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November 1999 - A Simple Plan to Become Debt Free

Occasionally I have clients ask me to help them figure out how to pay off their debts when they feel overwhelmed by them.

For many people, there is a simple three-step plan that gets the job done in a lot less time than you might think. First, list your monthly necessities and each debt you owe. I will give an example later in this article to give you an idea how to do this.

Next, look at those monthly necessities in detail and ask yourself which could be trimmed without too much pain. Your goal is to reduce the necessities by about 10%. This is a personal decision. You could review the cost of items such as insurance, telephone, internet service, bank account fees, etc. and see if there are ways to switch plans and reduce costs. Often there are. You might also decide to eat out less or eat less prepared food to reduce those costs. If you are paying on a storage unit, maybe you could take out the truly precious items and keep them at home, have a yard sale to raise some cash to pay down the debts, then donate whatever is left to charity. Now you don't have to pay storage unit rent any more. The specific items to trim are your call, but for most people a 10% reduction doesn't hurt too much.

The final step is to look at your list of debts and find the one with the highest interest rate. If more than one debt has the same interest rate, choose the one with the lowest monthly payment. This becomes your target debt to pay off as soon as possible. As soon as you get paid, pay your bills. When making the monthly payment on the target debt, add an extra amount equal to the savings found in the previous step. This will usually pay off the target debt in just a few months. It will also force you to either stick with your reduction plan, or generate some extra income through overtime or a side job to make up the difference.

Paying off the target debt quickly will give you a great feeling of confidence that you can do this! Use this to your advantage, choose a new target debt, and apply the money that was being used to pay the old target debt as additional money to pay off the new target debt quickly also. Keep repeating until you are debt free!

I'll use for an example a single retired person, living on a retirement income of \$1,495 each month, after medical insurance premiums have been deducted. Most of the retirement income is Social Security, and so for this example the income is low enough that no federal or state income tax will be due. Living expenses for food, utilities, mobile home park rent, medical co-pays, charitable contributions, and the like total \$835 monthly. This person is making payments on a mobile home, a new automobile, and four credit cards as follows:

<u>Loan Description</u>	<u>Payment</u>	<u>MonthlyBalance</u> <u>Owed</u>	<u>Time Left</u> <u>to Pay</u>	<u>Interest</u> <u>Rate</u>
New automobile	\$305	\$16,755	5.5 yrs	6.5%
Mobile home	\$139	\$ 3,400	2.5 yrs	15.0%
Credit card #1	\$96	\$ 4,700	9.5 yrs	21.0%
Credit card #2	\$57	\$ 2,700	8.5 yrs	21.0%
Credit card #3	\$30	\$ 1,550	11.0 yrs	21.0%

Credit card #4 \$20 \$ 454 2.5 yrs 21.0%

This person's goal is to reduce monthly living expenses by \$80 and apply this to credit card #4. You would voluntarily increase the payment on this debt to \$100, which would cut the repayment time to just 5 months! Then you would target credit card #3, and start paying \$130 monthly on that, cutting the remaining repayment time to 14 months. Next you would target credit card #2, and pay \$187 monthly on it. You can do the math through the rest of the process, or you can just trust me to tell you that after less than 4 years (45 months, actually) only the debt on the new automobile would remain. This would free over \$400 each month that had been going to debt payments, and lift a huge burden in this person's life.

At this point, my suggestion would be to start saving the \$400 monthly for the 21 months that would then remain on the car loan. That way, when the car is paid off, you would have well over \$8,000 in savings, plus the resale value of the six year old car, that could be used to buy a nice 2 or 3 year old car for cash. Then you would be totally debt free, including the car, freeing up over \$700 in monthly debt payments!

What a great feeling that would be! Next month, I'll be writing some year-end tax planning ideas. I hope to have you with me then!