A simpler way to save: the 60% solution

Twenty years of complicated budget calculations have led me to this one simple conclusion: By limiting all essential spending to 60% of total income, savings will soar.

By Richard Jenkins

How many of you have tried budgeting and think it's a waste of time? Come on, let's see those hands.

OK, that's just about everybody.

I've kept a budget of one kind or another, first on paper and then with the help of various software programs, for about 20 years -- despite a strong suspicion that I was wasting my time. The illusion of control, I argued to myself, was better than none at all.

My approach to budgeting was to carefully track my spending during the month and to adjust my budget targets up and down in each category, so that my total expenses never exceeded my income.

Laborious? You bet.

Useful? Sometimes.

Anal-compulsive? Probably.

After two decades of this, though, I started to wonder if there isn't an easier, more effective way to budget. I realized that the hardest part about keeping a budget is getting useful information from it. There's too much detail and not enough bottom line. My answer is "the 60% solution," a faster and easier way to structure your budget without having to account for every penny.

What you're trying to do with a budget is to prevent overspending, which ultimately leads to piling up debt. Contrary to the way most people budget, however, it rarely matters what you're overspending on -- dining out, entertainment, clothes. Who cares? It's still debt, right?

Looking at my own spending history, I realized that it wasn't the little luxuries here and there that got me in trouble. It was the large, irregular expenses, like vacations, major repairs and the holidays that did all the damage. To avoid overspending, I had to do a better job of planning for those.

And then there were the *really* big expenses: buying a car, putting a down payment on a new home or putting a new roof on an old home -- all of which can run into the tens of thousands of dollars. They also can often be postponed, sometimes for years, which theoretically should give me a chance to save for them.

Understand your committed expenses

As I looked back over the past 20 years of budgeting, I saw that there were a few years when my wife and I believed we were fairly on top of things, even with a much lower income than we have today. How did we manage?

The key was a drop in our fixed monthly expenses. It was a period when declining interest rates had lowered our adjustable-rate mortgage payment to about 15% of our household income. That left us with some extra money each month to set aside in a savings account for those irregular expenses.

We later moved to a bigger house with a much bigger mortgage payment, higher maintenance costs and utility bills, and obscene property taxes. The monthly mortgage payment was only 20% of our gross income, far lower than the 33% that most lenders will allow, but, suddenly, we were struggling again.

Even after refinancing our mortgage at a lower rate, we were still often running out of cash before the end of the month. I realized that other fixed expenses had crept upward over the years. As my children, Natalie, now 14, and Jackson, 11, have gotten older, they need things like music lessons and sports equipment that add several hundred dollars a month to our basic expenses. They’re also outgrowing clothes faster than we can buy them.

The slow but steady growth in our monthly spending commitments was putting a squeeze on our budget. I call these “committed” expenses rather than “fixed” or “non-discretionary” expenses, because things like music lessons are neither fixed in amount nor absolute necessities, but rather are commitments my wife and I have made to provide for our children.

The 60% solution emerges

After analyzing our spending patterns over the past couple of years using our Money data file, I determined that we needed to keep our committed expenses at or below 60% of our gross income to come out ahead at the end of the month. Those expenses include:

- Basic food and clothing needs.
- Essential household expenses.

- Insurance premiums.
- All of our bills -- even such non-essentials as our satellite TV service.
- ALL of our taxes.

I’m not saying that 60% is a magic number. It’s a workable goal for my family, and it’s a nice round number. But your number might well be a bit higher or lower. At any rate, it's a good place to start.

Then I divided up the remaining 40% into four chunks of 10% each, listed here in order of priority:

Retirement savings: consisting entirely of my 401(k) contribution, which is subtracted automatically from my paycheck.

Long-term savings: also automatically deducted from my pay to buy Microsoft stock at a discount as part of an unusual stock-purchase program. The relative lack of liquidity (i.e. the difficulty of turning these shares into cash) makes it harder to spend this money without some planning and a series of deliberate steps. In a real emergency, though, I could sell and have the cash wired into my bank account within three days, so this is also our emergency fund.

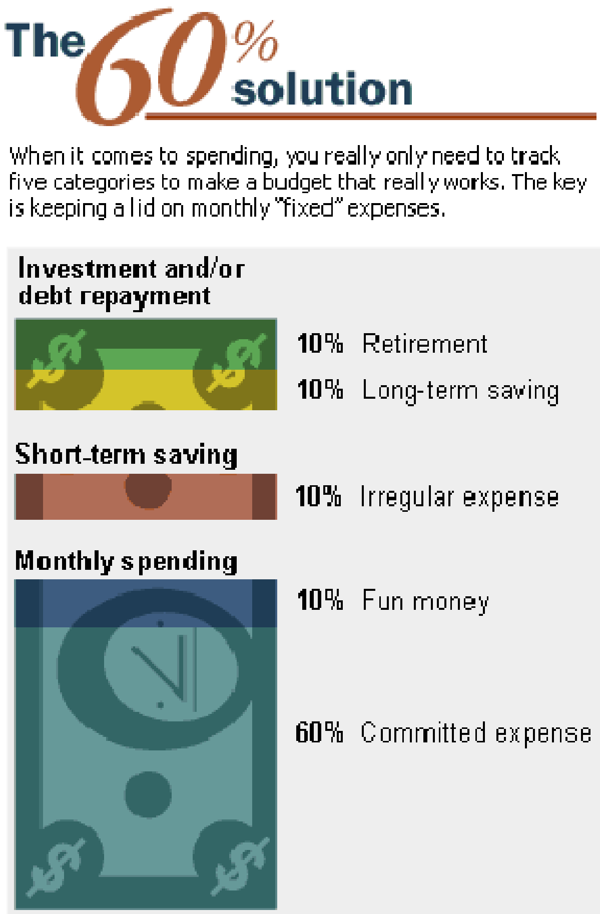
Short-term savings: which are direct-deposited from my paycheck into a credit union savings account. Money in this account can be easily transferred into our checking account, as needed, via the Web. Over the course of a year, I expect to use all of this money to pay for vacations, repairs, new appliances, holiday gifts and other irregular but more or less predictable expenses.

Fun money: which we can spend on anything we like during the month, so long as the total doesn’t exceed 10% of my income.

You may have noticed that only 70% of my paycheck is used for everyday expenses. Since we never see the other 30%, my wife and I generally don’t miss it.

We don’t really need to track our expenses, because our checking account balance is generally equal to the amount of money we can spend. That's the way a lot of people do it, but they don't first make provision for savings.

The key is keeping a lid on those committed expenses. You can categorize them if you want, but it isn’t really necessary. In fact, you could make a budget with just three categories: committed expenses, fun money and irregular expenses, and that's just what I've done with the budget in Money 2002 (see chart below). (I can't really give up my anal-compulsive ways completely, so I've also created a set of subcategories to track the committed expenses, partly because that also allows me to export parts of my spending data to a tax program at the end of the year.)



Now, at this point you may be saying, "Well, la-dee-dah for you, but there's no way I can get my committed expenses down to 60% of my income."

How to get your spending down

For a lot of people, part of the difficulty in reducing committed expenses comes from the need to make big monthly credit card payments. If you're carrying a substantial amount of non-mortgage debt, I'd suggest using the 20% that would otherwise go to retirement and long-term saving to aggressively pay down your debt -- but only *after* you cut up those cards.

Every dollar in interest that you *don't* pay is just like getting a guaranteed, risk- and tax-free return on your money equal to the interest rate on the debt. When your debts are paid off -- and it won't take long using 20% of your gross income -- immediately redirect that money into savings.

Now, let's take the really hard case: Even excluding debt payments, reducing your committed expenses to 60% still seems like an impossible goal. If that describes your situation, the odds are good that you're facing one of the following problems:

- You have a more expensive home than you can afford.
- You've committed to car or boat payments that are larger than you can afford.
- Your children are in a private school that you can't really afford.
- There's just a big, ugly gap between your income and your lifestyle.

If it's one of the first three, you can undo the damage by slowly unwinding the commitments you've made and choosing something less appealing but ultimately more appropriate. You might also be able to take other steps that could help to reduce your committed spending, outlined in "7 radical ways to save money."

If the problem is having champagne tastes on a beer budget, you'll need to take a long, hard look at where the money is going and why. Take the "Savvy Spending Quiz" on MSN Money to see if perhaps you're using money and things to fill a void in your life. Often, the steps needed to fill that void have little to do with money.

The real secret to building a budget that really works isn't tracking what you spend, any more than counting calories is the secret to losing weight. The key is creating a sustainable structure for your finances, one that balances spending and income and that leaves enough room to handle the unexpected.