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Isn't Debt-Free the Way to Be?

Debt isn't the root of all evil—but sometimes it sure feels that way.

If you're struggling to cover your bills and are being hassled by collectors, you may curse the day you applied for your first credit card. If you're straining to make minimum payments that feel like maximums, you may swear you'll never borrow again. If you've just graduated with massive student loans, you may question why you ever thought going into debt for education was a good idea.

Even if you've got your bills under control, you may fret about the interest you're paying to some faceless lender or worry that some setback—a job loss, illness, or divorce—could sink your financial ship.

Many books about debt agree with you that owing money is awful, terrible, wicked, and something to eradicate as soon as you can. The authors recount how many dollars are wasted each year on interest payments, and they use anecdotes of people who lost their homes, their marriages, their health, and their peace of mind to too much debt.

They're right that debt when mishandled can be as corrosive as cancer. But the usual prescription is to pay off everything as quickly as possible and learn to live debt-free. The message is enforced with testimonials from people who overcame mounds of bills and who are proud that they live entirely on cash, no longer owing anyone a dime.

Unfortunately, this approach may not be realistic, and it can easily backfire.

Debt Isn't the Enemy

People with serious debt problems may try to do too much too fast and then give up in despair. Or they might pay off the wrong kinds of debt, stranding themselves with too little flexibility to survive a financial crisis. In their zeal to pay off debt, some people neglect other important goals, such as saving for retirement, a home, or college, and ultimately end up hundreds of thousands of dollars poorer than they might have been.

Worse yet, they might be encouraged to continue fighting a battle they simply can't win.

If you're having debt problems, you need information, advice, and a clear-eyed assessment of your financial situation so that you can make the best choices for yourself and your family. Short-term fixes and inspirational slogans might help, but you shouldn't choose them at the expense of your long-term economic health.

Even if you're not in a crisis, it will help you enormously to view debt for what it is: a financial tool that's virtually essential for building wealth, reaching your goals, and living happily.

Think about it. Few of us could afford a home without taking on a mortgage, and many couldn't swing college educations without the help of a few loans. Consider the payoffs:

- The massive growth of the mortgage industry has helped boost the U.S. homeownership rate to nearly 70%, compared to less than 44% in 1940. That, in turn, has helped millions of families get richer: The median net worth for homeowners in a recent Federal Reserve study was $171,700, compared to just $4,800 for renters.

- Student loans helped more than 50 million people attend college, an investment in their futures that pays off in higher incomes and greater productivity. One study found that college graduates usually recouped the cost of their education, including the earnings they missed while attending school, by the time they were in their early 30s.

Debt also can help you survive a job loss, buy a safe car for your growing family, or even start a business—and sometimes all three.

I was raised by a mother who hated debt. She taught me to pay off my credit cards in full every month (thank you, Mom!) and to live within my means. I inherited her distrust of lenders to the point that, after my sophomore year at a small Northwest college, I turned down Stanford University's offer of admission as a transfer student because its financial aid package consisted entirely of loans rather than scholarships or grants.

Imagine my surprise, then, the first time I heard a financial planner tell a client that debt wasn't necessarily bad.

The advice was part of a "money makeover" feature I was writing for my newspaper. The planner suggested our makeover subject invest in her retirement plan rather than rushing to pay off her low-rate student loan debt. The idea that debt repayment needn't always be a top priority was news to me.

Later, I would consult with planners who routinely suggested that their clients open home equity lines of credit to supplement their emergency funds. I had always thought that home equity was sacrosanct, but these planners—smart, objective folks at the top of their field—pointed out it could also be a tool.

I'm glad I got that education because a few years ago my husband and I were able to put it to use.

My husband, who works in the animation industry, was laid off during a massive corporate downsizing that put 4,000 artists out of work. It was several months before he found another full-time job.

Just when our emergency fund was hitting a low ebb, Microsoft approached me about leaving my job at the *Los Angeles Times* to write for MSN. The money was great, and I could work from home—but because I would be forming my own corporation and MSN would be a client, there would be a three-month gap before I got my first check.

Oh, yes, and right after I decided to take the leap, I discovered I was pregnant.

Now, many in the anti-debt crowd would have told me not to leave my job—that it was too great a risk. I took it, though, and we lived on credit cards until those first checks started coming in. After our daughter was born, we used our home equity line to purchase a safer car.

Just a few years later, our income has soared. The credit cards have long since been paid off, and the car borrowing will be retired soon. Debt gave us the flexibility to seize an opportunity that might otherwise have passed us by.

When "Good Debt" Isn't

Debt clearly has a place in our economy and in our lives. That's what many financial gurus are trying to get across when they divide debt into "good" and "bad" categories. Typically, mortgages, student loans, and borrowing to start a business are considered good; most other borrowing is considered bad.

But that leads to another problem with typical debt advice, since too much "good" debt can sink you just as deep as too much "bad" debt.

I've received countless e-mails from people who borrowed $20,000, $50,000, and even more to attend college, only to find that they can't get a job in their field or make even the minimum payments on what they owe. Many had no clear idea of how much their borrowing would cost them when they graduated; they just knew that lenders were eager to give them the cash and that their educations were supposed to help them get ahead.

Furthermore, student loans are almost never wiped out in bankruptcy court, so they can be an albatross that hangs around your neck for life.

Charles borrowed more than $100,000 for his education, but a divorce caused him to drop out of his doctoral program before he got his PhD. He found a job paying $40,000 a year, and his lender agreed to reduce payments based on his income. But his debt is still accruing interest.

"My loan just keeps getting bigger and bigger," he wrote. "I have no hope of paying [it off] unless I win the lottery."

Mortgages are another area where people can quickly get in over their heads.

Many people assume, incorrectly, that a bank wouldn't lend them more money than they could comfortably repay. In fact, lenders know that you'll move heaven and earth to pay your mortgage, even if it means you don't have enough money for other goals, like retirement or vacations.

The reality is that you need to know your own debt limits based on your individual situation and goals.

Which Debts Should You Tackle First?

Then there's the issue of how to prioritize your bills. Often borrowers are advised to figure out which of their debts have interest that's tax-deductible, and to pay those last. They're told to concentrate on paying off the highest-interest-rate, nondeductible debts they have, while paying the minimum on other debts. Once the high-rate debt is paid off, they're told to apply the same payments to the next-highest-rate debt, in a process known as "snowballing."

In some cases, though, it can make more sense to pay a lower-rate debt first, or even a deductible debt before a nondeductible one.

Ginny owed $30,000 in student loans at 5% interest as well as $35,000 on her home equity line of credit, which hovered around 4%. Her income was too high to deduct her student loan interest, but her credit line payment was a write-off. The conventional wisdom would have her pay the student debt first.

But student loans have a feature not common to most other debt: You can get a forbearance (a temporary suspension of payments) that allows you to skip payments while you're unemployed. Since Ginny works in an unstable industry, she resolved to pay down the home equity line first so that she could use the freed-up amount of credit again in an emergency.

The key to managing your debt wisely is knowing which debts are helpful to you and which will leave you worse off. You need to figure out how much debt you can realistically take on so that you don't swamp your financial ship. You need to know when to accelerate your payments and when to pay the minimum. In short, you need to look at debt as a key part of your financial plan, rather than as a scourge that can and should be erased from your life.

Ultimately, being debt-free is a great way to be. But you want to get there the smart way.

Why Debt Management Sounds Strange

The idea of managing your debt rather than eradicating it is foreign to many people. If you have Depression-era parents or grandparents, you may have heard their tales of once-wealthy folks losing everything because of debt. In those days, lenders could "call" loans at will, demanding immediate repayment. As the economy crashed, many did so, meaning that people who had mortgages could face losing their home even if their payments were current.

But the roots of our unease go even deeper. Long before Ben Franklin opined, "So rather go to Bed supperless than rise in Debt," Americans believed there is something shameful about owing money.

In colonial times, excessive debt was a crime that could land you in jail—where you would remain until you, or your family, somehow paid what you owed. More than a few people died of the rampant disease and terrible conditions that typified prisons of that era.

Debtors' prisons weren't outlawed in the U.S. until 1841, and bankruptcy continued to carry a huge stigma until the end of the 20th century.

Of course, our cultural suspicion of debt hasn't kept us from piling up mounds of it. If you know anything about debt in America, you probably know that we owe more than people in any other country, and our pile of IOUs just keeps growing:

- The amount we owe on credit cards and home equity loans has tripled since 1990.
- Household debt burdens have risen to near-record highs, with 20% more of our disposable incomes devoted to debt than was the case 20 years ago.
- The amount and length of the typical car loan continues to increase. In the 1980s, the typical car loan lasted three years; today, 84% of all new car loans last more than four years.
- The average homeowner's equity represents just 55% of the home's value—down significantly from the 65–67% levels that were typical in the decades before 1990. What's remarkable is that equity dropped even as home prices rose spectacularly, indicating that people are putting down less and draining the value from their homes through home equity lending at a furious pace.

It's obvious that some people are overdosing on all this debt. Bankruptcy filings for individuals set new records in 2001, 2002, and 2003 before declining slightly in 2004. Foreclosures in 2003 reached their highest level in 30 years—a remarkable feat considering that foreclosures don't usually rise in a hot real estate market when most homeowners can sell their homes quickly. This indicates that a rising number of homeowners may owe more on their homes than the houses are worth.

Even when people manage to make their payments, the price of debt can really add up over time. The typical homeowner will pay for her house two or three times over by the time she retires a 30-year mortgage. Carrying just $5,000 on your credit cards can cost you $650 a year on average—money that, if invested instead, could grow to $170,000 over your working life. Most people who buy new cars these days are "underwater" as soon as they drive off the lot. They will make payments for years before their car debt is less than what the car is worth.

When Debt Repayment Plans Go Awry

So how could anyone argue that paying off debt is a bad idea?

I can, if you're approaching it in any of the following ways:

You're paying off the wrong debt. In the late 1990s, banks started pushing biweekly mortgage payment plans aimed at helping homeowners pay off their houses faster. By making payments once every two weeks, instead of every month, the homeowner would effectively make one extra house payment a year, shaving years—and thousands of dollars in interest costs—off their loans.

With a $200,000 mortgage at 6% interest, for example, the normal monthly payment would be $1,199.10. By making half that payment ($599.55) every two weeks instead, a homeowner could pay off the home five years early and save $47,282 in interest.

When the stock market started to tank in the spring of 2000, these plans got even more popular. People felt a lot better about "investing" money in their steadily-appreciating homes than they did "throwing it away" on stocks.

The problem with this approach is that many who pursued it were neglecting other financial goals or carrying other, far more expensive debt—including credit cards and personal loans.

The average credit card carries an interest rate of 13% or more, more than twice as high as the mortgage in our example. Furthermore, you typically can't deduct credit card interest on your tax returns. The deductibility of mortgage interest can reduce the effective rate you pay to 4.5% or even less, depending on your tax bracket.

There's something else you should consider—inflation. Most people realize that higher prices gradually erode the value of the dollar, which means many things will cost more in the future than they do today. But inflation also makes debt *cheaper* as time passes. The fixed-rate mortgage payment that seems so onerous today will be much less so in 10 years and might seem almost an afterthought in 30 years.

"Most people don't understand that even modest inflation makes a fixed mortgage payment cheaper every year it's in existence," wrote David, one of my readers on MSN. "My first mortgage, 28 years ago, was $271.60 a month. Had I stayed in that house, I would be spending far more today on my monthly utility bills than my mortgage."

By contrast, money you invest has a chance of beating inflation over time. That means your purchasing power can actually grow, particularly if you invest it in stocks or stock mutual funds. If you're forgoing the chance to invest while you prepay your mortgage, you've really got your priorities backward.

Mortgages are some of the cheapest money you'll ever borrow. Such low-rate, tax-advantaged debt is usually the last kind of borrowing you want to pay off.

You're limiting your financial flexibility. Carlos graduated from college in 1998 with $20,000 in student loans—more than most students at the time, but about average these days. He consolidated his loans to lock in the prevailing 7.455% interest rate. He decided to double his $237 monthly payment to retire his loan faster. Instead of taking 10 years to pay off the balance, he did it in just over five, saving about $5,000 in interest.

Then he lost his job.

If Carlos had put the extra payments into savings instead, he would have had an emergency fund of more than $11,000 by the time he was let go. He could have lived off the cash and asked his student lender for a forbearance while he looked for work. Instead, he had no cash, and his landlord, utilities, and car lender weren't interested in giving him a forbearance; they all wanted their regular payments on time.

By paying off his debt early, he limited his financial options instead of enhancing them.

This issue of financial flexibility has become critical in the last decades as incomes have become more variable, layoffs more common, and bankruptcies a near-epidemic.

Fewer than one in three households in America have enough cash saved to survive more than two or three months of unemployment—and the typical time out of work during a recession can stretch to eight months or more.

An incredible 43% of households have less than $1,000 set aside, according to an analysis of Census Bureau data by SMR Research.

So many families are living paycheck to paycheck that any crisis can tip them over the brink: a job loss, divorce, illness, or accident. (The Bureau estimates that 45 million Americans are uninsured, while millions more are underinsured.)

Instead of focusing single-mindedly on paying off all debt, today's families need to figure out how to put themselves on sound financial footing overall.

You're cutting yourself off from credit entirely. I often receive e-mails from folks who are paying off their credit cards and proudly closing down the accounts once the balances hit zero. They vow to never again use another piece of plastic.

Yet credit cards can be an important safety valve to help families survive job loss or other setbacks. If you don't have enough cash set aside in an emergency fund, you can live on your cards temporarily until the crisis passes.

Furthermore, you generally need to *use* credit to *get* credit. The credit-scoring systems employed by most lenders require you to have and use revolving accounts like credit cards to get the best scores.

Closing accounts can actually hurt those scores and make it more difficult to get future credit. The next time you need a mortgage or a car loan, you could be at the mercy of subprime lenders that charge astronomical interest rates to people with troubled or thin credit histories.

None of this means that you shouldn't learn to live on cash alone while you're repaying your debt. Just don't close the accounts once you've paid them off unless you really and truly can't keep from using them otherwise.

There are certainly people who have completely lost the ability to control their spending. One of them e-mailed me after filing bankruptcy for the third time. He wasn't the victim of bad luck, bad health, or unemployment; he simply spent too much money.

"If I make $150,000, I spend every single dime," he wrote. "What can I do to get my credit back and stop this madness?"

Credit to this man is like booze to an alcoholic. There is no safe way for an alcoholic to have even a single drink, and there may be no safe way for a chronic credit abuser to have plastic.

If that describes you, consider getting help through therapy or a 12-step program like Debtors Anonymous or Overspenders Anonymous.

Most people, however, can survive a credit crisis and move on to responsible credit use.

You're neglecting your retirement savings. One of the pieces of debt advice that most disturbs me is when people are urged to forgo retirement contributions to free up cash to pay their credit cards.

Yes, this will get the cards paid off more quickly—but at what long-term cost?

The problem is that contributions to retirement plans are usually a use-it-or-lose-it proposition. In other words, you can't get back an opportunity to contribute to a tax-advantaged retirement plan once you've let it slip away.

Many employers, for example, will put 50 cents into your 401(k) for every dollar you contribute, up to a certain cap—typically 6% of your salary. If you make $45,000 but don't contribute that 6%, you're missing out on $1,350 of free employer matching money each year. Even worse, you're passing up all the future, tax-deferred growth of your contribution and the employer match.

Let's say you suspend contributions to your 401(k) for five years while you pay off debt. We'll assume that you resume contributions at that time and retire 30 years down the road. If your account earns an average 8% annual return—which, given long-term historical trends, is a reasonable assumption for a portfolio invested 70% in stocks and 30% in bonds—your five-year hiatus could cost you more than $200,000.

You can try to make up for lost opportunities once your debt is paid off by making bigger payments to your retirement plans. But the amount you can contribute to tax-deferred plans is limited by law and often is limited further by company policy. Even if you could somehow compensate for the contributions you failed to make, you simply can't get back the free money you passed up in company matches, or the value of time in helping your money grow.

Here's another example of how this trade-off works. One of the posters on a message board I monitor at MSN was trying to decide what to do with an extra $250 a month: pay off her car loan or fund a Roth IRA.

Accelerating the payments on her $20,000 car loan would save two years on the five-year loan and save her more than $1,000 in interest, and it's the option many posters on the board urged her to take.

I pointed out that the same money, contributed to a Roth, could grow to more than *$175,000* of tax-free money in 30 years.

This isn't just an academic issue. Saving for retirement is critical, and by all reports most Americans are doing a pretty lousy job. Few of us will have the cushy, traditional pensions that previous generations relied on to fund their retirements, and many of us suspect Social Security won't be much help either. We need to be saving more and starting earlier—not delaying or interrupting our contributions.

You're raiding your retirement funds. Chris and Suzanne in Tennessee have $40,000 in credit card debt and $18,400 in an old retirement plan at Suzanne's previous employer. They want to pull it out to pay off part of their debt. They e-mailed me, asking if this was the right thing to do.

"We have been in debt for many years, and this could help kick-start us in getting out of debt," they wrote.

Most people have at least a vague notion that carrying credit card debt is a bad idea. So when they leave a job and their employer sends them a check for their 401(k) balance, they think they're being responsible by using the money to pay off credit card balances.

But if there's one thing worse than suspending retirement savings, it's raiding what you've already set aside.

Chris and Suzanne would face a tax bill come April 15 for taxes and penalties that will equal one-quarter to one-half of the withdrawal they just received. Furthermore, they're giving up all the future tax-deferred returns that money could have earned. (Figure that every $1,000 you withdraw will cost you $10,000 or more in future retirement income.) What they should do is roll the money into an IRA and find other cash to pay off those credit-card bills.

Otherwise, they're just opting for another quick fix that simply makes their financial situation worse. That kind of approach—grabbing for a short-term band-aid rather than the long-term cure—prevents many people from overcoming their debt problems.

Remember how I said there were worse ways to spend retirement money? I often get e-mails from people asking how they can withdraw money from their retirement funds so that they can pay off their *mortgage* early.

Think about that. They're proposing giving up tens of thousands of dollars in tax-deferred future gains and incurring a fat tax bill, so that they can pay off a low-rate, tax-deductible debt. That's just nuts.

Some people propose a variation on the theme. They understand that withdrawals from retirement accounts are stupid, but they think it's a good idea to borrow from themselves via a loan from their 401(k) rather than continue paying interest to a lender.

The big problem with this approach is that 401(k) loans typically come due if you lose your job. If you can't pay back the money quickly, it can be taxed and penalized as a distribution.

There's something else to consider. If your financial situation really takes a dive, you may be able to wipe out your credit-card debts in bankruptcy. Once you've paid them off with a 401(k) loan, that option is gone.

I also wonder how many folks who use 401(k) loans to pay debts are really covering up a serious spending problem. As long as they can keep shuffling loans around, they may never address the real cause of their financial problems: themselves. Forcing yourself to leave retirement plans for one purpose—retirement—can lead you to find real solutions that will ultimately create, rather than destroy, future wealth.

Your debt situation is hopeless. Like many others, I used to think that most people could avoid bankruptcy if they really tried. Now, after writing about the issue for more than a decade, I'm not so sure.

I've heard from too many people who faced six-figure medical bills or credit card debt that totaled more than their entire year's salary. They could struggle for years and still never pay off what they owe. Some empty their retirement funds, drain their home equity, and scrimp for years without ever making an appreciable dent.

Sure, many of these folks could have avoided the fix they were in. But many were as much victims of bad luck as bad choices. And some made decisions that the rest of us would be hard-pressed to fault.

Paul, a military officer, found himself $70,000 in debt after his wife Debbie was diagnosed with breast cancer. The conventional treatments didn't work, so the couple opted for experimental therapies their insurance didn't cover.

For Paul, there didn't seem to be any choice: Go into debt or say no to the only hope his sweetheart had.

"Debbie didn't survive," Paul wrote me, "but I would do the same again in the same circumstances."

Richard's long slide into bankruptcy started when he was laid off from a defense industry job at age 47.

"I worked hard, was a company man, and did the 50-to-80-hour workweek week after endless week, for years," said Richard, who lives in California. "I soon found, however, that my defense-specific knowledge and skills were nearly worthless in the commercial world."

Richard eventually found work, but not before racking up debts that proved unpayable on his new, lower salary.

Dan and Leah were managing just fine until their young son developed reactive airway disease and landed in the hospital with pneumonia. Dan's employer fired him because he missed too much work while attending to his son; without health insurance, the medical bills had to be paid for out-of-pocket.

"We filed for bankruptcy, and that was very difficult," Leah said. "I remember crying at the courthouse. I felt like such a failure for not being able to take care of our own debt."

Paul, Richard, Dan, and Leah have plenty of company. More than 1.5 million personal bankruptcies were filed in 2004.

What many people find is that bankruptcy isn't the credit-killer it used to be. Although the bankruptcy remains on their credit reports for up to 10 years, the growth of credit scoring and the subprime lending industry means that those who have declared bankruptcy can get credit cards before their cases have even closed, auto loans within a few months, and reasonably-priced mortgages within two years. Those who handle their finances correctly after bankruptcy find that they can restore their credit scores to near-prime status within four years of their filings.

Of course, some people feel such a strong moral obligation to repay their debts—however they were incurred—that bankruptcy is not an option.

Many people, though, are simply ignorant of their alternatives or the true gravity of their situation. If anything, they wait too long before they file, continuing to throw money after impossible debts when they could be using that cash to rebuild their lives.

Bankruptcy court is meant to give people a fresh start while protecting their homes and retirement funds, to prevent them from facing a poverty-stricken old age. Bankruptcy should never be the first choice, but sometimes it's the best of very bad options.

How can you tell if it's the right option for you? In the next chapter, you'll see how to evaluate your financial situation, prioritize your debts, and find the expert advice you may need to make that decision.

Addressing the Ants as Well as the Grasshoppers

I'll never forget the father who wrote to me proudly detailing his progress at becoming financially independent. He and his wife were saving prodigiously for retirement, and they had a fat emergency fund. They decided that their next goal would be to retire their mortgage as early as possible. When he worked the numbers, though, he realized that accelerating the mortgage payments meant they'd have to cut way back on their vacation fund. They had long wanted to take a special trip with their daughter, who was 11. He asked me if I thought it wise to put off that journey until the mortgage was retired.

If you have teenagers, you will probably understand my response to him. Go on the trip now, I told him, while your daughter is still delighted to spend time in your company and you can really enjoy the trip as a family. Before you know it, she'll have all sorts of interests and friends that will make her reluctant to take a long trip with her folks, and then she'll be off to college. Seize the moment and go now. The mortgage will still be there when you get back.

That advice shocked a few folks, who presumed that it's always better to save than to spend. In reality, financial planning isn't about one or the other; it's about both. The hardest part of managing your money can be figuring out the balance between living fully today and preparing for the future.

Most debt advice is aimed at the grasshoppers—people with a "live for the moment" attitude. They wind up paying for every purchase two or three times over, because they put it on their credit cards, pay just the minimum balance, and rack up prodigious interest charges over time.

But we shouldn't forget the many ants out there—people who may be erring on the side of living too much for the future. After all, life is not a dress rehearsal—it's the only one you've got. Make sure you live it along the way.

Debt-Free Is the Way to Be—Eventually

Although debt has its place, I'm not among those who believe that it's always better to use "other people's money." These folks advocate having a mortgage as long as you live because you can almost always invest the money at a higher rate of return than you're paying.

That may be true, but there's a strong psychological advantage to being beholden to no lender in retirement, when your income will likely be fixed and your ability to survive financial setbacks may be lessened. Knowing that their house is paid for helps a lot of older folks sleep soundly at night.

Summary

Let's review some important concepts that will guide you throughout this book:

- Debt is a tool that, if handled properly, can help you create wealth.
- "Good" debt can sink you as quickly as "bad" debt; you need to determine your own limits.
- Mortgage debt is some of the cheapest money you'll ever find and is usually the last debt you'll want to pay off.
- The order in which you should pay off other debt depends on your individual situation and goals—not one-size-fits-all advice.