Spend Smarter Save Bigger

Finding BIG savings
in your Home, Mortgage,
Vehicles, Insurance
and Investments

MARGOT BAI

Chapter Two From

Spend Smarter, Save Bigger

By Margot Bai

www.spendsmarter.ca
margot@spendsmarter.ca

Chapter 2

Other People's Money

He who loves pleasure will become poor; whoever loves wine and oil will never be rich. Proverbs 21:17

George & Kathy

George met Kathy during his third year at the University of Toronto at a party. Talking late into the night, they discovered they were both from the city, loved live theatre, were avid Leafs fans, and wanted three kids. After a year of dating they were engaged, and they married the summer after they both graduated. Kathy had always dreamed of a fairytale wedding, and due to the generous contributions from their families, she had one, complete with a designer gown!

George landed a great job with a Chemical Engineering firm and his salary rose each year. Kathy also found work in the Human Resource department at a telecommunications company. They rented a comfortable three-bedroom condo near Yonge & Sheppard. Over the next few years, they accumulated all the things they knew they should have: a new dinette, sofas, a complete bedroom set, two televisions including a high definition plasma flat screen and satellite dish, a stereo receiver with surround sound speakers, and deluxe office furniture.

They decided they wanted a more luxurious vehicle and fell in love with a sleek black Toyota Forerunner with black leather interior. Kathy was able to take the subway to work but George really needed a car for commuting and they were able to get financing no problem. Plus they got a great deal and it was important for his image at work to have the right kind of vehicle.

Three years later, Kathy discovered she was pregnant and the two realized they would need a home of their own. Planning for a large family, they bought a five-bedroom detached house in Richmond Hill, their parents helping out with a 10 % down payment, since they didn't have any money saved. With the baby came new baby furniture and an endless array of toys and clothes for the growing girl. Kathy quickly found being stuck home all day without a car was unbearable. They decided it was time to buy a minivan and since they liked their Forerunner so much, they financed a brand new Toyota Sienna. They got a special deal where they put no money down and made no payments for 3 months, plus they arranged financing over 6 years, so their monthly payments were affordable.

Kathy's company topped up the government maternity leave to 80% of her income so they barely noticed any difference in income. But as her one-year maternity leave was coming to an end, Kathy just didn't feel ready to go back to the office. George and Kathy had a dilemma: with vehicle loans, payments to furniture companies, huge credit card balances and a mortgage to pay, they couldn't afford to give up Kathy's income. Their consumer debts combined were over $30,000 and their mortgage payments a hefty $2,400 per month!

Even more frustrating was how much tax George was paying. Last year alone it totaled $27,000! Their accountant told them if they contributed to their RRSPs they could reduce their taxes significantly. They thought he must be crazy! With all their expenses, there was simply no money left for saving!

Thinking their parents might again help them out, George and Kathy were shocked to learn that their parents had cleaned out the bulk of their unregistered savings for the down payment on their house. There was nothing left to give. Kathy and George were forced to pay for daycare for the baby so Kathy could return to work. As if they didn't have enough to pay for already...

Living in Debt

Why is it that some people are always struggling to make ends meet while others seem to have more than enough? As George and Kathy show, it's not just about how much money the household is *earning*, but how they are *spending* their money! Believing they were entitled to a certain lifestyle, they spent money they didn't have to attain it! Their spending was haphazard, based on emotions instead of a financial plan. From the start they established a pattern of buying on credit and made no effort to pay it back. They did not attempt to save for future needs, figuring that their parents would bail them out in a crunch.

George and Kathy gave up their freedom to their creditors when they chose to purchase more than they could afford. Kathy lost the ability to choose to stay home with her baby. She was obligated to give her time to her job, to pay back the debt they had incurred. Sure, they have a beautiful home and furniture, but not the time to spend enjoying their home together as a family. George and Kathy have gone in the exact opposite direction of financial freedom. They became financially burdened to pay in the future for purchases made in the past!

Advertising a Desirable Life

Perhaps part of the reason for George and Kathy's spending habits is the constant bombardment of advertising. Advertisers try to convince you their product will make you more beautiful, more desirable or just plain happy. Advertising often creates a need that isn't there: just when you think you are doing okay, another commercial is pointing out what your life is missing.

Of course, advertising presents a skewed view of the world. People in commercials are uniformly beautiful, well manicured and dressed - in other words, rich! Most importantly, they are happy now that they have the featured product. The message it sends is powerful: other people have this great lifestyle, why shouldn't you? If we see enough beautiful, rich people driving around in luxury SUVs on television, it's easy to start to want this for ourselves.

Advertisers frequently surround their product with images of a desirable life. If only you have this type of tissue, you too will have the beautiful home, stylishly appointed furniture, attractive, loving mate and adoring children. Of course we understand these things do not pop out of the package of ultra-soft toilet paper. But the images in advertising teach us what the good life looks like. For many people, the desire to have that lifestyle before they can pay for it leads to big financial trouble.

All that advertising exists for just one reason: to get you to spend your money! One thing is certain: if you buy their product, they become richer and you become poorer. These marketers are not responsible for your financial well-being, they are only interested in their own bottom line!

Insecurity and Conformity

Why are people so easily tempted to strive for a lifestyle they cannot afford? Psychologically speaking, many people are insecure and are seeking approval from others. They see others driving newer, more expensive cars and they feel inadequate in an older vehicle or worse, on the bus! A lack of self-confidence will lead people to make decisions based on what others are doing rather than on what is right for them. Material goods provide image and status in a society that judges based on outward appearances.

All humans possess a powerful desire to be liked by others. We also tend to be most comfortable around people who are similar to ourselves. So it follows we can get more people to like us by becoming more like those people. Keeping up with the Jones' may in fact be driven by a powerful need to be liked by the Jones'!

Advertisers know these things well. A well-designed commercial taps into key human needs to feel successful, desirable and loved. In fact, some commercials are so blatant in the way they portray these messages, that they are more effective when you are not really paying attention to them! Advertisers are hoping their images and words will bypass your rational thought processes and tap directly into your emotions. Later, when you see their product at the store, your emotions are stirred and you buy it without even understanding why!

Ironically, people are attracted more to those who appear self-confident than those who simply follow the crowd. One of the best compliments I have ever received is from a friend who said she admired me because I had my own ideas and wasn't trying to impress anyone. Our efforts to be loved by imitating those around us are misguided. We will attract more people to us by creating our own, unique lifestyle and being confident about our own path.

Action

Are you being manipulated by the influence of advertising around you? For the next week, every time you see an advertisement, whether in print, on the radio or on television, observe it closely with your emotions off and your rational thought on. Think critically about what they are telling you and look for the false messages the advertisement is sending. Can shampoo really revitalize your libido? Will make-up turn you into a supermodel? Could whiter teeth possibly make you happier (they just can't stop smiling)? Would owning an SUV result in exciting family-bonding treks across the Canadian wilderness? When you break it down, you can see how ridiculous some of these messages are.

Other People's Money

If George and Kathy's story seems extreme, think again. Over 30% of Canadian credit card users carry a balance! Canadians collectively carry over $40 billion on their credit cards, double the amount five years ago, and triple that ten years ago! More and more Canadians are living the good life on borrowed money.

If you carry a balance on your credit card, lease or finance your car, or are in the red on your line of credit, you are living on other people's money! When you buy on credit, essentially you are asking a financial institution to pay for you, placing yourself in their debt. Interest is the fee the financial institution charges for providing the money you didn't have so you could purchase a product or service you couldn't afford.

Really, financing is all about time. You don't have the money to buy something right now, but you figure you will have the money in the future. So, instead of waiting until you have saved up enough, you buy it right away and pay it off over time. When you buy on credit, you really are making two purchases: the item itself plus the privilege of owning it before you can pay for it!

Good Debt versus Bad Debt

Debt in itself is not necessarily a bad thing: there is good debt and there is bad debt. Good debt includes student loans that enabled you to get the higher education needed to develop your career. A mortgage can normally also be considered good debt, provided it is not excessive, since a home is likely to appreciate. Similarly, debt taken out for investment purposes or to start a business is usually also good debt.

Most consumer debt of course is bad debt! Carrying a balance on a credit card is the most common and most punishing type of consumer debt. Keeping a balance on your bank credit line is another bad debt. Stay away from loans offered by furniture or electronics stores to buy their goods. Even with zero percent financing, there is often a set up fee, plus a clause that will charge interest retroactively if the balance is not paid in full by a certain date. To be fair, car loans should really be considered bad debt too. If you cannot afford to pay cash for a newer car, buy an older car instead and start saving up for something better next time.

Consumer debt locks you into making payments in the future for items acquired in the past. When you create debt, you are making an assumption that your income will continue uninterrupted. But life is full of surprises – anything could happen tomorrow! You might lose your job, become disabled, or encounter some unexpected expenses that will make it difficult to repay those debts. Wouldn’t it be better if you were debt-free when life takes a sudden turn?

Deciding to Get Out of Debt

Perhaps you can relate to some of the choices George and Kathy made. Maybe you leased or financed a new car that, together with gas and insurance costs, now consumes more of your monthly cash flow than you anticipated. Or your credit card balances might have gone well beyond your ability to pay them back anytime soon. If you are carrying consumer debt, big savings can be found by paying off those loans. However, you will only be successful if you commit yourself to not incurring more debt.

- Make a firm commitment to only pay in cash until you have paid off all your debts completely.
- Pay off the debt with the highest interest rate first to provide the best return on your money. Look for opportunities to refinance larger debts at a lower interest rate. While making the required payments on each loan, put all extra cash toward the loan with the highest rate. After you have paid off the first loan, move on to the next loan without missing a beat.
- Continue making the biggest possible payments toward your loans until you are debt-free!
- Free debt counseling is available in most communities to help people get back on track. If you are paying high interest rates on consumer debts, credit counseling may help you combine those debts into a consolidated loan at a reduced interest rate.

Once you have made the decision to stop adding to your debt, your debt repayment becomes your savings plan. Paying off your debt will almost always give you the best return on your money. It doesn't make sense to set money aside in a savings account when you are paying 18% interest on your credit card balance. Once you have eliminated all your debts, you can continue your savings plan by directing those payments into savings.

Finding Big Savings in your Debts

Consider April, a young woman who is carrying a $5000 balance on her credit card at 14% interest. Each year she carries this balance, she pays about $700 in interest charges. Suppose April also has a line of credit with her bank with a $10,000 balance at 9% interest. Each year, this loan will cost her $900 in interest. Taken together, these two debts will cost her $1600 per year in interest charges! If she still has these loans three years later, April will have paid $4800!

Anyone carrying debt has the potential for big savings by paying those debts back. Further savings may be found by negotiating a lower interest rate. Sometimes you may be eligible for a reduced introductory rate on balance transfers to a new credit card. This little extra effort may save you hundreds in interest charges and speed up the time it takes you to pay off a credit card balance!

Similarly, you may be able to get a better rate on your credit line just by asking. Look around to other banks hungry for your business and let your bank know what the lender down the street is offering. If you own a home, you may be able to obtain a better rate on your credit line by using your home equity as collateral. Tell your bank that you expect them to cover any fees involved. Arranging a secured credit line takes a bit of effort but usually provides the best possible rate.

Credit cards offer many benefits when used wisely. Credit cards are a convenient and secure way to pay for large purchases, make reservations, and shop by phone or online. You receive a monthly statement of your spending and benefit from reward programs. Responsible credit card use can help you build a positive credit history that may help you obtain mortgages or investment loans in the future. As long as you commit to always pay your balance in full each month, a credit card doesn't need to cost you a penny!

A credit line also has many advantages. When the credit card bill is due on Wednesday but payday is Friday, a line of credit enables you to cover the gaps in your cash flow and pay your bills on time. You may have heard that it's a good idea to have emergency savings stashed away. But leaving thousands sitting in a low interest savings account is not the best use of your money. Better to put that money against your mortgage and arrange a secured credit line to provide access to your home equity in emergencies.

Tax Strategies for High Income Earners with Debt

While debt costs you in interest charges, income costs you in income taxes. If your taxable income is in the middle or upper tax bracket, combining RRSP contributions with debt repayment will put you farther ahead in the long run. This is especially important for earners in the highest tax bracket. Suppose you are earning $80,000 per year. In Ontario, you can expect to pay about $21,000 in income tax. If however you contribute $10,000 to your RRSP, your taxable income will fall to $70,000 resulting in a $4300 tax savings that can be applied toward your debt. By contributing to your RRSP, you lower your income tax bill while saving money for retirement. After your RRSP contribution, the tax savings and any extra cash can go toward debt repayment.

Sure RRSP contributions cost more than the tax refund they generate. However, you are building up your retirement savings instead of kissing that money goodbye to the federal government! Even though it will take longer to pay back your debts, the tax refund will put you ahead in the long run, as long as the interest charges are not excessive. Just remember that this strategy works best for people in higher tax brackets. For those in the middle tax bracket, contribute only enough to reduce your taxable income down to the lowest tax bracket to avoid paying the higher marginal rate on that portion of your income. Funnel the rest of your savings directly toward debt repayment.

When contributing to your RRSP, don't allow Canada Revenue Agency (CRA) to hold your tax refund until April. CRA has a form that will instruct your employer to reduce the income taxes being deducted from your paycheque (Form T1213). By doing so, you will free up more cash sooner to pay down the debt as quickly as possible. See chapter 17 on RRSPs for more information.

Cheat Sheet

- George and Kathy bought all the toys of the good life before they could afford to pay for them. Their debt burdened them to work in the future for purchases made in the past.
- Advertisers associate their product with a desirable life, but happiness and success are not the result of material possessions.
- All advertising has the same goal: to make someone else richer.

- People who lack self-confidence may use material things to improve their status in society.
- If you carry a balance on your credit card, have consumer loans for furniture, lease or finance your car, or are in the red on your line of credit, you are living on other people's money!
- Learn the difference between good debt and bad debt. Make it your goal to pay off bad debt and only take on good debt in the future.
- If you are in debt, paying your debt off is your first step to saving for the future!
- Bigger debts present bigger opportunities for saving! Try to secure a lower interest rate while paying off your debts as quickly as possible.
- Once you have retired your debts, use your new cash flow to start a savings program.
- Use credit cards and credit lines wisely for the convenience and rewards, and to build a favourable credit history.
- If you are in a higher tax bracket, combine RRSP contributions with debt repayment.

George and Kathy showed us the dangers of using other people's money to finance today's pleasure. Our next young couple will show us how to do things right from the start. In the time it took George and Kathy to nearly bankrupt themselves, Adam and Jody will create a strong financial foundation that will give them freedom to create the life they want. Keep reading to learn how they accomplish so much from modest beginnings.