Six Ways to Make the Most of a Pay Raise

If you have been lucky enough to receive a pay raise this year, congratulations! Getting a raise is exciting and brings with it a sense of accomplishment. Military members typically have three ways to get a pay increase: annual cost of living increases, with promotion, and every two years for time in service. It can be tempting to run out and treat yourself as a reward for getting a pay raise, but before you spend all of your hard-earned money, there are a few things you should consider.

1. Pay yourself first.

Instead of adding the full amount of your raise to your take-home pay, consider putting a portion toward your retirement by increasing the percentage of your pay that goes into your TSP or 401(k) account. If you're already contributing the maximum amount allowable by law, you could open an Individual Retirement Account (IRA) to supplement your other retirement accounts. An IRA allows you to contribute up to $6,500 annually toward retirement (or $7,500 if you are 50 years old or older). Note that if you contribute additional traditional funds to your TSP or 401(k) account, you will lower your taxable income for the year – meaning you may be paying a smaller tax bill come April. Roth IRA contributions do not lower your taxable income.

2. Pay down debt.

If you have high-interest debt, putting funds from a pay raise toward paying it down can reap significant benefits. By paying down your debt (specifically, paying more than the minimum payment) you can decrease the amount of interest that you will pay over time and increase the speed with which your debt gets paid off. Once your debt is completely repaid, your paycheck will go further than before. There are two common methods of debt repayment:

- Snowball Method: A strategy in which debt is paid off in order of smallest balance to largest balance, regardless of the interest rates. It involves making minimum payments on all debt and then putting as much extra money toward the smallest debt as possible. Once the smallest debt is paid in full, the amount paid toward that debt can be applied to the next smallest debt, and so on and so forth, until all debts are completely paid off.

- Avalanche Method: A strategy in which debt is paid off in order of highest interest rate to lowest interest rate, regardless of the amounts. It involves making minimum payments on all debt and putting as much extra money toward the highest-interest debt as possible. Once the highest-interest debt is paid in full, the amount paid toward that debt can be applied to the next-highest-interest debt until all debt is completely paid off.

Keep in mind that regardless of which method you choose to pay down your debt, the key to success is not to add any more debt to the balance. Keeping your spending in check will help speed up your debt repayment.

3. Reevaluate your household spending plan.

Every time your income changes, it's a good idea to take a look at your budget. How much has your take-home pay increased with your pay raise? Where would your budget benefit most from additional funds? Maybe you want to boost your emergency fund or put money toward a short-term goal, like a vacation. Maybe it would be best to allocate the entire increase to paying off debt. Allocating additional funds to a "bucket" can prevent frivolous spending while maintaining your family's financial security.

> Note: It's easy to think of a pay raise as a treat and increase your spending habits. This isn't always a sustainable option, though. Do you actually need to buy coffee every morning? Do you need to upgrade your car and take on additional debt? Spending habits can be hard to break, and if your fortunes change in the future, it may be difficult to alter your lifestyle and reduce your accustomed spending. Think twice before letting unnecessary purchases become routine.

4. Think about taxes.

If you have received a raise, you can generally expect to see an increase in the amount you owe in taxes. However, not all of your income is subject to the same tax rate. A raise may knock you up into a higher tax bracket, but only the added income above the bracket ceiling is taxed at the higher rate. Regardless of your tax rate, it's a good idea to look at your previous year's taxes when you get a raise. If you ended up owing money to the government, you may want to increase your withholding to avoid an unpleasant surprise in April of next year.

5. Bolster your rainy day and emergency funds.

You never know when something unexpected is going to happen and you'll suddenly need cash – and quick. Air conditioners fail on the hottest day of the year, cars give out in the middle of road trips, and refrigerators lose their cool right before a dinner party. Having an emergency fund in place ensures that you have the money you need, when you need it. Life events such as separating from the military, moving, or welcoming a child may require you to increase the amount that you typically keep in savings. Experts generally recommend having at least three months of living expenses saved in an emergency fund and about $1,000 saved in a rainy-day fund.

6. Save for a specific goal.

If your spending plan is in good order and you've allocated money toward retirement or paying down debt, you could use the extra funds from a pay raise to save toward a specific goal. For example, if you know that you want to purchase a home or renovate your kitchen, you can tuck your additional earnings aside to speed up the timeline on making that large purchase. If you dream of taking your family on a summer vacation, starting to save now can make that dream a reality. Once you've saved up to your goal, any additional funds can be rolled over to start working toward a new one.

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