Unit 5
Budgeting

Lesson 5A:
Making a Budget—It Is All Spending!

Rule 5: Live within your means.

People work to earn income to purchase goods and services now (spending), later (saving), or for someone else (sharing). Because income is limited, the amount of goods and services people can buy is limited. These lessons look at how to allocate, or budget, your income without exceeding the income you earn.

Lesson Description

Students discover that all elements of a budget are essentially spending on goods and services. They are shown a process for establishing a budget.

Standards and Benchmarks (see page 110)

Grade Level

9-12

Concepts

Budget

Financial investment

Gross income

Net income

Saving

Spending

Compelling Question

How do people plan for regular, irregular, and future spending?

Objectives

Students will be able to

- distinguish among various types of spending: regular (variable and fixed), irregular, and future and
- follow a process to establish a budget.

Materials

- Visuals 5A.1: Elements of a Budget or Spending Plan
- Visuals 5A.2: The Budgeting Process
- Handout 5A.1: Assessment, one copy for each student

Time Required

30 minutes

Procedure

1. Begin the lesson by asking the following:
   - Why do people work? (*To earn income to buy goods and services they want*)
   - Once you earn income, what are some of the things you can do with it? (*Answers will vary but may include spending on goods and services, saving, paying taxes, or sharing it with others.*)

2. Explain that while we can do many things with money, these things have one thing in common: They *all* represent spending. **Spending** is using some or all of your income to buy things you want now. Buying a video game, a pizza, or a new car are examples of what we generally think of as spending.

3. Discuss the following:
   - Why do people save? (*Usually so they can spend on goods and services later*)
   - **Saving** is not spending on current consumption. It involves giving up some current consumption for future consumption—that is, setting aside part of your income today for future spending on goods and services.

- People may invest part of their savings in hope of growing their wealth over time so they can spend it on goods and services later, such as in retirement.
- What do people get from paying taxes? (*They get government-provided goods and services, such as roads, schools, police and fire protection, and national defense. Through government transfer programs funded by taxes, people help the disadvantaged [e.g., the poor, unemployed, elderly, or disabled] buy goods and services.*)
- Why do people give to churches and charitable organizations? (*Answers will vary but should include to help people who may be unable to buy or obtain goods and services.*)
- Emphasize that when people share their income, they are essentially spending on goods and services for others.

4. Define a **budget** as a plan for managing income, spending, and saving during a given period. It is an itemized summary of probable income and expenses for a given period.

5. Display *Visual 5A.1: Elements of a Budget or Spending Plan*. Define monthly ***gross income*** as the total amount of income a person earns. Explain that before making decisions about how to spend income, you need to determine what your monthly net income is (see Unit Four: Paying Taxes). Define ***net income*** as gross income minus taxes (and possibly other deductions, such as for insurance).

6. Explain the following and refer to the examples on Visual 5A.1:
   - There are three ways to allocate monthly net income—that is, three ways to *spend* net income: regular spending, irregular spending, and future spending.

   Regular Spending

   - Regular spending is for goods and services normally or regularly purchased during a month.
   - Regular spending can be broken down further into fixed spending and variable spending.
   - An expense is considered *fixed* if the amount spent is the same every month, such as a car or house payment.
   - An expense is considered *variable* if it can vary from month to month, such as for food, utilities, or entertainment.

   Irregular Spending (Short-Term Saving)

   - *Irregular spending* (also called periodic spending) is for goods and services that are not normally purchased every month but on a different payment schedule (such as annually or semiannually) or on an irregular basis.
   - Irregular spending is allocating income to what most people think of as short-term saving.

- For example, a $600 fee might be charged annually. To prepare for this irregular spending, a person could save $50 per month.

Future Spending (Long-Term Saving)

- *Future spending* is for the purchase of goods and services in the future, typically beyond one year.
- Future spending is allocating income to what most people think of as *long-term saving* or investing.
- For example, a person might save 10 percent of his or her income over an entire career (40 years or more) to spend in retirement.

7. Explain that the elements of a budget are all the ways your income can be spent.

8. Display *Visual 5A.2: The Budgeting Process*. Explain that the visual shows a four-step process for creating a budget or spending plan—one of many ways to do so.

   (***Teacher note:*** *The spending on Visual 5A.2 assumes a household with a gross annual income of $54,000—a little more than the 2014 U.S. median household income of $53,657. For the most recent median household income data, see FRED® at https://fred.stlouisfed.org/graph/?g=2khG.*)

   Step 1: Determine Your Monthly Net Income

   - In Step 1, you determine your monthly net income, which is how much money you have to allocate each month.
   - Net income is calculated by subtracting taxes and other deductions, such as health insurance premiums, from your gross income (the actual amount you earned).
   - Net income may also be called your "take-home" pay or disposable income—it is the income that you have available for spending.
   - In the example, the household's gross income is $4,500 per month and its deductions are $1,000 (which include withholdings for income taxes, Social Security and Medicare taxes, and other deductions), leaving the household a net income of $3,500 to decide how to spend.

   Step 2: Plan Future Spending (Long-Term Savings)

   - In Step 2, you "pay yourself first"—you set aside money—save—to meet your long-term goals (such as a down payment on a house or savings for retirement, college tuition, or to start a business).
   - Not spending part of your current income is called saving.
   - Long-term savings are usually used to buy assets such as stocks, bonds, and certificates of deposit. The purchase of these assets is called **financial investment**.
   - How much you set aside to meet your long-term goals depends on your financial plan (see Unit Two: Planning and Tracking).

- In this example, the household saves $500 for long-term goals, leaving $3,000.

Step 3: Plan Irregular Spending (Short-Term Savings)

- In Step 3, you set aside money—save—to meet your short-term irregular expenses.
- How much you need to set aside each month is based on your annual irregular expenses divided by 12.
- This money is typically held in a savings account to pay for irregular expenses as they come up during the year.
- In this example, the household is expecting $6,000 in irregular expenses for the year, so they need to set aside $500 each month.

Step 4: Plan Regular Spending (Fixed and Variable)

- The remaining money is what you have left to meet your regular monthly expenses—both fixed and variable.
- It is best to think of the fixed expenses much like taxes and deductions in Step 1: Fixed expenses are commitments to pay for specific items.
- Fixed expenses must be paid *before* making any choices about spending on variable expenses. In this example, housing and transportation are fixed expenses, but fixed expenses could also include things such as cable, Internet, and phone services.

Closure

9. Explain that if you go through this budgeting process and don't have as much to spend on variable expenses (in Step 4) as you would like, you need to reconsider each of your expenditures as follows:
   - Are your fixed expenses too high because, for example, you purchased (or rented) a house that is too big, a cable package that is too large, or a car that is too nice?
   - Do you need to reduce some of your irregular expenses (such as the amounts allocated to vacations or gifts)?
   - Do you need to rethink your long-term goals and decide if they are as valuable to you as having more money for variable spending now?
   - Overall, what trade-offs should you consider for adjusting your budget based on your income and your goals—both short-term and long-term goals.

Assessment

10. Keep Visual 5A.2 displayed. Distribute a copy of *Handout 5A.1: Assessment* to each student. Review the directions and allow time for students to work.

Handout 5A.1: Assessment—Answer Key

Directions: Imagine the information on Visual 5A.2 is your personal budget and answer the following questions.

1. What will happen to the "regular spending" part of your budget if you decide to allocate more money to future spending (long-term savings)?

   If I allocate more to future spending (long-term savings), I will have less money for regular spending.

2. How would you categorize an annual maintenance fee of $480 from your apartment landlord?

   This expense occurs annually, so it would be considered irregular spending (short-term saving).

3. How would you categorize $200 per month set aside for retirement?

   Setting aside $200 for retirement is future spending (long-term saving).

4. How can saving for retirement be considered "spending" even though you are actually saving the money?

   The reason you save money is to spend it in the future.

Visual 5A.1: Elements of a Budget or Spending Plan

Gross income – Deductions = Net income

Net income = Regular spending + Irregular spending + Future spending
(Short-term savings) (Long-term savings)

Regular Monthly Spending (Fixed and Variable)

- Housing (e.g., rent or mortgage)
- Food (e.g., groceries and dining out)
- Transportation (e.g., car payment, gas, or bus pass)
- Utilities (e.g., electric, water/sewer, phone, cable, and oil/gas)
- Personal (e.g., apparel and personal care items)
- Entertainment (e.g., movies, hobbies, and sports)
- Miscellaneous

Irregular Yearly Spending (Short-Term Savings)

- Insurance (e.g., life, medical, home, and auto)
- Taxes and fees (e.g., property taxes and auto registration)
- Expected expenses (e.g., health care, education, vacations, gifts, home maintenance, and charity)
- Unexpected expenses (e.g., car repairs, health care, and home repairs)
- Near-term goals (e.g., car, home addition, and education)

Future Spending (Long-Term Savings)

- Retirement
- Other long-term goals (e.g., starting your own business)

Visual 5A.2: The Budgeting Process

Step 1. Determine Your Monthly Net Income

Gross monthly income – Deductions = Net income

Gross income: $54,000/yr., or $4,500/mo.

Deductions: $1,000/mo.

$4,500/mo. – $1,000/mo. = $3,500/mo.

Step 2. Plan Future Spending (Long-Term Savings)

(Long-term savings is determined by your financial plan.)

Long-term savings: $500/mo.

$3,500/mo. – $500/mo. = $3,000/mo.

Step 3. Plan Irregular Spending (Short-Term Savings)

(Determine yearly short-term savings and divide by 12)

Insurance/taxes .... $1,500/yr.

Expected expenses .... $2,500/yr.

Charity .... $1,000/yr.

Unexpected expenses .... $500/yr.

Near-term goals .... $500/yr.

Short-term savings .... $6,000/yr./12 = $500/mo.

$3,000/mo. – $500/mo. = $2,500/mo.

Step 4. Plan Regular Spending (Fixed and Variable)

Housing .... $800/mo.

Transportation .... $500/mo.

Food .... $400/mo.

Utilities .... $300/mo.

Personal/health care .... $200/mo.

Entertainment .... $200/mo.

Miscellaneous .... $100/mo.

Regular spending .... $2,500/mo.

Handout 5A.1: Assessment

Name:____________________________________

Directions: Imagine the information on Visual 5A.2 is your personal budget and answer the following questions.

1. What will happen to the "regular spending" part of your budget if you decide to allocate more money to future spending (long-term savings)?

2. How would you categorize an annual maintenance fee of $480 from your apartment landlord?

3. How would you categorize $200 per month set aside for retirement?

4. How can saving for retirement be considered "spending" even though you are actually saving the money?

Standards and Benchmarks

National Standards for Financial Literacy

Standard 2: Buying Goods and Services. People cannot buy or make all the goods and services they want; as a result, people choose to buy some goods and services but not others. People can improve their economic well-being by making informed spending decisions, which entails collecting information, planning, and budgeting.

- Benchmarks: Grade 8
  5. A budget includes fixed and variable expenses, as well as income, savings, and taxes.
  6. People may revise their budget based on unplanned expenses and changes in income.
- Benchmark: Grade 12
  6. People may choose to donate money to charitable organizations and other not-for-profits because they gain satisfaction from donating.

Standard 3: Saving. Saving is the part of income that people choose to set aside for future uses. People save for different reasons during the course of their lives. People make different choices about how they save and how much they save. Time, interest rates, and inflation affect the value of savings.

- Benchmark: Grade 8
  8. Different people save money for different reasons, including large purchases (such as higher education, autos, and homes), retirement, and unexpected events. People's choices about how much to save and for what to save are based on their tastes and preferences.
- Benchmark: Grade 12
  1. People choose between immediate spending and saving for future consumption. Some people have a tendency to be impatient, choosing immediate spending over saving for the future.