Chapter 1:

Budgeting, Saving, Borrowing

A. Budgeting & Spending

Your personal **BUDGET** is a list of your monthly income and expenditures, grouped by categories such as rent, food, clothing, transport, entertainment, etc. It can help you understand how much you earn, where your money goes, how you can save, identify potential fraud, and above all – make sure you earn more than you spend!

> The surest way to financial ruin is spending more than you earn and borrowing – with interest! – to make up the difference.

The first thing to understand is how much you earn. The main source of income is typically your wage or salary – what you earn from a job you hold, whether full or part time. Salaries are often low for young people, because they lack the qualifications and experience needed for higher-paying positions. Some entry-level positions only pay the minimum wage, which is typically set by the government at a level sufficient to cover basic needs (though what these are is subject to debate).

Unfortunately, not all the salary goes straight to your bank account: there may be upfront deductions for things like national or unemployment insurance, loan repayments, etc.; there may also be income tax that is deducted from your "gross" to derive your "net" pay.

On the other hand, there are other sources of income than what you earn from working: for example, benefits from government programs, stipends for university, allowances from your parents, or income from capital (e.g., dividends or interest you collect). All these are added to your monthly income.

If you monthly expenditures exceed your income, there are several options. You can try to **increase your income**, for example by doing additional work or selling items you don't need on online marketplaces. Sometimes parents and family can be tapped.

A key part of the solution is almost always to be **more frugal and selective** in your spending: for many items, cheaper options exist that will not ruin your life (nor your image...) – for example, buying private labels in-

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stead of fashion brands, cooking instead of eating out, sharing your apartment with a roommate, and walking, cycling or using public transport instead of driving a car.

An absolute priority is to **prioritize spending** (no pun intended). You need to distinguish between things you absolutely need or really make a difference to your life, and those that may be nice to have but are not critical. For every expensive purchase you're planning, ask yourself whether you really need it or are just responding to pressure from friends, social media, and advertising? Have you fully researched the market to see if there are cheaper alternatives that will also do the trick?

A good way to think about your budget is to estimate your "DISCRETIONARY INCOME". While there is no precise definition, it means the difference between what you earn and your fixed and essential expenditures – things like rent, utilities, and food. You can then decide how to allocate what's left to things that you want most or simply can't wait to have.

Many purchases offer different payment options, such as cash, credit card, store card, hire purchase, installment plan, bank loan, etc. Choosing among then is an important part of the buying decision.

The first thing is to understand the full costs and conditions of all options:

EXAMPLE: You see an ad for a TV requiring monthly payments of $20 over 2 years. The cash price is $300. Interest rates on savings accounts are 2%. Which is cheaper?

Answer: Buying cash! Monthly payments over 2 years are $480, which is $180 or 60% more than the cash price. You should wait until you can either afford to pay cash or borrow more cheaply from your parents or a bank.

B. Borrowing & Debt

While you should always be careful in incurring debt, buying on credit can be appropriate in some cases.

For example:

- Purchases paid by credit card, provided you pay the card bill in full at the end of each month
- Purchases of durable or long-lasting goods that are too expensive to be paid upfront
- Investments in physical capital (e.g., a home) or human capital (e.g., university degree) that generate benefits over the long run

You can see from the above that two of the most common uses of debt are to pay for a home and for education:

→ **Mortgages** are loans that can cover up to 90% or more of the purchase price of a home; they

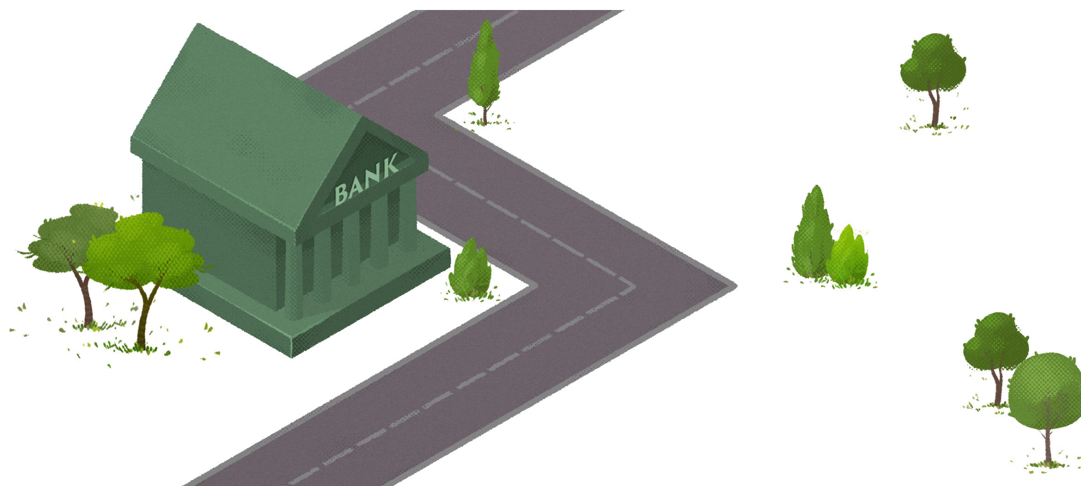
require regular income to cover monthly mortgage payments and are secured against the value of the home (see chapter on Housing)

- **Student loans** are sometimes provided or guaranteed by governments to cover the costs associated with university studies; they can (though not always) offer subsidized interest rates, and repayment can be linked to the future income of students.

Both mortgage and student debt are generally considered to be “good” kinds of debt, allowing borrowers to build their physical and human capital, though this not invariably true.

Before taking the plunge, you need to carefully assess the risks and consequences of any kind of borrowing. Ask yourself:

- Is this a good reason for borrowing?



- How much will it cost me over time, including interest and other charges?
- Have I compared this against other loan offers and payment options?
- Have I considered all potential impacts, including on my comfort, stress level and credit record?
- What is the payback time, i.e., how many years will it take me to repay the loan?
- And last but not least: can I afford it?

To determine how much you can borrow, you need to compare future payments to your total income. A good rule of thumb is that all your monthly debt payments combined should not exceed **36% of your total gross (pre-tax) income**. While this is not cast in stone, it’s a useful yardstick for financial planning, especially since many lenders also consider it.

One particularly dangerous form of borrowing are **payday loans**: they are cash advances against your upcoming paycheck, which often charge very high interest. Stay clear if you can!

An important factor to determine whether you’re eligible to borrow and at what interest rate is your **CREDIT SCORE.** The credit score is a number that measures how likely you are to pay your debts. It depends on your borrowing and loan repayment history. **The most important thing you can do for a good credit score is to pay all your debts on time!**

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There are other tips and tricks on how to improve your credit score, depending on the country you live in. In almost all places, clearing up past-due accounts is a big plus.

A bad credit score can have many adverse consequences, for example:

- *Higher interest rates on credit cards and loans*
- *Declined loan applications*
- *Denied cell phone contract*
- *Higher premiums for auto insurance*

C. Saving & Investing

SAVING is a lifetime habit that's best acquired when you're young. You should always strive to set some money aside, in order to:

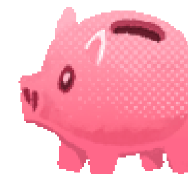
1. Be prepared for unforeseen events
2. Save up for a large purchase (like a car or house)
3. Build wealth for the future

A good way to start is to divert part of your salary to a savings or investment account before you have a chance to spend it, through **AUTOMATIC PAYROLL DEDUCTION**.

If you leave the money in the account and reinvest interest and dividend income, this is called **compounding** and is a powerful force for accumulating wealth over the long run. Albert Einstein once called compound interest the most powerful force in the universe!

The **rule of 72** is a quick formula to estimate the impact of compounding: the number of years to double an investment roughly equals 72 divided by the interest rate or dividend yield. So at 6%, you double your money in 12 years!

Unfortunately, the same principle applies to interest owed on debt – which is why you should pay off your debts as soon as possible and never borrow to pay interest.



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