Sorting out the 'good' debt from the 'bad'

by Jason_Alderman

You may have heard people refer to "good debt" and "bad debt." Ideally, we'd have no debt at all because we'd be rich enough to never need a loan. But few of us belong to that exclusive club, so sometimes we take on debt out of necessity.

One key to achieving financial stability is to minimize bad debt wherever possible, while looking for opportunities where so-called good debt works to your advantage. A simple distinction: Good debt can help boost your credit rating or allow you to buy something that will increase in value over time, while bad debt often fuels purchasing items that are disposable, unnecessary or that rapidly depreciate in value.

Good debt might include:

Building credit history. One of the best ways to build a strong credit history is to show lenders that you can pay off debt responsibly, possibly by taking out a student loan to finance your education, or by opening a credit card account and using it wisely. Lenders are more apt to qualify you for a mortgage, car loan, or other large debt if you've demonstrated sound repayment behavior, and they usually reserve their best rates and terms for good-risk candidates.

However, keep in mind that carrying excessive loans or high-limit credit cards may harm your credit rating because you could potentially take on more debt than you'd be able to pay back.

Investing in your future. According to the U.S. Census Bureau, high school graduates earn, on average, $1.2 million over a lifetime, while someone with a bachelor's degree will average $2.1 million - nearly twice as much. Escalating college costs sometimes force young adults to enter the workforce saddled with overwhelming debt - or cause their parents to postpone saving for retirement. Talk to a financial advisor or high school guidance counselor about scholarships, low-income grants and financial assistance options as early as possible.

Buying a home. Chances are, once you pay off your mortgage your home will be worth far more than it originally cost. Plus, the interest and mortgage points you pay are tax-deductible, which lowers your taxes. Just make sure you don't buy more house than you can afford - that includes mortgage payments insurance, property taxes, utilities and repairs. (The same goes for buying too much car.)

Bad debt. Fancy meals out, excessive vacations, and unnecessary clothing or electronics all can result in bad debt if you're not careful. If you can't pay the bill in full within a month or two, reexamine whether it's a worthwhile expense, particularly if you don't have an emergency cushion of money in the bank or are trying to

save for a car or home.

There are many warning signs you may be carrying too much debt - bills start piling up, you can barely afford minimum payments, using one credit card to make payments on others, etc. Practical Money Skills for Life, a free personal financial management site sponsored by Visa USA, contains a complete guide to debt management, including calculators that help you determine the true costs of borrowing.

Bottom line: Used correctly, certain debt can work in your favor. Just make sure you're managing the "bad" debt so it doesn't manage you.

Sorting out the 'good' debt from the 'bad' by Jason_Alderman