The Myth of 'Good' Debt

By David Francis | Fri, Apr 27, 2012

The economic crisis and the tepid pace of the recovery have left millions of Americans deep in debt. And amid this slow recovery, many are struggling to make minimum payments to keep ahead of creditors.

The amount of debt the average American holds is staggering, compared with the average American salary. In its latest findings in 2010, the Social Security Administration calculated the average American wage index to be $41,673.83.

According to Creditcards.com, a website that tracks the credit card industry, the average American household holds $15,956 in credit card debt. The Census Bureau has determined than 60 percent of Americans own their homes; many of these people still owe money to a bank for mortgage payments. Estimates on the size of these payments vary, but most organizations say the majority of monthly payments fall between $700 and $1,700 per month.

On top of that, most Americans have to borrow money to buy a car. According to the auto website Edmunds.com, monthly car payments should average between 8 and 11 percent of monthly income, although many people pay more. College students are also forced to take out loans to pay for education. The Project on Student Debt has found that the average graduate of a four-year nonprofit university carries more than $25,000 in loans.

Based on these numbers, it seems almost impossible for the average American to be debt-free. But there are steep variations among these loans. Paying off some loans should be a priority. Others, while burdensome, can wait.

Better debt vs. worse debt. Prior to the Great Recession, many financial experts differentiated between "good" debt and "bad" debt. The former included loans with low interest rates, such as a home loan. Because the value of a home presumably appreciated over time, the debt helped the borrower work toward building wealth. "Bad" debt included credit card loans, or loans taken out to pay for things that current cash reserves couldn't cover. The value of the product purchased with the credit card immediately depreciates upon purchase, while the money placed on the credit card immediately begins to accrue interest.

But according to David Bach, author of the Finish Rich book series and founder of www.FinishRich.com, the financial downturn changed these perceptions. "Good debt and bad debt is almost a myth that we were sold for 20 years," Bach says. "There's just debt. For the most part, debt is basically bad and difficult. It comes down to the interest rate."

Debt now seems to fall into two new categories: better debt and worse debt. Better debt is a loan with a low interest rate used to purchase something that adds value. Worse debt is used to buy a depreciating asset or debt used as a substitute for cash. A home loan, according to Bach, is an example of better debt.

"For the most part, most people have to borrow money to buy a home. The key is if you borrow money to buy a home, the faster you pay that loan off, the faster you're free," Bach says.

The Catch-22 of debt is that one needs to go into debt to be considered a credit-worthy borrower with the ability to pay off large loans. Rod Ebrahimi, founder and CEO of ReadyforZero, a website that helps people plan to get out of debt, says establishing a good credit score is imperative for transitioning out of college. "A good debt you could have had through college is a credit card you had going into college and never carried a large balance," he says. "It may actually make sense to have some history."

However, Bach warns that this kind of debt can quickly become burdensome if the cardholder doesn't manage it responsibly. "If you're going to borrow money on your credit card, the goal should to be pay it off in full at the end of the month," Bach says. "Don't get stuck in the trap of paying minimum payments. Pay off these cards as fast as possible."

Making sound education decisions

Ebrahimi says the growing student loan burden and the poor state of the economy, especially for young people, means students must approach student loans differently. They are often necessary, but one needs to be strategic in how they are used. He warns against using loans at for-profit universities, which promise much but often fail to deliver jobs that allow students to pay off their loans.

"At for-profit schools, you can get all kinds of degrees and you end up with six-figure debt, then can't find a job that allows you to pay them," he says.

He adds that loans should also be used strategically at nonprofit universities. "There can be good and bad students loans" at nonprofit universities, Ebrahimi says. "Many people believe they can pay at any university," but often, payments at state school are easier to manage.