Behavioral and Personal Finance
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Module – 02
Personal Finance
Lecture – 27
Taxes and Financial Planning (Contd.)

Hi, there continuing with the previous session, where we were discussing about how taxes influence our personal finance decisions and it is an important part of personal financial planning. We will discuss in this session how the Taxes and Financial Planning can be integrated together and we also discuss the behavioural factors that are important for incorporating financial planning and making a better financial future.

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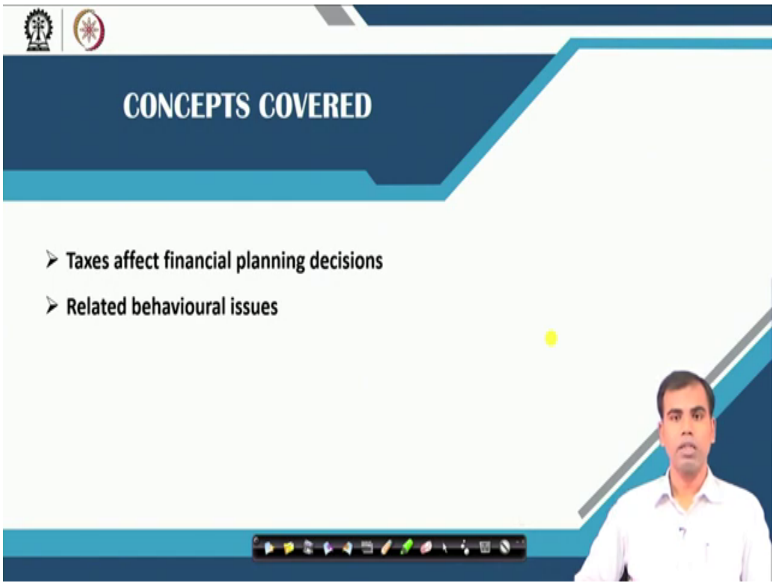

So, the topics that we are discussing in this session now are the role of taxes as part of better financial planning and how behavioural factors can influence the choices related to taxes and personal financing together.

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Before I move further or we discussed more about the nitty-gritty of personal financial process with respect to taxes, I would like to highlight a sequence from the book Alice in Wonderland. Now, if you remember in that book as well as in the movie if you have seen, it shows that the protagonist is confused and is in dilemma and asking her advisor a simple question and the question is would you tell me please which way I ought to go from here. So, the individual is in dilemma and asking the advisor to some way out.

Now, the advisor being a cat asks that totally depends on a good deal on where you want to get to which is basically the final goal or the final objective to achieve. The protagonist says I really do not know or I just do not care much about it, to which the cat or the advisor response that it does not matter which way to you go. Now, this sequence essentially show case that, if you are trying to achieve certain objectives and you are not sure which objectives are important or which type objectives are prioritized, then it does not matter which path you are taking to achieve those objectives. Or in worst case if you do not have an objective at all, then it really does not matter which path you are taking.

So, taking this into the context of financial planning; if you do not have an objective to achieve, it does not matter how much you earn, how much you save and how much you invest. So, keeping this issue in mind most of our financial decisions or rather all of our financial decisions should be targeted towards achieving some financial goals.

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Now, taxes deviate us from achieving those goals in a timely manner. Now, if we try to understand the role of taxes on our financial decision, we have already discussed that a tax of 30 percent reduces our net income in the hand or the net gain that we are expecting from an investment.

So, if we have incorporated it into our financial planning or our financial decisions, we are basically avoiding that loss in gain or the loss in value from that investment. So, as a general rule taxes should not be seen as a separate activity rather it should be integrated with personal financial planning and it should be done simultaneously. So, that the objective that you have started with for example, achieving a financial goal or any other financial objective that you started with should be achieved in a systematic manner.

Now, we all know that in general financial planning has three major goals to achieve or rather three dilemma or three decision the choices that are to be achieved. The first one is, if you have some money, if you have some income what to do with that income? If you recall from the first module of the course, we have already discussed these things in a very generic way. Now in the context of tax implication on personal finances, we are trying to explain this to contextualise how taxes can affect our personal financial planning.

So, the first decision choice that we have is whether to consume now or save for future. If you have got some money, you have a choice to consume the money right now or save it for future so, that you can have better utility in future or less uncertainty in future. Second dilemma that we all often face is whether to create asset versus reduced liability, essentially what it means is to use the money or the economic resources that we have for creating some assets right now or for reducing the liabilities that we have.

So, this is second dilemma that we have and the third dilemma or the third decision choice we have is to pay more taxes right now or to have something which will help us in having differ tax liabilities. So, these three decision choices are actually important to understand in the context of tax implications. Suppose, you have to save some money for future; now another alternative is you can use that money for now and do something which will get you some utility. If you remember the concept there is always a trade off between consuming now versus saving for future. If we try to incorporate behavioural issues in here, we know that immediate gratification comes into the picture when it is about assuming the economic resources.

Most of us tend to consume the economic resources or in particular and the resources in general immediately so, that we can achieve the utility or we can obtain the utility that are available. And this is pertaining to savings versus consumption. Second choice is can be contextualized or explained in terms of let us say buying a house versus paying rent or creating some asset in terms of having an asset with you or reducing the liability. If you recall the example which we discussed while discussing the financial planning, we know that if you are going to get a job and you are getting a salary, you can use that salary to create some asset or reduce the liability in terms of reducing the education loan this trade off is always there for any individual.

Similarly, if we have got some money, you can invest in something which is not tax exempted versus you can invest in investment of venues which are tax exempted or tax deferred. So, that you pay less taxes in future. So, paying more taxes in present versus paying more taxes in future that is a third choice that we have.

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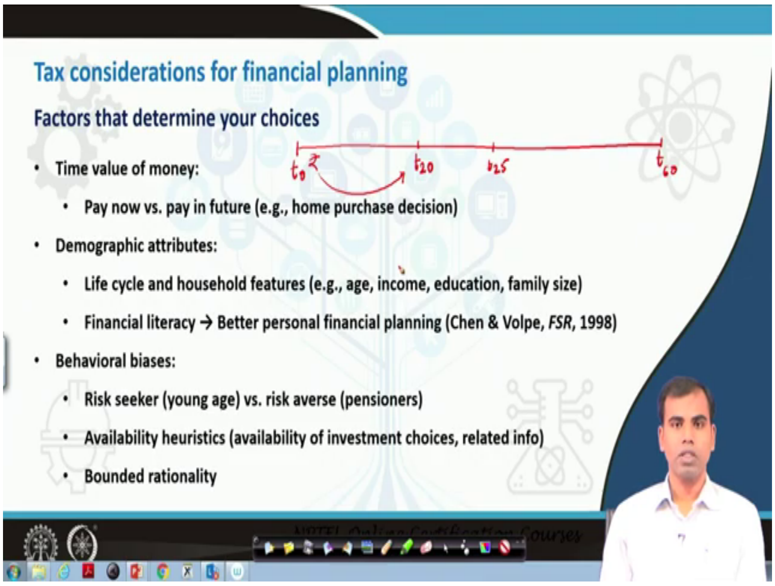

Now, what are the factors that determine these choices? The choices with respect to consume versus save, buy versus rent or pay more taxes now versus pay more taxes in future.

The factors that we are going to discuss here are as follows. The first factor is time value of money. If you remember from previous discussion, time value of money is a concept that explains why a rupee today is not equal to a rupee tomorrow. So, if you try to contextualize this time value of money factor in a very simple example, we know that individuals make decisions that have economic consequences at different points of time. For example, if I make a career choice today, it will have economic consequences in future.

For example, if I take up a job that pays me certain amount of salary today and I stick to that job for a long time probably I get a better recognition and better promotion in future, but my salary would not grow as much if I had jumped from a one job A to job B.

Similarly, if I have an income today and that income can be saved and invested in some investment a venue that investment of venue will yield me some return and that return will be occurring in future. So, I will have higher income in future. So, the decisions that we make are basically having consequences of economic terms in future. And this is where this time value of money understanding helps us. So, we know that if we are going to make some decisions with respect to some financial choices, the time value of money in future.

For example, this is today this is let us say 20 years down the line this is 25 year down the line and so on. So, let us say this is 60 year down. The line the economic decisions that we are making today will have some consequences on in future. Let us say if we prefer to buy a house instead of living in a rented house, we might have to pay a higher EMI which is Equal Monthly Instalments for next 20 years, but after 20 years we will be relieved off paying the rent rental income or E M I rather we will have an asset.

On the other side that asset might require some maintenance or some reinvestment after 20 years. So, we will have to incur some more money. So, these choices at different points of time in the timeline has to be considered for better decisions and to understand it in a more practical way we should incorporate the time value of money attribute, when we are making a decision that have economic consequences in future.

Second factor that are important are basically demographic attributes or the demographic features. For example, the stage of life cycle that you are living in will be an important factor of making financial decision or incorporating taxes into financial planning.

Similarly, the household features such as the size of family or the number of people living in your household will also be an important demographic factor or feature which will help you or which should be incorporated in your financial decision. One factor that are most important rather is financial literacy research have shown that a higher financial literacy among individuals basically, leads to better personal financial decisions. There have been several attempts to understand those impact of financial literacy on personal financial decisions. And over and over again it has been shown that if an individual has gained some financial literacy through some training or some education or some courses, they make better choices and better personal financial decisions.

So, if you have to make a better financial decision, it is very important for you to understand the economic consequences of all your decisions through some training or any other financial literacy process. On the top of everything, we have discussed earlier as well that behavioral biases significantly affect our decisions with respect to personal financial planning. For example, if an individual is of young age, versus an individual of retired age will have different risk choices. We know that young people are risk seeker. So, they can make investment or financial planning which might be seemingly very risky whereas, people who are pensioners would not like to take up that much risk. So, risk seeking versus risk averse behaviour is one of the significant factors that influence your personal financial planning in the context of tax implications.

Another factor in terms of behavioural bias is availability heuristics, we have all also discussed that investment information or financial information availability as well as the choices that are available to individuals would be determining the personal financing process and similarly the factor such as bounded rationality or overconfidence or under confidence or loss aversion, these are some factors which will make your choices biased and in many cases, you end up making decisions that are not so optimal.

So, when you are trying to incorporate taxes into personal financial planning decisions, you should be aware of these factors namely, time value of money which is the value of money over time changes and your decision should incorporated demographic and cultural attributes and behavioural biases significantly affect the personal financing decisions as well.

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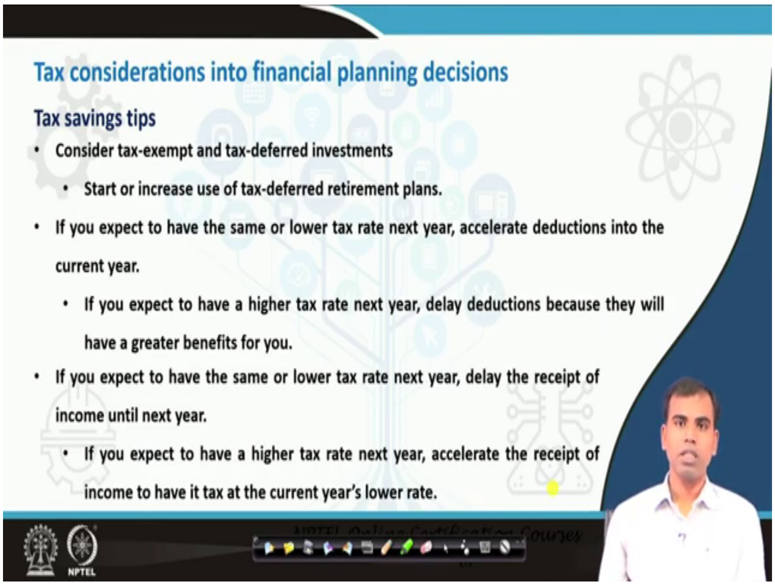

To bring all the discussions in past two sessions in one context of tax implications into personal financing financial planning process. Let us highlight some tax saving tips which will be in incorporated in your personal financing decisions. So, first important thing that an individual must consider is to invest in tax exempt and tax deferred investments. So, whenever you have got some money to invest in you first look out for investment of venues which are tax exempt or in different case tax deferred.

So, the tax deferred or tax exempted investment avenues are basically those investment avenues where you save some taxes and you pay less taxes so, that the net gain that you have at the end of the investment cycle is higher compared to the tax taxable regime.

So, we should always start or increase use of tax deferred investment such as retirement plan or saving plan or any other investment avenues. Second tip that we must keep in our mind is that, if you expect to have the same or lower taxes in future which is let us say next year, we should always try to accelerate deductions into the current year Which means, if I am hoping that next year my tax rate is going to be low be it for my lower tax slab or the government policy change or any other factor, if I hope that I will be falling in a lower tax rate next year. I should try to accelerate all the deduction in current year which means if I have to pay a 100 rupees of tax this year and I increase the deduction I accelerate the deduction in current year my tax liability might go down.

And on the contrary, if we expect that the tax rate is going to be higher in next year, we should try to delay the deduction because they will have a greater benefits for you which means, if we are paying taxes 100 rupees this year and next we are we are likely to pay more than that, then deduction should be taken to next year so, that the tax liability next year will be reduced. Similarly, if you expect that you have same or lower taxes rate next year, we should try to delay the receipt of income until next year which means if you have low tax next year and the income will be received next year, the total tax liability on that income will be lower.

On the other hand, if we expect that the next year tax rate will be higher or we will have to pay a higher rate of tax, we should try to accelerate the receipt of all income to this year only so, that the tax at current year will be paid at a lower rate. So, these are some important tips that can save you some money out of tax payments, but then after all these consideration of tax implications on our income and our financial planning process what is the next challenge that we should keep in our mind.

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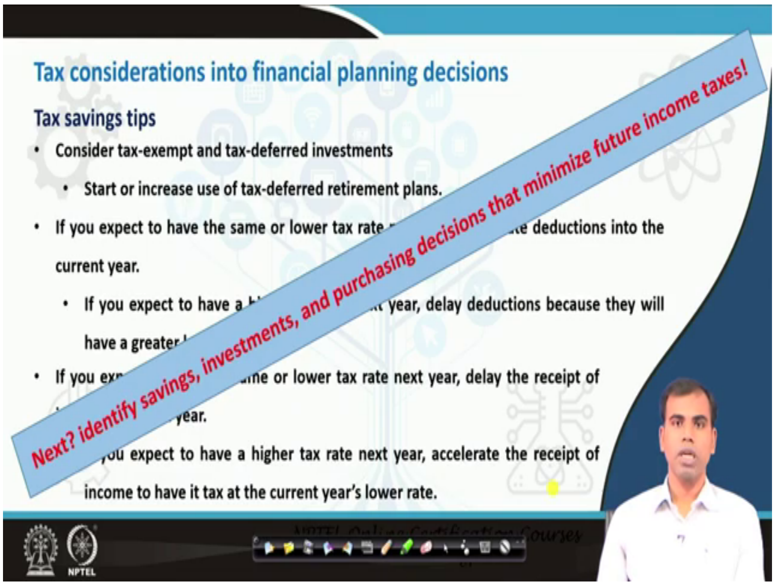

The next thing that will that will be discussed is basically the decisions pertaining to savings investment and purchasing activities of individuals and household. So, that the tax liability or future income taxes can be minimized and more money can be saved for individuals or the household. This is it for now; we will discuss more about the behavioral aspect of investing, savings and purchasing decisions and in next session.

Thank you very much.