Topic 6

Personal budgets and spending choices

Learning outcomes

After studying this topic, students will be able to:

- carry out simple calculations relating to budgets and spending;
- explain how to use a budget to identify what can be spent now;
- explain how to cope with unexpected spending needs;
- outline the impact of personal spending on the economy.

Introduction

We looked at the importance of budgeting and how budgets can be used in Topics 3, 4 and 5. This topic will look at some of the practical issues that an individual may need to consider when making spending decisions, and how personal spending can have an impact on the country as a whole.

6.1 Making spending decisions

Most of the time people have choices when it comes to spending their money; they can choose whether to spend and, if so, how much. In Topics 3 and 4 we looked at how sound budgeting will help people to keep track of their money and, of course, good budgeting will allow them the opportunity to make those choices.

We'll start by looking at some of the important decisions that people need to make regarding spending.

6.1.1 Spend now or save until we have the money

As we saw in Topic 4, good budgeting involves checking actual income and spending on a regular basis, and making changes if needed to keep within the budget. It enables a person to see what they will have each week or month and how much they can afford to spend without getting into financial trouble.

Obviously, people have little choice over when to buy essentials, such as food and necessary clothes, or pay bills such as the mortgage, rent and electricity. However, they do have choices over what we can call 'non-essential spending' – things such as holidays, new furniture, a tablet PC or an iPhone. A mistake many people make is to think that non-essential spending is more important than paying for essentials; they are misguided. They need to make sure that they have a roof over their head and that the family is warm and has food. You can't eat an iPad or live in a television!

Think back to Andy and Diana in Topic 4.

We are very good at budgeting, and make sure that we live within our income. We try to save any spare money we have at the end of the month so that we have a reserve fund we can dip into. This means that if we want to buy something that isn't essential, we will probably have enough in our savings to be able to buy it, depending on the cost. If we don't have enough in the reserve fund, we can work out when we will have enough to buy it.

Assuming that we do have enough to buy it now, we still need to check that we don't need to buy anything else more important. We also need to be happy that the purchase won't leave us with reserves below a level we are comfortable with. Don't go buying that motorbike just yet, Andy!

Discuss

It's the start of the month, and Andy and Diana have decided to buy two new sofas, at a total cost of £800.

They will have to pay a £200 deposit when they order the furniture, and pay the balance when it is delivered, which will be eight weeks later. They have £900 in a savings account, which they use for holidays and as a general reserve for unexpected spending. They also have £3,000 in another savings account, but this is their emergency fund and only to be used when major things go wrong. In their view this would include problems such as the washing machine needing replacing, the car needing major repairs or a problem with the plumbing at home.

They have income of £2,900 a month and calculate their monthly essential spending to be £2,400 a month, which includes a small amount to cover unexpected needs. They move any money left over in their bank account to their reserve account at the end of each month. Andy has worked out that they will have some other unusual spending in the next three months, and doesn't like to leave less than £200 in the reserve:

- Car service and minor repairs next week – roughly £300.
- Diana's sister's wedding in six weeks' time. Their daughter, Ayesha, will be a bridesmaid and Andy and Diana have agreed to pay for her outfit. The family will also need to stay in a hotel for two nights because the wedding is 150 miles away. Andy thinks it will all cost around £350.

Diana would like to order the furniture today, as long as she can be sure that they will be able to pay the balance in eight weeks' time. Could they do it? Be prepared to share your thinking!

When you have finished, check your answer at the end of this topic.

6.1.2 Buy now and pay later

What if Andy and Diana really wanted the furniture but didn't think they could afford it now? They might decide to buy it now and pay for it later. There are a number of ways they can do this, all of which involve borrowing. We will look at borrowing in detail in Topics 10 and 11, so we'll just cover the key points here.

There is one important principle about borrowing: any money borrowed has to be paid back eventually. Unfortunately, some people seem to forget that rule, or ignore it, and get themselves into financial trouble by borrowing more than they can afford. However, we know that Andy and Diana are too sensible to borrow irresponsibly, so how could they buy now and pay later?

6.1.2.1 Credit card

They could use a credit card. We'll look in detail at credit card borrowing in Topic 10, so for now we'll focus on the basics.

Andy could use his credit card to buy the sofas, and he won't have to pay any interest if he pays the money back by the next payment date, which is usually between 25 and 56 days after he makes a purchase. The exact time depends on when in the month he buys the furniture. If he spent £800 on the card, he would have to make a minimum payment of about £25 on the payment date, but could choose to pay as much above that as he wanted. He will be charged interest on any money he doesn't pay off, and the rates are quite high.

As you'll see in Topic 11, using a credit card and not paying off the balance each month can be an expensive and long-term way to borrow.

6.1.2.2 Personal loan

Again we'll be looking at loans in Topic 10, so we'll just look at the basics here.

With a personal loan, Andy and Diana would borrow the money for a fixed period, usually ranging from six months to five years. They would make a fixed payment each month, which includes interest, and would have paid it off by the end of the term.

Although the loan interest rate would usually be lower than a credit card, many lenders have a minimum loan of £1,000, which is more than Andy and Diana need, and they may want to repay the borrowing earlier than in six months' time.

6.1.2.3 Store credit

Many shops selling higher-value items offer a range of finance deals to encourage people to spend. Some take the form of interest-free loans, where the buyer pays a deposit and takes out a loan for the balance. As long as the full amount is repaid in monthly instalments by the agreed date, no interest is charged. The term of the loan will often depend on the amount borrowed.

To take an example from one large furniture chain, a loan of £800 could be spread over 12 months, while a loan of £2,400 or more could be spread over 36 months. In Andy and Diana's case, they could pay a deposit of at least £80 and pay the balance over six months.

Other stores may offer an arrangement where the buyer pays a deposit and agrees to pay the balance by an agreed date, typically in 12 months' time.

These are sometimes advertised as 'buy now, pay in 12 months with no interest'. No regular payment is required and, as long as the loan is repaid in full by the agreed date, no interest is charged. However, if full repayment isn't made on time, interest is charged at quite a high rate, calculated on the whole loan over the loan period.

These deals can be attractive – in fact, they look so good that people can sometimes be tempted to borrow more than they can afford.

The 'buy now, pay in 12 months' deal can be great for those who are disciplined and know they will have the money to pay off the loan at the end. However, they can be a very expensive mistake for those who aren't so disciplined and might not have the money to repay on time.

Discuss

Looking at Andy and Diana's situation and their handling of their finances, if they wanted to buy now and pay later, which method do you think would suit them best?

6.1.3 Unexpected spending

It doesn't matter how well someone manages their finances, there will always be times when an unexpected spending need occurs. We're not talking about emergencies, just times when there is a need to buy or pay for something that wasn't expected – we could call them 'spur of the moment' purchases. Examples could include the following.

I received an invitation to a party and had to pay the train fare.

A friend I hadn't seen for a long time got in touch, so I arranged to meet up for a night out.

I had to replace a damaged tyre on my car.

None of these problems involves major expense, although tyres aren't cheap, but it would be sensible to have enough spare money to be able to cover this type of expenditure without having to borrow.

The simple solution to this problem would be to include it in the monthly budget. So, in addition to all the normal expenses, include an estimated amount to cover the unexpected. The exact amount will depend on the individual, their lifestyle and, obviously, the amount of money they actually have. In Andy and Diana's case, they allow £100 each month for unexpected spending. As a result of their ability to manage their money, they are also able to put some money into a savings account each month, which gives them additional back-up.

A credit card could be a useful tool in this situation, because it allows the holder to cover these surprises if they don't have enough money, although it is very expensive if they don't pay it back quickly. So, really, using a credit card is only putting the problem back for a short period until the bill has to be paid.

If we think back to Alison in Topic 4, that's exactly the problem she had.

I ran out of money each month because I didn't work to a budget, and then used my credit card to continue spending when I ran out of money. I couldn't afford to pay the full credit card bill each month, but had to pay some of it, which left me short of money again. In order to carry on enjoying myself, I used the credit card again. I was building up debts like a snowball grows when it rolls downhill.

6.1.4 Emergency fund

We covered the importance of an emergency fund in Topic 1, but it's also worth mentioning here.

We all know that life doesn't always go according to plan, and that washing machines break down, cars need repairing, and other financial surprises often occur. It's also important to make sure that people have funds to help them to manage if they lose their job or can't work due to illness or injury. We don't count the unexpected night out or visit to a friend as an emergency – we are talking here about more serious and expensive occurrences that we couldn't predict.

A good financial planner will make sure that they have an emergency fund, tucked away in a savings account with a mental lock on it that says 'for use in emergencies only'. The best place for an emergency fund would be in a building society or bank savings account that allows instant access to the money.

The amount in an emergency fund will vary from person to person, but advisers generally suggest that an amount between three and six months' essential expenditure would be a sensible minimum amount for most families.

This would allow the family to live as normal financially if the main earner was to lose their job or suffer from a fairly long illness, and would allow them time to arrange help, claim benefits and sort themselves out.

If someone has good benefits from work, they might feel that a smaller fund would do.

6.2 The impact of consumer spending on society

In many ways the phrase ‘money makes the world go round’ is true.

> Economics is the study of the production and consumption of goods and the transfer of wealth to produce and obtain those goods. Economics explains how people interact within markets to get what they want or accomplish certain goals. Since economics is a driving force of human interaction, studying it often reveals why people and governments behave in particular ways.

(Source: www.whatiseconomics.org)

Economics is not an exact science, and there are many different opinions and theories about how things work and what is best for a country. However, there are some basic principles, which we can consider now.

Did you know?

In very simple terms, each £1 we spend in a supermarket provides an income or payment for a number of people:

the company or person growing or providing the raw material for making the goods → the company that provides or makes the goods → the employees of the companies that grow, make or provide the goods → the company that transports the goods from the maker to the supermarket → the people who work for the transport company → the companies that make the vehicles used to transport the goods → the employees of the company that makes the vehicles → and so it goes on, and we haven’t even got near to the person who works on the supermarket checkout yet!

Each of those links in the chain receives some of that £1, and will then spend it themselves somewhere in the economy.

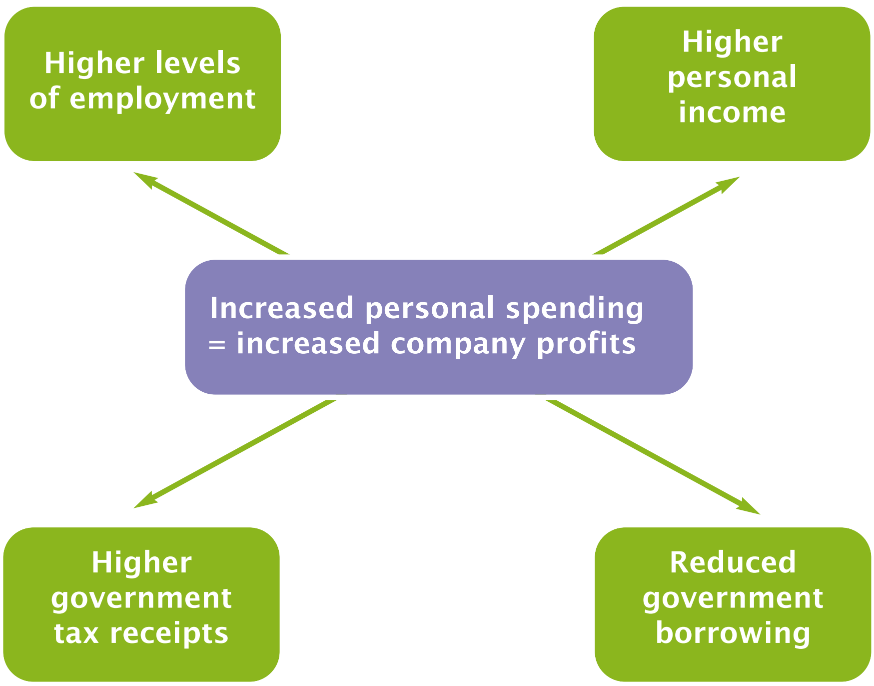
6.2.1 The impact of increased consumer spending

In theory, spending is the key to economic prosperity. If people (and the government) have money to spend, the demand for products and services will increase. This will result in companies producing and selling more. In a perfect world, this would lead to higher levels of profits, which would encourage companies to expand and invest in the business.

As shown in Figure 6.1, this will provide a boost to the economy through:

- higher levels of employment;
- higher levels of personal income;
- higher levels of tax receipts for the government from companies and individuals;
- reduced government borrowing.

Figure 6.1 How consumer spending influences the economy



When the government has more money coming in, it can spend money on things such as roads, transport and buildings. This is known as spending on 'infrastructure', which is the term for things that help the country to function efficiently.

Spending on infrastructure will provide a further boost to companies because they will be paid to carry out the work.

When there are problems in the national economy, such as we've experienced in the past few years, it affects ordinary people as well as investors and companies. People don't have so much money to spend for a number of reasons.

- Unemployment may increase, leaving some people with a lot less income than before.
- Employers may freeze employees' pay or award very small pay rises, both of which will leave employees with less disposable income.
- Some people will start to save money rather than spend it, because it will give them some security if they lose their job, take a pay cut or have other financial problems.
- If interest rates increase, people with debts may have to use more of their money to make the monthly repayments. This is likely to be taken from money they might otherwise have spent.
- Many people don't like debt, and if interest rates increase, they worry that if their income reduces they will have problems making payments. They may decide to reduce their debts by making extra payments while they have the money. Again, this is money that might otherwise have been available to spend.

6.2.2 The impact of reduced consumer spending

If the public doesn't spend as much, the profits of many companies will reduce because demand will fall. Apart from the problems the company may have in paying and keeping its workforce, the government receives less in taxes from workers and companies. It may also have to pay out more in state benefits to people who are unemployed or on low pay. The government then has the challenge of filling the gap between what it needs to spend and the money it has coming in.

The government can:

- increase its borrowing, which may actually make things worse in the longer term because it will have to be repaid at some point;
- cut its spending, which could lead to further unemployment, both because the government is a major employer and because many companies depend on the government for their work – reducing spending on state benefits and important services can lead to social unrest, such as demonstrations;

- raise taxes, which could also cause problems by reducing the money available for people to spend;
- take action using a combination of the three measures above.

You've probably worked out by now that the government has to be very careful about what action to take and how far to go, because it could lead to even less spending and the problem getting worse.

6.2.3 In an ideal world

In an ideal world, people would spend but also to save some of their income. Financial services providers, such as banks, raise some of their funds from savers, who receive interest for letting the bank use their money. The bank then uses that money to invest in the economy through loans and other investments, always making sure that they have enough money available to pay those savers who need to take their money out. The money invested by the banks helps the economy by providing funds for companies to operate and make a profit, which is then ploughed back into the economy.

People can also invest their money in shares and similar investments, which again can help companies to operate and expand by providing them with extra funds, in return for the possibility of making a profit on their investment and sometimes a small income as well.

So, a healthy economy needs people to spend but also save some of their money. When you see in the news that the government is trying to stimulate the economy, it really means that it is looking for ways to encourage people to spend more and companies to invest in expanding to make more profit, so that it can filter back into the economy.

We will look later, in Topic 11, at how borrowing can be a way to increase the amount of money available to spend. We will also see how borrowing too much can be dangerous for individuals and the economy.

Summary

Finally, we can recap what we have learned in this topic.

We have learned:

- to carry out simple calculations to help with budgeting and spending;
- how to use a budget to work out what we can spend now;
- what to consider when we're deciding whether to buy something now or wait until we can afford it;
- what to do if we have unexpected spending needs;
- how personal spending can affect the country's economy.

Key terms

Consumer spending – spending by ordinary people.

Infrastructure – the important physical systems of a nation – for example, transport, communication, water and sewage, and power.

Non-essential spending – spending on items that we want, but which are not essential to surviving. Examples would include holidays and luxury items such as an iPad.

Unexpected spending – when a need to spend arises that was not expected; not emergencies, but times when there is a need to buy or pay for something that wasn't planned for in advance.

Answer to discussion point on page 3

They could order the furniture today, to be delivered in eight weeks' time.

It's the start of the month. They have £900 in their reserve now, so they could pay the £200 deposit now and cover the cost of the car repairs as well. That would leave them with £400 in their reserve fund until the end of this month.

They will have a further £500 in their reserve by the start of next month, topping it up to £900. However, they will have to pay £350 for the wedding, which will reduce their reserve to £550.

The furniture will be delivered at the end of next month, when they will have to pay the balance of £600. Andy and Diana will have £550 in their reserve and would normally move another £500 from their current account, so they should be able to pay the £600 balance and still have £450 in reserve.