dollar you were taxed, so 22%. The **effective tax rate** is the amount you pay on your total income. This number is calculated by dividing your taxable income by the total amount of taxes paid ($52,000/$6,242.50), so 8.3%.

5. **Tax Credits:** These reduce your tax bill by giving you dollar-for-dollar credit towards what you owe. They can be refundable or non-refundable.
   - **Non-Refundable Tax Credits:** Can reduce your tax liability to zero, but **not below** for a refund. Examples: Lifetime Learning Credit and Retirement Savings Contribution Credit
   - **Refundable Tax Credits:** Allow you to reduce your tax liability and **may provide** a refund. Examples: Earned Income Tax Credit and Additional Child Tax Credit.
   - **Partially-Refundable Tax Credits:** Will reduce your tax bill, but are complicated. If your tax liability goes below zero, only a portion of the credit may be refunded. An example is the American Opportunity Tax Credit, which is for tuition paid at higher institutions of learning.

## How to Be Prepared to File Taxes

**First, gather all the needed tax documents.**

**Year-End Income Statements**

- W-2s for each job.
- 1099 forms for retirement, Social Security, unemployment, interest, dividends or stocks, and misc. income.
- Year-end amounts for MFIP, SSA, MSA, GA, vets benefits, workers' compensation.
- Student loan interest statement (Form 1098-E).
- Tuition paid for you or your child for college or university (Form 1098-T).
- Verification of health insurance (Form 1095-A).
- Record of charitable donations.

**Records of Child Expenses**

- Any record of educational expenses for children in grades K-12.
- Child care expenses: Provider name, address, and tax ID or SSN.

**Property Tax Refunds and Deductions**

- Homeowners: Mortgage interest and real estate taxes paid past two years.
- Renters: Certificate of Rent Paid (CRP).
- Mobile homeowners: All the above documents.

**Identifying Documents Needed for a Free Tax Preparation Site**

- Picture ID.
- Social Security or ITIN card or letter for all persons listed on tax return.
- Previous year's tax return.
- If you are self-employed or run a home daycare, there are specific tax organizers that need to be filled out before your appointment.

**Next, determine how to file:**

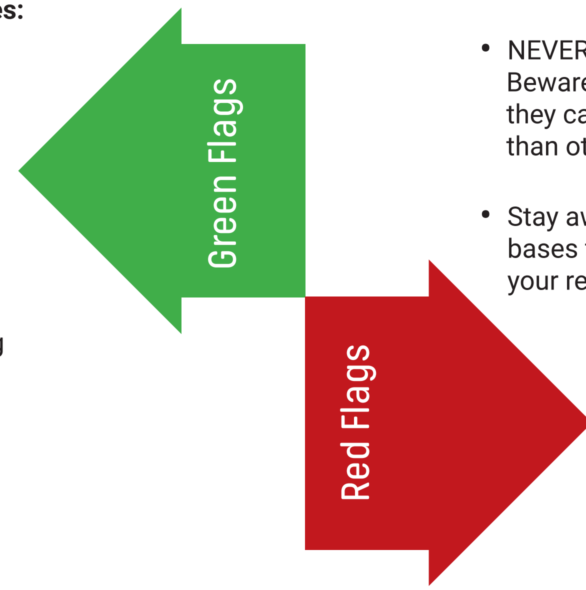
- Online:
  For those who feel comfortable doing it on their own.
  irs.gov/filing/free-file-do-your-federal-taxes-for-free.

- Free Tax Preparation:
  Find at a Volunteer Income Tax Assistance (VITA) site via:
  irs.treasury.gov/freetaxprep/.

- Paid Tax Professional: See the graphic on the next page.

## How to Be Prepared to File Taxes

**If you pay someone to do your taxes:**




- A reputable preparer signs your return and provides their IRS issued tax identification number (required by law).
- Get a copy of your return and look it over. Make sure to ask questions about any entries you do not understand before signing your return. In the end you are responsible for what is filed.

- NEVER sign a blank tax return. Beware of anyone who promises they can get you a bigger refund than other preparers.
- Stay away from a preparer who bases the fee on a percentage of your refund.

**Tax Refund Advances:** To try to get your business, some tax preparers offer 0% loan advances that are paid off when the refund comes later. It may be tempting to get money faster.

But it is not really free because you have to pay them for their services, and they may charge higher fees and push add-ons you don't need. Essentially, you end up paying to access your own money. For example, if you pay a $59 tax preparation fee for a $500 loan, that's like 142%!

Sometimes you may not know if you qualify for a refund until after they have finished, and then you must pay them anyway.

**Bottom Line:** You are better off waiting for your refund for an extra week or so, especially if you can file for free. The Minnesota Attorney General has a great handout on this topic.[7]

**Helpful tips:**

- Think about whether your tax preparer will be around to answer questions about your returns if you are audited. Keep in mind that an audit can happen years after filing.
- Get the refund faster and safer using direct deposit and e-file. Gather the routing and account numbers for a checking account, savings account and/or prepaid card.
- You may be able to further reduce your taxable income through itemized deductions. Make sure to explore and review the list of deductions from the IRS to see if you qualify.
- If you get a tax refund, make a plan for it. Will it be used for savings, debt repayment or getting caught up on certain bills?
- If you think you will owe taxes, start setting aside money if possible. That will help you be more prepared. Also, you can arrange IRS repayment plans or your state's department of revenue if you owe on state taxes (more on that later).
- Beware of scams! There are many scammers out there that prey on people, especially during tax season. The IRS will never call you and ask for your personal information.

7 https://www.ag.state.mn.us/Consumer/Publications/TaxPreparerFees.asp
Tax preparation information found at: https://prepareandprosper.org/free-tax-preparation/what-to-bring/

LSS Financial Counseling

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