

The following is an excerpt from the book *Money for Life – Budgeting Success and Financial Fitness in Just 12-Weeks*, written by Steven B. Smith, President and CEO of In2M Corporation. (Dearborn Trade Publishing, 2004) This excerpt has been edited from its original version in the book.

Secrets of Envelope Budgeting

Isn't it amazing how often we learn about simple principles that, when applied, have the ability to impact our lives in profound ways? Such is the case with the traditional envelope method of personal financial management. Many have heard of or are familiar with someone who has used this simple system for spending management. The envelope system has worked exceptionally well for many people in the past. These people understood the basics of the system and how to use it, but many could not articulate the principles behind the system that allowed them to be successful.

The envelope system as it was used with cash is very simple. In the days before the proliferation of credit cards, debit cards, and other forms of cashless spending, many couples were very dedicated to this system and used it effectively for years. Initially, a couple would sit down together and determine how much cash they would receive each month. This available cash represented the net amount of all of their paychecks for the month. Then, they determined where they would be spending money. Their areas of spending included things that they would purchase and pay for each and every month, and things that they would spend money on only periodically. After completing their list, they took out a stack of envelopes and labeled one for each area of spending. Their next task was to determine the amount of money required for each envelope every month. For the areas of periodic spending, they calculated the amount they would spend each year, and then they divided this amount by 12. This represented their monthly spending plan.

When they received a paycheck, they would go to the bank and cash the check. Then they would sit together at the kitchen table and divide the cash into different envelopes based on their defined spending plan. When they paid for goods or services, they would simply spend from the specified envelope. The envelope became a self-policing spending account. Couples always knew how much money they had left to spend and how long it needed to last.



Cash from
 Paycheck= \$1,200.00

Mortgage	Gas	Electrical	Vehicle	Groceries	Savings	Misc.
\$400	\$25	\$75	\$100	\$150	\$75	\$25
Medical	Gifts	Donations	Taxes	Education	Vacation	
\$90	\$25	\$25	\$125	\$75	\$10	

Sum of Envelopes= \$1,200.00
 Sum of Paycheck is Equal to Sum of Envelopes

The envelope system automatically encapsulates four principles that are keys to financial success. They reveal the secrets of how you can achieve financial fitness utilizing the envelope system.

FIRST: *Set money aside in advance.*

When you commit yourself to the use of the envelope system, you become dedicated to living within your means. One of the primary reasons for this is that the envelope system requires you to set aside money in advance for each of the spending requirements you have, including monthly required and discretionary and periodic required and discretionary expenses. As discussed earlier, many people in America live paycheck to paycheck. The envelope system helps eliminate this problem, because the funding for spending comes from available cash resources that are allocated to spending before the spending takes place. After following this system for just a few months, you can quickly get to the point where you have enough money set aside at the beginning of the month to meet all of that month's spending requirements.

One of the significant problems people face today is not understanding how future spending requirements will impact their monthly cash flow. Have you ever had an annual insurance payment surprise you? Other periodic spending requirements include vacations, property tax payments, holiday spending, gifts, auto registration fees, auto maintenance fees, house maintenance fees, furniture and appliance replacement costs, and so on. As you think about it, there are many things that can catch you off guard if you don't plan ahead. For many people, their consumer debt is directly associated with being unprepared for periodic spending requirements.

Most people manage spending by their checking or savings account balance at the bank. Unfortunately, this account balance does not prepare you for the periodic spending needs that will arise in the coming months. It also does not alert you to the spending your partner is planning over the next few days or weeks. So you make independent decisions about how much you think you can spend without really understanding the big picture. This is a very dangerous approach and leads to problems, including bounced checks, frustration, and, ultimately, more debt. Most of the overspending in families can be traced to an inability to incorporate periodic spending requirements into their current cash resources and spending practices. A great example of this is the amount of credit card debt that is created during the holidays or on vacations each year as a result of not having money set aside in advance. Many justify this spending by telling themselves that they will pay the credit card balance next month. This rarely happens, because next month's spending requirements are already based on 100 percent of the cash resources for that month.

The envelope system addresses this problem of periodic spending requirements by allowing you to set aside money in advance of periodic spending needs. For example, if you were going to spend \$2,400 on Christmas each year, you would be setting aside \$200 each month. To state this another way, if you want to spend \$2,400 each year for Christmas, you need to spend \$200 less on other things each month. Perhaps your parents or grandparents used an envelope budgeting system. Imagine how they felt each December when they prepared to purchase gifts for Christmas and the Christmas envelope was full! Imagine how you will feel when you want to take a vacation and know that the money is already set aside in advance. Or imagine how nice it will feel to know that you have money set aside to replace the tires on your car the next time it's required. The envelope system holds the secret to setting aside money in advance.

SECOND: *Spend from how much is left.*

One of the significant secrets to not overspending is to know daily how much you have left to spend in any area of defined spending. While this seems very simple and even obvious, consider how often you make purchases without knowing how much you can really spend before your spending exceeds your available resources—or how many times you buy something without knowing how it will negatively impact your ability to meet other spending requirements.

When people used the traditional envelope system to make purchases—to buy clothes, for example— they would take the clothing envelope with them. They knew immediately how much they had left to spend and how long it had to last before they funded the envelope again. This information was invaluable in assisting them to make sound spending decisions.

If you choose to spend less than you make, then spending from what's left becomes very simple. If there is not enough in the envelope to complete the purchase being considered, the purchase is delayed or another purchase decision is made. Without knowing how much is left, you can only hope that the purchase decision you are making will not negatively impact other areas of your financial life. Unfortunately, you will not know this until it is too late. Knowing in advance how much is left to spend is the secret to making smart spending decisions every day.

THIRD: *When you run out, you must make a choice.*

We all want to be fully empowered to make choices. Often, this is one of the justifications we make for spending money. "It's my money, I've earned it, and I have the right to decide how to spend it! If I want to purchase that coat, I will, period." The problem with this thinking is that it often takes choices away later on: because you purchased that coat, you may not be able to purchase the birthday gift you wanted for your daughter.

The envelope system does not eliminate the ability to make personal choices; it provides information so you can make more informed decisions. With the envelope system, it is quite possible to run out of money before you fund the envelope the next time. If this happens, you have three options:

1. Put off the purchase until you fund the envelope the next time
2. Purchase something less expensive
3. Purchase the item and transfer money from another envelope to cover the cost

All three choices will still allow you to live within your means. With the third option, you can determine at the point of purchase which other area of spending you would like to impact. For example, if you wanted to purchase the coat and didn't have enough money in the clothing envelope to cover the cost, you could transfer money from your groceries envelope to cover the cost.

If you made this decision, you would do it with the knowledge that you would not be able to spend as much on food this month. There's nothing wrong with having made this choice. Perhaps you know that your grocery needs were less this month than in the past, or perhaps you did not spend all the money in your grocery envelope last month and you have extra.

Whatever your thinking, you have to be able to make a purchase decision and understand exactly what impact it will have in other areas of your financial life. Making a purchase choice is great as long as you do it on an informed basis. The envelope system holds the secret to truly *empowered* purchase decision making.

FOURTH: *At the end of the period, what's left is savings.*

One of the key principles to securing financial fitness is to save something first. In addition to setting aside a specified amount for savings each month, the envelope system allows you to save the balance remaining in many envelopes at the end of each period. For example, if you have some money left in your groceries envelope at the end of the month, you could take that money and apply it to savings, since you would be funding the envelope with enough money next month to take care of your needs for that period.

Many of your discretionary spending envelopes would qualify for this review at the end of each period. Discretionary spending envelopes are envelopes covering areas of spending that are not tied to fixed or required expenses. Based on the spending decisions you make in these areas, you may often have money left over at the end of each period. Examples of discretionary spending envelopes include clothing, groceries, eating out, entertainment, and so on. By adding the amount left in each of these envelopes to your defined

savings, you can significantly increase the amount you apply to savings, debt repayment, or long-term investments. The envelope system holds the secret to increased savings.

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While people in our grandparents' day used cash to successfully implement the envelope system, it is more difficult today. Many purchases can still be made conveniently with cash; however, we often pay for goods and services using checks, debit cards, credit cards, online bill pay, and even automatic withdrawals from our bank accounts. For some, the cash-based envelopes may represent the best approach for ensuring financial management success. For others, cash may simply not be a feasible alternative.

The envelope principles outlined above are not dependent on the implementation tool used. As a result, you can successfully incorporate the envelope process using one of four basic approaches:

1. Cash
2. A paper ledger or computer spreadsheet
3. A computer-based envelope system such as Mvelopes® Personal
4. A combination of these

The most important part of choosing an implementation tool, is that you find one that works for *you*.

*Money for Life, Applied Principle 9, pages 69-74 – Learn the Secret of Envelope Budgeting.
Dearborn Trade Publishing, 2004.*