Good Debt vs. Bad Debt

Tips for planning your financial future in the turbulent market.

By Jacob Yadegar

In most countries outside the U.S, one of the major non political reasons for poverty and a small middle class is lack of access to credit. Most people can not afford to pay all cash for the big ticket items such as homes, cars, televisions etc. Since there is limited financing available, most are forced to live without these basic necessities, so while the majority of the population lives debt-free, they also live below our standards.

In the U.S. on the other hand, it's almost impossible to live debt-free. While most of us can't pay cash for our homes either, we are able to live a more comfortable lifestyle due to the abundance of credit in all areas of our lives from our children's college education to loans for the purchase of cars, boats, furniture etc.

I can't help but wonder whether others' ways of doing without credit would be better for our sanity and peace of mind. Would we take more favorably to a simpler way of life? I doubt it. Credit is part of our psyche by now.

Unfortunately, too many of us let debt get out of hand. Is the constant stress and turmoil created by debt worth it? Many lives have been ruined, marriages destroyed and families torn apart as a result of debt.

Ideally, your total monthly long-term debt payments -- including your mortgage, car loan and credit cards should not exceed 36-40 percent of your gross monthly income. Unfortunately, it is far too easy to spend more than you can afford, especially when you pay by credit card.

Recent statistics show that personal bankruptcies have hit record highs in recent years and the amount of credit card debt has ballooned to record levels as well, with reports showing an average balance of over $8,000 per household in carried over credit card balances.

Now, I'm not suggesting that we avoid debt at any cost. Nor am I suggesting that all debt is bad. What I am suggesting is the importance of finding the right balance so that you can enjoy your life more as a result of your use of credit, without having the debt overhang drive you crazy. A good rule of thumb to follow is that good debt includes anything that you need vs. bad debt would be things that you want. Examples of good debt would be a home, car, college education. Examples of bad debt would be that trip to Europe that you have not saved up for, expensive clothing that you know you can't afford. Another good rule has to do with whether the debt payments can be written off against your income, as is the case with a home loan, vs. credit card debts that are most often non-tax-deductible.

Most people get caught in the payment trap. "The payment is only $175 a month. I can afford that." You must stop living your life based on payments and start viewing things on a longer term basis. With the current condition of the economy and the outlook for Social Security everyone must take responsibility for his or her own future. If you don't start managing your debt responsibly and spending and investing your earnings with proper forethought, you will most definitely end up in a stressful and uncomfortable position.

Sometimes the decision to borrow could be a difficult and confusing one. With interest rates being at historic lows, compare rates and look at ways to consolidate your accounts to reduce your interest expenses. Using credit can be good if used properly.

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