

THE ENVELOPE BUDGET
The Easiest Budgeting Tool I Know
By David Dopp

My son, who has always had a problem keeping track of his money, had tried just about every budgeting trick he had ever read. Despite his efforts, every budget failed him because of the bookkeeping he had no time to do. He often wound up eating Top Ramen noodles for a few days before every payday ... and he hates Ramen noodles!

Knowing that “Ole’ Dad” had years of experience in financial planning and budgeting, he asked me to design a simple but effective budget method that didn’t demand a whole lot of time to maintain. (He had a pretty active social life, which is probably why he couldn’t keep track of his money!)

Now this was a challenge! I know exactly how to manage the finances of a large corporation, but Eric could not afford to hire half a dozen accountants to keep track of his money. Reaching way back to my college days, I remembered a course I took called “Governmental Accounting.” Governments account for money differently from you and me.

Governments use a process called Fund Accounting. Every major budget item is a “Fund” and governments allocate their budgets according to those funds. Fund accounting can become pretty complex, mainly because of the “smoke and mirrors” that often accompany government, but this idea had possibilities!

If I think of Eric (or a family) as a small government, why not set up some basic funds and use that as the basis for a simple budget? There should be a minimum number of fund categories, say Operating Fund (Living Expenses), Debt Service (Credit Cards, Vehicle Debt, Etc.), Capital Fund (Housing) and Reserves (Savings).

OK, we have the funds. Eric is not a government, so he can’t raise taxes. He does however have an income. (“Not enough, Dad, not enough!”) The big question now is how to divide his income into the fund categories. Oh yeah, and make it so easy he doesn’t have to think about it!

Part of Eric’s problem is he needs to spend money every week, but he only gets paid twice a month. It was also a stretch trying to pay the rent, car payment, credit cards, etc. (Plus these items were not all due on the same day!) He had enough cash coming in during the month. What Eric faced every month was a cash flow crisis, usually half way between paydays. To get a handle on his money problems, we had to first determine his monthly costs.

It took us about two hours one day to sit down and fix his money problems. We determined that he needed money to cover his weekly living expenses (groceries, gas, laundry and entertainment or partying, as he said.)

Next he had to cover his monthly debts and rent. He also needed to cover routine vehicle costs (oil change, tire replacement, license plates, insurance) and he needed a savings amount for emergencies.

THE “A” LIST

We started by making a list of all his monthly debt payments (and rent) and the dates each payment was due. For example, his rent was due on the 1st, utilities were due on the 3rd, one credit card was due on the 5th as well as his Jeep payment, another credit card was due on the 12th, and his insurance payment was due on the 25th. These bills had to be paid first. We called this his “A” list of bills because he had to pay these each month no matter what.

His rent was \$275 per month. (He shared a two-bedroom apartment with his brother. His brother has no problem with budgeting.) Utilities averaged \$100 per month (Texas is HOT in the summer!) It helped that the utility company allows people to pay an average monthly bill. Since he only paid half, his cost was \$50. His MasterCard was pretty close to \$50 per month. His other credit card was \$25 per month. His Jeep payment was \$375 per month. Finally, his insurance payment was \$175 per month (He’s under 25 and liability is the killer.)

Total for his “A” bills was \$950 monthly.

LIVING EXPENSES

Next, we estimated what he needed for gas, groceries, haircuts, laundry, movies, dating, and other entertainment each month. We called these his “Living Expenses.”

His jeep is not the most fuel-efficient vehicle. He was spending about \$100 per month on gas. He also paid with a gas credit card. He decided to allocate \$125 per month for gas and gradually switch over to paying cash for his gas. (Paying cash allowed him to buy cheaper gas!) The first month he bought one tank of gas for cash and the rest on credit. When the gas card bill came in, he only owed \$75. The next month he bought two tanks with cash and the rest on credit. When the bill came in, it was only \$50. The next month he bought three tanks for cash. After the fourth month, he was all cash for his gas. (And his monthly gas bill dropped to \$90.)

He estimated he spent about \$40 per week on groceries. We multiplied that weekly amount by 52 and divided by 12 to estimate his monthly grocery bill at \$173.33. We rounded up to \$175.

Eric is pretty particular about his haircuts. (His boss requires it!) He spent \$10 per month on haircuts. His laundry bill was \$4 per week or \$16.70 per month. We rounded that down to \$15, figuring any shortfall he could make up out of his grocery budget.

Eric kept track of his spending on movies, dating, video games, paint ball (he loves playing war games at a paint ball arena) and fast food restaurants for about three weeks. He averaged \$72.50 per week on entertainment. \$72.50 times 52 weeks divided by 12 months comes to \$315 per month.

Total for his living expenses is \$630 per month.

SAVINGS

Next we estimated what he would need for tires, auto repairs, clothing and miscellaneous savings. We called these “Savings.” This category was the most difficult to determine.

We estimated his tires would last at least 40,000 miles and cost around \$350. Since he was driving about 2,000 miles per month, he would need tires every 20 months. $\$350/20$ months comes to \$17.50 per month. We rounded up to \$20; figuring inflation would raise the cost of the tires.

Since his jeep was new and under warranty, about the only repairs he needed for the next couple of years were periodic oil changes, washing and maybe a brake job. He changed the oil about every 3,000 miles at a cost of \$15.00 and washed it on the same schedule at a cost of \$7.00. This meant he spent about \$44 every three months on maintenance or \$174 per year. We divided the annual cost by 12 to come up with \$14.50 per month. We rounded that to \$15.

For clothing we lucked out because his employer provided him with uniforms. Still we estimated he was spending \$300 per year on underwear, socks, shoes, etc. This works out to \$26.66 per month (we rounded down to \$25.00.)

Finally, he was trying to save about 5% of what he earned for emergencies. Since his take home pay was about \$1,600 per month, he wanted to save at least \$80 per month. (He contributed 10 percent of his earnings to a 401k, which his employer matched at 50%. Retirement savings were not a problem.)

Total for this category is \$140 per month.

Your list may or may not be the same as Eric’s. Regardless of the number of items in your list, you will always have three categories; the “A” List, Living Expenses and Savings.

The “A” list is the category for bills you must pay every month. You don’t have a lot of control over the monthly amount you have to pay.

Living Expenses is money you spend every month on yourself (and your family.) Usually, you have the greatest control over these expenses.

Savings is for money you will have to spend in the future. For example, if you pay auto insurance every six months, it goes into Savings. If you pay it monthly, it belongs in Living Expenses.

THE BUDGET

Now that we had converted everything to monthly costs, we could come up with a budget!

“A” Bills

Rent	\$275
Utilities	\$50
MasterCard	\$50
Other Card	\$25
Jeep Payment	\$375
Insurance	\$175
Subtotal	\$950

Living Expenses

Gas	\$125
Groceries	\$175
Haircuts	\$15
Entertainment	\$315
Subtotal	\$630

Savings

Tires	\$20
Maintenance	\$15
Clothing	\$25
Emergencies	\$80
Subtotal	\$140

The Bills Grand Total	\$1720
The Income Total	\$1600
Shortfall	\$120

Now we have identified Eric’s problem. He spends more than he earns! This is a prescription for disaster!

Eric had to make some tough decisions. Where should he cut expenses? There was nothing he could do about his “A” bills, in the short run. He COULD squeeze a little out of his “Savings”, but these are critically important expenses, which he could not avoid. That left only one area, “Living Expenses.”

We examined what he was spending under “Living Expenses.” He could have squeezed \$25 out of his gas budget, but it was important to him to get away from buying gas on credit. Haircuts he had to have to keep his job.

He was spending two dollars a day on Dr. Pepper at work. He bought the drinks from a vending machine. He decided he could buy the drinks by the case and take a couple to work each day. That reduced his grocery expense by about \$20 per month.

We still needed to find \$100 per month. Next we looked at Entertainment.

Eric spent each month about \$60 on fast food, \$80 on paintball, \$35 on rented video games, \$75 going out to the movies, and \$60 on dating. He decided not to cut anything out of dating (can't fault him there!). He decided to cut his fast food in half (saving \$30), cut one trip to the paint ball arena (saved \$20), cut his movie theater visits in half (saved \$40) and renting a movie at Blockbusters for the movies he cut out (added \$10), and cut his video game rentals in half (saved \$20.) Total cuts were \$100.

Now we could use these numbers to come up with a revised budget. The table on the next page shows what the new budget looks like.

Eric said, "I'm beginning to feel a little better about my money, Dad. But there's got to be a catch!"

"Just wait, Son, it gets better!"

REVISED BUDGET

"A" Bills

Rent	\$275
Utilities	\$50
MasterCard	\$50
Other Card	\$25
Jeep Payment	\$375
Insurance	\$175
Subtotal	\$950

Living Expenses

Gas	\$125	
Groceries	\$155	(was \$175)
Haircuts	\$15	
Entertainment	\$215	(was \$315)
Subtotal	\$630	(was \$630)

Savings

Tires	\$20
Maintenance	\$15
Clothing	\$25
Emergencies	\$80
Subtotal	\$140

The Bills Grand Total	\$1600
The Income Total	\$1600
Shortfall	\$0

Now the question was, how could he keep track of all of this without having to do a lot of paperwork every month? ("This is too much like work, Dad", he said. "Hold on, Son", I said, "until you see how automatic it will be.")

THE ENVELOPE METHOD

Eric gets paid on the 15th and the last day of the month. Since he gets two paychecks, the budget above has to be divided by two.

	Monthly	½ Month
“A” Bills		
Rent	\$275	\$137.50
Utilities	\$50	\$25
MasterCard	\$50	\$25
Other Card	\$25	\$12.50
Jeep Payment	\$375	\$187.50
Insurance	\$175	\$87.50
Subtotal	\$950	\$475
Living Expenses		
Gas	\$125	\$62.50
Groceries	\$155	\$77.50
Haircuts	\$15	\$7.50
Entertainment	\$225	\$107.50
Subtotal	\$510	\$255
Savings		
Tires	\$20	\$10
Maintenance	\$15	\$7.50
Clothing	\$25	\$12.50
Emergencies	\$80	\$40
Subtotal	\$140	\$70
The Bills Grand Total	\$1600	\$800
The Income Total	\$1600	\$800
Shortfall	\$0	\$0

Now the ½ month budget matches his paycheck. Eric has both a checking and a savings account. When he gets paid, he deposits \$475 in his checking account, \$70 in his savings account and keeps \$255 cash. When his “A” bills come due, he should have enough in his checking account to pay them. When he needs to buy something on his “Savings” list, he will transfer the amount he needs to his checking account and write the check. Automatic and no work needed to keep track of those items!

The only thing remaining is how to handle the \$255 he kept in cash. This is where the envelopes come in!

What Eric needs is to have enough money each week to cover his Living Expenses. The table below shows how to convert his monthly Living Expenses into weekly amounts.

Living Expenses	Monthly	Annual (Monthly x12 months)	Weekly (Annual divided by 52 weeks)
Gas	\$125	\$1500	\$29
Groceries	\$155	\$1860	\$36
Haircuts	\$15	\$180	\$3.50
Entertainment			
Fast Food	\$30	\$360	\$7
Paint Ball	\$60	\$720	\$14
Video Games	\$15	\$240	\$3
Movies	\$40	\$480	\$9
Movie Rentals	\$10	\$120	\$2.50
Dating	\$60	\$780	\$14
Total	<hr/> \$510	<hr/> \$6200	<hr/> \$118.50

Now we know how much Eric can spend each week. The problem is he doesn't want to do a lot of penny counting. To make this as easy as possible, we wrote the name of each category on envelopes. We had 10 envelopes labeled "Gas", "Groceries", "Haircuts", "Fast Food", "Paint Ball", "Video Games", "Movies", "Movie Rentals", "Dating", and "Miscellaneous."

Each payday Eric would make his deposits to his checking and savings accounts and bring home \$255 in cash. He placed the \$255 in the envelope labeled "Miscellaneous." On the next Friday, he took \$118.50 out of the "Miscellaneous" envelope and put \$29 in the Gas envelope, \$36 in the "Groceries" envelope, \$3.50 in the "Haircut" envelope, and so on until he had the entire amount allocated to envelopes.

Now, when he went to buy groceries, he took only the \$36.00 out of the "Groceries" envelope. If he spent less than \$36.00, he put the remainder back in the "Groceries" envelope. He followed the same procedure for each category. If he ran out of money in an envelope, he knew he only had to wait until the next Friday when he would put more money in the empty one.

If, by the next Friday, he had any money left over in any of his envelopes, he just added it to another envelope where he figured he might be a little short in the coming week. After a couple of weeks, he began putting his leftover weekly allowance into his savings account.

As he told me a couple of weeks after starting The Envelope Budget, "This is a way cool budget, Dad! I haven't had any Top Ramen noodles in two weeks!"

CONCLUSION

The Envelope Budget enabled Eric to exercise "sound fiscal responsibility" (as all the good budget books say) without the hassle of budgeting to the penny. He used the budget for about two months then found he didn't need it. He had painlessly learned to keep up with his spending mentally.

On a few occasions since then, Eric has felt like his spending was going out of control. When that happens, he just starts using the envelopes again until he gets himself back in control of his finances.

The Envelope Budget is the easiest budgeting tool I know. May it bring as much peace of mind to you as it did to my son!