

Keep a Reality Check on Personal Debt

Most everyone has, at some point in their lives, accumulated personal debt-some more than others. Whether debt is a cause for concern depends upon a number of factors, including: how the economy is faring; your particular earning and economic prospects for the near and long term; and the type of debt you incur. By being conscious of your spending habits, including credit card use and large purchase habits, you can better understand ways to control debt-before it starts to control you.

According to the U.S. Attorney General and the Bureau of Consumer Protection, approximately nine million individuals have turned to credit counseling agencies. One reason for this is debt incurred by credit cards. In fact, consumers nationwide have accrued approximately \$700 billion in credit card debt alone (U.S. Attorney General, Consumers and Debt: Finding the Right Credit Counseling Agency for You, 2004).

To gain a perspective on personal debt, it is useful to distinguish between healthy and unhealthy debt. Healthy debt refers to borrowing in order to purchase assets that are likely to appreciate in value, such as a home or business. Healthy debt is especially worthwhile to assume if you are able to itemize certain repayments (e.g., home mortgage interest) on your tax return and, as a result, qualify for certain tax deductions.

Unhealthy debt, on the other hand, refers to borrowing in order to purchase consumables or assets that are likely to depreciate in value, such as a vacation or an automobile. Unhealthy debt has taken an even more negative turn since the government stopped allowing tax deductions for most consumer debts, such as personal loans and credit cards.

Debt Management Basics

For most people, managing debt effectively is a learned skill. The following pointers may help you get your debt under control:

Categorize debts. To gain control of personal debt, you might start by developing an overall picture of your current debt situation. Debts should be categorized as healthy or unhealthy. They should then be scheduled according to whether they are short-term (e.g., credit cards), intermediate-term (e.g., auto loans), or long-term (e.g., mortgages and home equity lines of credit). The interest rate for each type of debt should be noted.

Pay off the "right" debt first. It usually makes the most sense to pay off high interest rate debt first, especially if the interest is not tax deductible (e.g., credit cards). Ideally, you should have enough in savings to pay off short-term debt, if needed. Because credit cards are typically used to purchase consumables, rather than assets that appreciate, they can easily tempt consumers to live beyond their means. Thus, it is best to develop the habit of paying off this type of debt on a monthly basis.

Avoid the minimum payment trap. Interest that accumulates by stretching out payments can make even a "bargain" costly in the long run. To understand the impact of making only minimum monthly payments, you may want to ask your credit card company how long it would take to pay off your current balance at that rate, and how much total interest you will ultimately pay. This information prompts many individuals to adopt a "pay-as-they-go" strategy.

Curb impulse spending. If you are prone to impulse spending, you may find it best to avoid shopping when you don't have a specific purpose in mind. Or, you could try to delay impulse purchases for 24 hours. Once you have had a chance to "sleep on it," you may discover the impulse has passed.

Benefits in Good Times and Bad

If you are like many people, spending may not be based solely on financial considerations. Emotional factors may sometimes cause confusion between what you think you need, and what you actually do need. Still, the reality of living in the twenty-first century may leave you with little choice but to amass at least some debt. However, with discipline and planned spending, you can most likely manage your debt and live within your means.

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