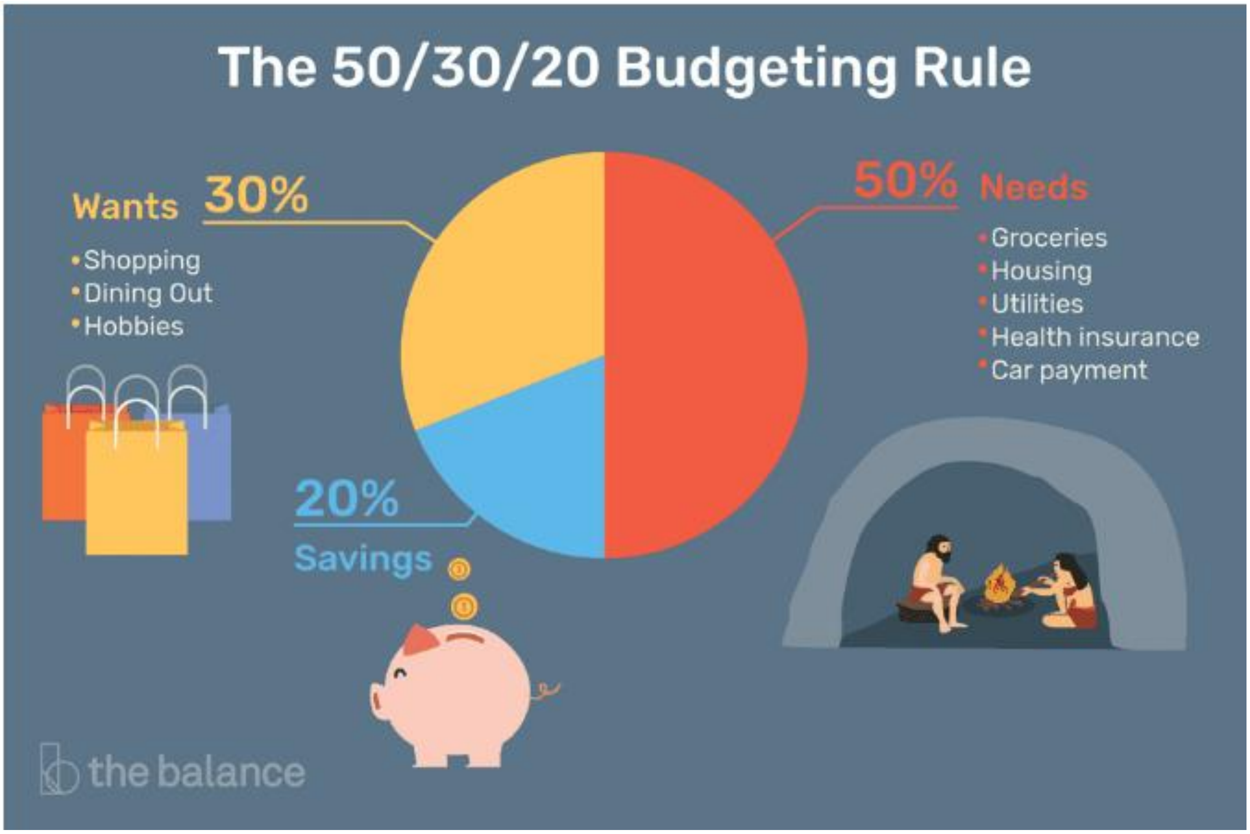
The 50/30/20 Rule of Thumb for Budgeting



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You've reviewed your spending and created a budget, and now you know exactly how much you spend on your home, your car, discretionary spending, and how much you divert to your retirement accounts. That's all good, but make sure you've also thought about how to allocate your savings for things such as an emergency fund. How does your financial allocation compare to the amount you should ideally spend and save?

Harvard bankruptcy expert Elizabeth Warren—U.S. Senator from Massachusetts and named by *Time m*agazine as one of the 100 Most Influential People in the World in 2010—coined the "50/30/20 rule" for spending and saving with her daughter, Amelia Warren Tyagi. They co-authored a book in 2005: "All Your Worth: The Ultimate Lifetime Money Plan."

So how does the 50/30/20 plan work? Here's how Warren and Tyagi recommend you organize your budget.

Step One: Calculate Your After-Tax Income

Your after-tax income is what remains of your paycheck after taxes are taken out, such as state tax, local tax, income tax, Medicare, and Social Security. If you're an employee with a steady paycheck, your after-tax income should be easy to figure out if you just look at your paystubs. If health care, retirement contributions, or any other deductions are taken out of your paycheck, add them back in.

If you're self-employed, your after-tax income equals your gross income minus your business expenses, such as the cost of your laptop or airfare to conferences, as well as the amount you set aside for taxes. You're responsible for remitting your own quarterly estimated tax payments to the government because you don't have an employer to take care of it for you.

Just remember that being self-employed means that you must also pay the self-employment tax, so include this in your calculations. The self-employment tax is double what you would pay in Medicare and Social Security taxes if you were employed.

Step Two: Limit Your Needs to 50% of Your After-Tax Income

Now go back to your budget, and figure out how much you spend on "needs" each month—things like groceries, housing, utilities, health insurance, car payments, and car insurance. According to Warren and Tyagi and their 50/30/20 rule, the amount that you spend on these things should total no more than 50% of your after-tax pay.

Of course, now you must differentiate between which expenses are "needs" and which are "wants." Basically, any payment that you can forgo with only minor inconveniences. This can include your cable bill or back-to-school clothing. Any payment that would severely impact your quality of life, such as electricity and prescription medicines, is a need.

If you can't forgo a payment such as a minimum payment on a credit card, it can be considered a "need," because your credit score will be negatively impacted if you don't pay the minimum. By the same token, if the minimum payment required is $25 and you regularly pay $100 a month to keep a manageable balance, that additional $75 isn't a need.

Step Three: Limit Your "Wants" to 30%

This sounds great on the surface. If you can put 30% of your money toward your wants, you may be thinking about beautiful shoes, a trip to Bali, salon haircuts, and Italian restaurants.

Not so fast—your "wants" don't include extravagances. They include the basic niceties of life that you enjoy, like that unlimited text messaging plan, your home's cable bill, and cosmetic (not mechanical) repairs to your car.

You might spend more on "wants" than you think. A threadbare minimum of warm clothing is a need. Anything beyond that, such as shopping for clothes at the mall rather than at a discount outlet, qualifies as a want. The rules are tricky, but if you think about it, they make sense.

Step Four: Spend 20% on Savings and Debt Repayments

Now about the extra $75 you pay on that credit card each month. That's neither a want nor a need. It's the "20" in the 50/30/20 rule. It's in a class all its own.

You should spend at least 20% of your after-tax income repaying debts and saving money in your emergency fund and your retirement accounts.2 If you carry a credit card balance, the minimum payment is a "need" and it counts toward the 50%. Anything extra is an additional debt repayment, which goes toward this 20% category. If you carry a mortgage or a car loan, the minimum payment is a "need" and any extra payments count toward "savings and debt repayment."

An Example of the 50/30/20 Plan

Let's say your total take-home pay each month is $3,500. Using the 50-30-20 rule, you can spend no more than $1,750 on your needs per month. You probably can't afford a $1,500-a-month rent or mortgage payment, at least not unless your utilities, car payment, minimum credit card payments, insurance premiums, and other necessities of life don't exceed $250 a month.

If you already own your home or you're locked into a lease, you're pretty much stuck with that $1,500 payment. Consider relocating when your lease expires to make your budget more manageable or take a look at your other "needs" to see if there's a way that you can reduce any of them. Maybe shop for more affordable insurance or transfer the balance on that credit card to one with a lower interest rate so your minimum payment drops a bit.

Your goal is to be able to fit all these expenses into 50% of your take-home after-tax income.

You can spend $1,050 a month on your "wants" based on that $3,500 you're bringing home each month. You might consider doing without a few things and shifting some of this money to your "needs" column if you're coming up short there—not necessarily indefinitely but until you can get your needs down to a more manageable level. Remember, you still need 20% leftover so you can save and pay down your debts according to the 50/30/20 plan.

Now you have $700 left, that last 20%. You know what to do with it. Pay down on debt, save for an emergency, and plan for your future.

Source: https://www.thebalance.com/the-50-30-20-rule-of-thumb-453922