FINANCIAL PLANNING HIERARCHY OF NEEDS

Money Owners LLC
ClydeBank MEDIA

EXPLAINING THE HIERARCHY OF FINANCIAL NEEDS

Maslow's Hierarchy of Needs

In his 1954 book *Motivation and Personality*, American psychologist Abraham Maslow presented a theory of psychological health now referred to as Maslow's Hierarchy of Needs. The theory attempts to explain human motivation in terms of ranked needs. The fundamental idea is that there are some basic physiological needs that must be fulfilled in people before they can move on to solving their more complex or nuanced problems.

The concept is usually presented as a pyramid-shaped graphic with five levels of needs. The most pressing ones—physiological needs such as hunger and warmth—make up the wide base of the pyramid. Moving upward, the next level of the pyramid is safety. We all want to feel safe and secure, but we need to make sure our physiological needs are met first. Maslow then goes on to identify love and belonging, and then self-esteem, as the next most important human needs that must be fulfilled. According to Maslow, self-actualization, or the ability to learn, grow, and accomplish goals (whatever they may be), is the ideal state we all strive for. This ideal state, however, can only be reached if all the preceding basic needs have been met.

The Hierarchy of Financial Needs

The hierarchy of financial needs works in much the same way and presents a similar goal. Once we have addressed our basic financial needs, we can move up the pyramid of financial needs to the top: financial freedom. People who are living financially free lives can spend money that's not set aside to meet other needs, and thus it can be said they are living a "financially self-actualized" life.

Income

The base of the pyramid represents the financial needs that must be met before any others can be realistically contemplated. Without a sufficient income, paired with sensible spending habits, none of the other steps to building a healthy financial outlook can be achieved.

Like our basic needs for food and warmth that Maslow identified as the base of his hierarchy of needs, managing our income to produce a positive cash flow (spending less than we are making) and taking care of unavoidable expenses such as housing and groceries set the foundation for the next level.

A 50/30/20 budget can be really helpful when addressing basic financial needs. Also, be sure to check out our growing list of actionable financial tips for managing day-to-day finances.

With your basic financial needs addressed, you can move on to the next level of the pyramid—building your emergency fund.

Emergency Fund

Life comes at you fast. An emergency fund acts as a financial buffer and ensures that you are prepared for unexpected expenses. It just seems like common sense, right? The ability to cover financial emergencies without having to rely on debt instruments like credit cards or high-interest short-term loans makes good financial sense.

For people who are struggling to navigate the world of personal finance, the financial hierarchy of needs can be instructive. You know you need to have an emergency fund, but how do you go about doing that—where do you start? Looking at the pyramid, the answer is clear: make sure you have your income and basic financial needs sorted out first.

Other Savings

With your basic financial needs handled and an emergency fund cushion established, you can focus on other savings. These miscellaneous savings are your first step (or a continuation of other steps you have already made) toward saving for your future.

This stage of the financial planning hierarchy is also sometimes referred to as the accumulation stage, because at this stage excess income is being diverted to savings accounts where it can accumulate. While it is true that the previous two stages of the financial hierarchy are important steps toward the goal, the accumulation stage is your first real taste of financial independence.

Insurance and Estate Planning

With your survival needs accounted for, an emergency fund in place, and your excess income accumulating, you can confidently protect your assets and secure your financial future. Renter's insurance, life insurance, and other estate planning tools come into play. These aspects of future-proofing your financial journey may seem frivolous, especially if you are young, but the peace of mind that comes with securing your financial future can be invaluable.

This stage is also a time to think about your financial future in another way—your credit score. For some people this will mean building credit, and for others it will mean repairing distressed credit scores.

It's common knowledge that a low credit score can restrict your financial future, but it bears repeating here. Building your credit score results in more options (and often lots of money saved) in the future. Once you have reached this stage in the financial hierarchy of needs, you are in a good position to work on your credit; before this stage it can be tough to appropriately build or repair credit.

Investments

The financial hierarchy of needs represents a path toward financial independence, with each successive stage dependent on the last. At the investments and taxes stage, your survival needs (basic, unavoidable costs) are taken care of. You also have an emergency fund in place, are saving a portion of your income, and have the preservation of your assets taken care of—now it's time to take the next step toward financial independence.

Savings accounts are great as vehicles for the accumulation of excess income, but ultimately a savings account amounts to little more than an account for deferred spending. The only way to truly build wealth is with investment and/or stock market exposure.

Investments can range from the exciting to the mundane. A full exploration of the world of investment and a survey of the stock market is beyond the scope of this text, but the bottom line is that you won't grow your wealth with savings alone. Putting your money to work for you is an important step toward the ultimate goal of financial independence. But, as indicated by the financial hierarchy of needs, there are several personal finance needs that must be addressed before money can be devoted to investing activities.

Self-Actualized Spending

Self-actualized spending—and financial independence in general—is the ultimate destination on your financial journey. The challenge at every stage of the financial hierarchy of needs is to keep this goal in mind, while understanding that it isn't something you can rush.

The top of the pyramid is everyone's goal. It's also the part that everyone focuses on (sometimes to their personal financial detriment). Discretionary spending (spending on hobbies, indulgences, or other nonessential items) makes up the bulk of expenditure at this level. Your basic financial needs are accounted for and you have taken steps to secure your financial future. This spending can be dedicated to whatever you want!

LOOKING FOR MORE PERSONAL FINANCE TIPS?

Check out our growing list here.