Why Save?
By John Morton and Signè Thomas

Nearly all of us believe we need to save more, but in 2014 Americans saved only 5.5 percent of their disposable income.[1] Disposable income is the amount of money which is left after we pay income taxes and make Social Security contributions. Savings is the amount of our disposable income that we do not spend. Savings plus consumption equal disposable income.

There are many reasons to save. First, savings allow you to face the world with confidence. Everyone has emergencies such as unexpected car repairs, medical expenses, and job loss. Without savings you must cover these expenses with credit cards or loans with high interest rates. An emergency fund brings peace of mind.

Second, when you save early, you will be better off in the long run because your spending goes for goods and services rather than to pay for interest on a loan. As of June 2015, Americans had $11.85 trillion in debt. This included $890.9 billion in credit-card debt, $8.17 trillion in mortgage debt, and $1.19 trillion in student-loan debt.[2] These numbers are too large to be meaningful for most people. A simple example, however, illustrates how this debt affects people's lives. Assume that a credit-card holder has accumulated $3,000 in credit-card debt. The credit-card company charges 1.5% interest (APR) a month, i.e. 18% APR a year. The credit-card company, however, requires the cardholder to pay off only 4% of the balance each month. If the cardholder never charges another penny on the card, it will take nine years and five months to pay off the balance. Total payments would be $4,673.52, of which $1,673.52 is interest.[3] Think about what the cardholder could buy with $1,673.52.

Third, savings will help you take advantage of future opportunities. It will be easier to change jobs, start a business, move to a nicer home, and invest.

Finally, even though it may be the farthest thing from your mind, you must save to fund retirement. By saving early and taking advantage of compound interest, you can have a more comfortable retirement. Compound interest is interest earned on past interest and on the original amount saved or invested.

Scary Facts about Retirement

Most Americans are not on track for a comfortable retirement. Here are a few frightening facts from the stock investing website, The Motley Fool[4]:

- Only 42 percent of private sector workers of age 25 to 64 have pension coverage in their jobs.
- According to a 2012 study, 30 percent of workers reported they had less than $1,000 in savings and investments.
- Nearly 75 percent of retirees say they did not save enough and if they could do it all over again, they would save more.
- For those age 65 and above, Social Security benefits provide more income than any other source for over 60 percent of households. One-third of those households are entirely dependent on Social Security for income. The average monthly Social Security benefit is $1,230—hardly enough to pay for a comfortable retirement.
- Many people believe they cannot afford to retire and plan to work forever, but one-half of current retirees surveyed said they left the workforce unexpectedly because of health problems, disability, or layoffs.
- A 2014 survey by Bankrate.com reports that 36 percent of adults have not started saving at all. Although Millennials (people age 18-29) are the most confident age group about the future, 69 percent of them have no savings for retirement. The good news is that people are saving for retirement earlier than before.

Why Don't People Save?

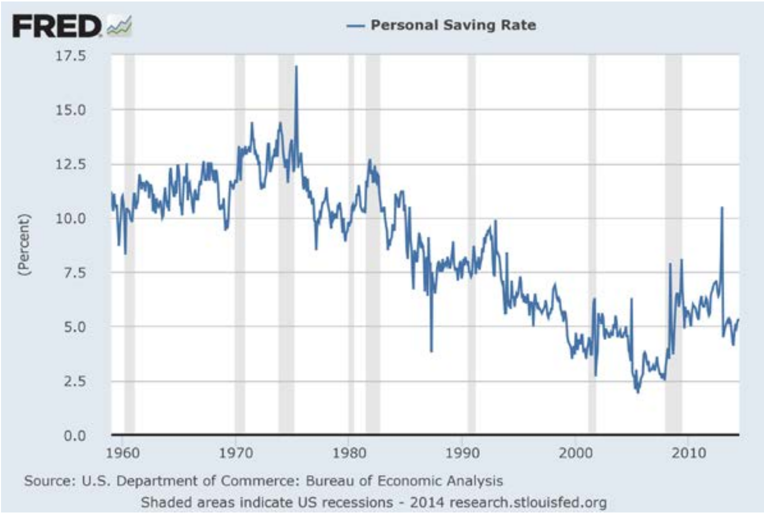
If saving can improve our current life and provide for a comfortable retirement, why don't we save more? Remember the economic way of thinking about choices (as explained in *Common Sense Economics*: (Section I: Element 3). Economists believe people choose for good reasons. In other words, they compare the marginal costs and marginal benefits of alternative choices.

The benefits of saving are in the future and can be hard to conceptualize while the opportunity costs of saving are immediate and certain. People like instant gratification. With saving, all of the costs come today and they are certain—for example, contributing $300 of my income per month into a retirement account. On the other hand, the potential benefits from this action come in the future—and far in the future for young people—and they are not known with certainty. Some people die before reaching retirement while others may save but poor investment decisions lead to an unsatisfying retirement. The incentive to save now is too weak for some people.

Here's another example: Some people tend to eat too much and exercise too little even though they understand such behavior is unhealthy in the long run. In order to be financially healthy in the long run, we have to save more and buy less today. Look at the following chart to find out how the personal savings rate has changed over the years. On the whole, are we becoming more or less able to handle emergencies and build wealth?

The Difference between Saving and Investing

A good financial plan should include both savings and investments. You will hear people talk about saving and investing as if they were the same thing—and indeed, the two are related, and some financial assets provide both savings and investment. Strictly speaking, however, there is a difference between saving and investing, and it is important for you to understand the difference in order to achieve your financial objectives.



Saving is putting money aside on a regular basis in a safe place or product that allows you to access your money quickly and without significant penalty. Examples include savings accounts insured by the U.S. government, short-term bank certificates of deposit (CDs), short-term U.S. government bonds (Treasury bills), and money market mutual funds. Your money is safe in these products, and it is easy to access, but the down side is that there is little opportunity to grow your money.

An investment is an asset designed to grow your money over time. Investments include stocks, bonds, real estate, and commodities such as gold and silver. You may own these investments by buying them directly, or through mutual funds that will purchase and manage them for you by using pooled money from many different people. Your money is not as safe in these investments as it would be in a savings account, and in some cases it may be more difficult to access quickly, but there is an advantage: you might get a higher return.

To get a higher return, you must be willing to take on more risk. For example, over time the stock market has returned about 7 percent per year to investors, after correcting for inflation. However, the stock market fluctuates greatly from year to year. If you need to sell your shares of stock in a down year, you might lose a lot of your investment. Therefore, you should only use money that you will not need in the near future for stock investments. Tax-deferred accounts such as 401(k) and 403(b) accounts are good places to hold investments for your future. These accounts allow your money to grow tax free, but you must pay taxes when you take money out of the account.

Although saving and investing are different activities, they are both protecting you against the future. Savings protect you against unexpected costly events in the near future, and investing protects you against loss of income after you retire. In casual speech, most people refer to both activities as saving—people "save money in a savings account," but they also "save for retirement with a 401(k)." Again, strictly speaking, the first is savings and the second is investment, but just make sure to understand that you should do both.

Why You Need a Budget

A budget is a tool to help you reach your spending and saving goals just as a GPS system helps a driver reach a destination. Even if you are a spreadsheet pro, budgeting and managing your money can be a daunting task. Here is a step-by-step plan to help you reach your financial destination, building on the budget advice of *Common Sense Economics*.

1. Estimate your income.

This may seem simple, but many people make a critical error here. They think in terms of their gross income, but they can spend only their net income. For example, if you earn $30,000 a year, you may think you have $30,000 a year (or $2,500 per month) to spend. You do not. Your employer withholds some of your income for taxes (federal and perhaps state and local) and Social

Security (FICA) tax. You might also have money withheld for insurance or union dues. The money that is left, your net income, is what you actually receive to spend and save.

2. Estimate your expenses.

The next step is to estimate your expenses. There are two kinds of expenses: fixed and variable.

Fixed expenses are payments that are the same each month. Some examples are rent, a car payment, cable package, phone contract, gym membership, and college loan payment. Just because an expense is fixed, does not mean it cannot be reduced. However, choosing to reduce the payment is a long-term decision, which will require a change in lifestyle—or in the case of loan payments, higher interest charges.

An important expense that many people ignore is a "real-world savings account," (*Common Sense Economics*) for unexpected expenses, such as medical bills, appliance repairs, and auto repairs. It is so important to save monthly for an emergency fund that you should treat it as a fixed expense.

Expenses that change from month to month are called variable expenses. Some examples are food, clothing, and entertainment. Variable expenses are the first candidates for cutting if you are not saving enough. If you are accumulating credit-card debt, variable expenses are candidates for slashing.

A good way to get an accurate estimate of your expenses is to write down everything you spend for one month, and then analyze the results. Remember that every expenditure has an opportunity cost, and your analysis will show that you may be spending money on items that you either do not need or do not matter to you. Spending money should bring satisfaction. If an expenditure does not have more benefit than the opportunity cost, cut it out of your budget and increase your emergency fund.

3. Decide your spending goals.

Before you start a trip, you need to know your destination. Likewise, before you start to make a budget, you need to decide your goals. Which of your goals can be achieved with money, and when do you hope to achieve those goals? Some goals are short-term, such as paying for new clothes, your monthly rent, or entertainment. Some goals are long-term, such as paying for a car or retirement. Your spending should reflect your values. Because your financial resources are limited, you will have to make choices among your spending goals and limit some of them. If your spending goals are realistic, you can live within your income and reach your destination.

4. Plan for your savings.

As you plan and analyze your budget, you must consider your long-term spending goals. Long-term spending goals can be reached by putting money into savings. How do you know how much to save for long-term spending and how much to spend monthly on short-term goals? Unless you have very few spending goals or a very large income, you will have to choose which ones to fulfill. Do you need to rent that movie or buy that pair of jeans? Think about what you really want before you make a purchase.

5. Evaluate and adjust your budget.

A budget is a work in progress and must always be evaluated and adjusted. It is wise to do this monthly. You may decide to cut some expenditures by moving to a less expensive apartment, spending less on clothes, or getting a roommate. Or, you may decide to add to your income by taking a second job. Roads other than the one originally mapped out may take you smoothly to your spending and saving goals.

6. Stick to your budget.

Many people fail to stick to their budgets. They can't resist spending on those new shoes or that new car. Impulse spending is tempting. Consequently, people find they cannot accumulate the savings that would allow them to live with financial confidence and allow them to purchase the things they really want.

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[1] "Personal Saving as a Percentage of Disposable Personal Income," *FRED: Federal Reserve Economic Data*, Bureau of Economic Analysis, accessed June 12, 2015, http://research.stlouisfed.org/fred2/series/A072RC1Q156SBEA.

[2] Chen, Tim. "American Household Credit Card Debt Statistics: 2015 - NerdWallet." *NerdWallet Credit Card Blog*, accessed June 12, 2015, https://www.nerdwallet.com/blog/credit-card-data/average-credit-card-debt-household/.

[3] "Credit Card Minimum Payment Calculator," *Credit Card Minimum Payment Calculator* accessed June 12, 2015, http://bankrate.com/calculators/credit-cards/credit-card-minimum-payment.aspx.

[4] *The Motley Fool*, accessed June 12, 2015, http://www.fool.com.