Is There Really Such a Thing as "Good" Debt?

We often see articles about or hear about something called "Good Debt", and if you're like me you may wonder how any kind of debt could be considered good. The emotional, physical, and psychological effects of debt are getting more and more attention by the medical community, and credit card debt, household debt, and the national debt get plenty of headlines. So what might be considered good debt? Let's take a look at some debt and decide for ourselves.

For debt to be good, it would have to provide a benefit…a benefit that outweighs the burden of carrying the debt, and the affects that debt has on our decisions and planning. Long after the purchase, debt is like a taskmaster that must be paid first…with interest. Debt is always considered first in financial planning and when a financial decision is being made. It's true that borrowing allows us to buy things that we couldn't otherwise buy, and there are times when there seems to be no other option. Such as the purchase of a home, a child's education, or an unexpected major medical expense for example. Bad debt is when we buy things on credit that we "wouldn't" otherwise buy, and can probably do without. This debt stakes a claim on our lives and these kinds of purchases need more severe scrutiny. This is truly bad debt.

One of the most popular "good" debt topics is a mortgage. Proponents point to the tax deductions associated with a mortgage, and many call this good debt. There are many good reasons to buy a house, but being able to deduct mortgage interest from our income taxes is really not one of them. In the highest tax bracket (top wage earners), the deduction return is 35%. So for every $1.00 paid in mortgage interest, the deduction saves us $0.35. This is in the top tax bracket, and it goes down from there. Here are the others (2013 tax bracket data):

Single			Married Filing Joint		
Taxable Income between		Bracket	Taxable Income between		Bracket
$0	$8,700	10%	$0	$17,400	10%
$8,700	$35,350	15%	$17,400	$70,700	15%
$35,350	$86,650	25%	$70,700	$142,700	25%
$86,650	$178,650	28%	$142,700	$217,450	28%
$178,650	$388,350	33%	$217,450	$388,350	33%
$388,350	and above	35%	$388,350	and above	35%

Example: If my wife and I earn a combined total of $128,000 a year, then for every $1.00 of mortgage interest that we pay we get $0.25 back. This is not a winning proposition. Any investment that loses 75% every year is not a "good" investment. For many years, homes appreciated in value and that would factor into the scenario, but as we've seen in the last five years, home value appreciation is something we shouldn't count on.

Another popular "good" debt suggestion is Opportunity Cost. Very simply put, opportunity cost is the return on investment that I give up when I use my money a different way. It's what I could make in interest, if I don't take my money out of savings to buy something. Here's an example.

Let's say I have $15,000 in my savings account that pays me 0.5%, and I need a new car. I find a car in very good shape for $15,000. I could pay cash using my savings, or I could finance the car at the current interest rate…let's say 6%. Remember, my savings account is paying me 0.5% interest.

1) **Financing:** My savings account is earning 0.5%, and the car loan would be 6% interest. I'd keep my cash handy in the account and continue to earn 0.5%, but I'd be paying 6% on the loan. I'm giving up 5.5%.
2) **Paying Cash:** If I pay cash for the car, I no longer pay the 6% interest on the car loan, but I give up the 0.5% that I'm earning on the savings. I'm giving up the opportunity to earn 0.5%, in order to purchase the car with cash and not have a car payment.
3) **Muddy Water:** To complicate things a little, I hear about an investment that is returning 7.5%. Now I can invest the $15,000 and earn 7.5% while buying the car through financing and pay 6%. This way I actually earn 1.5%. If I decide against the investment and pay cash for the car, my opportunity cost is the 7.5% (what I could have earned with the investment). If I finance the car and leave the $15,000 in the bank, I pay 6%, give up the opportunity to earn 7.5% on the investment, but I earn 0.5% on the savings. Maybe I was better off not knowing about the investment.

So, would any of these options be considered good debt? It depends…

There are emotional and psychological aspects to this too that must be considered. Some people prefer to finance items when they could pay cash, and keep their cash in the bank. Others prefer to keep their money invested and borrow at lower rates than what they're earning (when possible). It's an individual decision.

I'd rather not associate the word good with debt, but here's a potential good debt scenario. Let's say I'm 22 years old, I have a job, and I need to establish credit for those times when it's necessary (hopefully later in life). I have $12,000 in savings and I need a car. I find a new car that I like for $18,000 and I can get 0% financing for 5 years with a $2,000 down payment. The car comes with free maintenance up to 39,000 miles. I run it by my parents as a double check, they agree, and I buy the car. The interest rate on the loan is 0%, and I pay a little more each month than the required payment. The benefit is establishing credit. Something I really can't do except to borrow and pay back so it goes on my credit report. The interest (cost of the loan) is 0%. The remaining $10,000 in my savings is the cushion, and there's a benefit. I establish good credit.

This scenario might seem too good to be true, but what do we do when we don't have the cash and need something quickly? We've all seen car dealers offer 0% financing, but it's usually when we're not shopping for a car. We need to align our purchases with seller incentives. When we can't (like when the refrigerator breaks), that's when we tap our emergency fund. If we haven't established an emergency fund, sometimes signing up for a store credit card when we need to buy an appliance quickly can come with a great savings. Just don't use the card after that. If we can wait for a good deal, or look around and take advantage of dealer and seller incentives, we can often save ourselves large amounts of money.

Another example is a loan for education when the education has a measurable payback, like a job promotion coupled with a raise that requires specific courses or training. In this case we see a direct and anticipated benefit that will payoff year after year.

Impulse buying and impractical reasoning often create bad debt. A vacation taken on credit will be forgotten long before the debt is paid, and it will impact my budget month after month. A shopping spree out of boredom, or an expensive vehicle for show or because "I deserve it" is a very impractical use of credit and one that I'll pay for over and over. If I use the "48 hour Rule" and sleep on it before I make a major purchase decision (especially one on credit), I usually don't make the purchase. Why is that? Quite simply I come to my senses and realize that I really don't need it, or that I can make due nicely with what I already have.

There aren't many scenarios where debt could be considered "good". It's an individual decision, but it should be based on practicality, sound reasoning, and real numbers. Is there good debt? The long term benefit realized as a result of the debt is the deciding factor coupled with the preferences of the individual. Barring this, the only good debt, is no debt.

Email comments to: articles@jazersolutions.com