Budgets can benefit from rules of thumb

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Experts in the financial world are often reluctant to rely on rules of thumb, saying that everybody's money situation is different. And that's true to an extent, but good rules of thumb can be powerful.

First, they're so easy that people uncomfortable with money topics might take the time to do a little budget examination. Second, the rules can provide perspective about your money and give you ideas to restructure your spending and saving habits.

One rule of thumb is the basis of "All Your Worth: The Ultimate Lifetime Money Plan," a 2005 book by Harvard University professor Elizabeth Warren and her daughter, Amelia Warren Tyagi. In it, the authors suggest 50 percent of your after-tax income should be spent on "wants" and 20 percent on savings.

You have to delve a little deeper to learn what they include in each category. For example, the "must-haves" is a desperation-type budget like you might live on after you've lost a job. Clothes, cable TV and cell phone service fall into wants category. And paying off debt counts as savings.

To calculate your after-tax income, add employee and employer contributions to your 401(k) and your portion of health insurance costs. They are allocated to savings and must-haves, respectively.

It's a useful exercise to tally your own spending to see how it breaks down, compared with the 50/30/20 formula. Many people will find their must-have commitments much higher than 50 percent.

The main drawback for such rules of thumb is that spending should reflect your priorities. Some people would gladly buy a cheap car because cars don't matter to them. But they want to spend lavishly on gourmet foods, Christmas gifts or electronics because that's how they choose to spend money.

"The problem with conventional wisdom is that there's always an exception," said Christopher Jones, founder of Keystone Financial Planning, near Allentown. "Your budget should be based on your priorities, what you value."

Below are a few spending rules of thumb to consider. Many are so ubiquitous, it's difficult to trace their origin. Take them with a grain of salt, especially if your situation is very different from the typical American's. But they are quick benchmarks against which you can measure your spending:

- **House**. Your mortgage and associated costs should not exceed 28 percent of your gross monthly income. This includes mortgage principal and interest, real estate taxes and homeowner's insurance, the usual items included in a monthly mortgage payment. "The housing decision is the biggest," Jones said. That's the single largest area that people overspend in."
- **Debt**. Total debt payments should not exceed 36 percent of gross income. This includes the monthly payments for such items as mortgage, automobile loan, credit cards, student loans and alimony. Keep in mind that the debt rules of thumb are ceilings. A healthier household budget would spend far less on debt.
- **Car.** This may be the most shocking calculation for most people. Your car or truck payment shouldn't exceed 8 percent of your gross income – less if you have other debt. This is derived from the previous two numbers: 36 percent total debt, minus 28 percent mortgage debt leaves you 8 percent maximum for auto loans. To be prudent, figure your car payment with 36-month loan. That means with using the 8 percent rule, a household with $50,000 in gross income and no debt except the mortgage can afford one car payment of

$333. That will get you an $11,000 car financed over three years, assuming no money down and no trade in. Given new-car prices today, which average more than $28,000, it basically means that household is limited to buying used cars. A household with a healthy income of $120,000 can afford payments on one $26,000 new car, using the same assumptions and current auto-loan rates. That's closer to Honda Accord territory than BMW-land. The bottom line is that people with average incomes and average debt loads cannot safely afford the average price of a new car today.

- **Credit cards**. A total balance on cards of more than 15 percent of gross annual income could spell trouble. Less than 5 percent is safer.
- **Holiday gifts**. Still paying off your holiday spending from November and December? Try spending no more than 1.5 percent of your gross income on the holidays, including gifts, decorations, travel, wrapping paper – everything. That means a household with $40,000 in income would spend $600.00, while a $100,000 household would spend $1,500. If you have a lot of debt, you might consider less than 1 percent as a target.
- **Life insurance**. A bread-winner whose family depends on his or her income should consider term life insurance equal to six to 10 times gross pay. Another rule advises five times your gross income, plus such expenses as the mortgage, consumer debt and kids' college costs.

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