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October 2002 - Which Debt Should I Pay First?

Average consumer debt per household in the United States is now over \$15,800, and growing at about \$800 per household each year.¹ My personal experience dealing with the public confirms these figures and further shows average annual interest of over 18% on this debt. At 18% this debt costs over \$2,800 each year just for interest before any reduction in the balance can occur. A few people pay less interest, but many pay much more.

This article identifies some of the hidden costs of debt and then some practical steps to gradually work your way out of what can truly be a debt trap!

High Interest is Expensive, and That's Before The Added Fees

A sad example that recently came through my office was a credit card bill that could be paid in full for \$600, but had a credit limit of only \$300. The interest rate printed on the bill was 29.8%, which alone would result in annual interest on this account of \$178. That is before adding monthly fees for being over the credit limit (\$29 monthly, or \$348 per year) and for paying late (\$35 monthly, or \$420 per year). **So the total cost of having this particular \$600 credit card balance was \$946 per year, making the effective interest rate 158%.** If you paid \$75 each month on this card, but were careless and paid a few days late each time, you would wind up owing \$46 more at the end of a year of these monthly payments than you did at the beginning of the year without making any new purchases with the card!

Post-Dated Check Loans

Another expensive, but very popular loan, is the post-dated check loan. They are typically easy to get and are popular because they can temporarily solve the problem of running out of cash before the next payday. An example of this loan is to borrow \$255 for ten days by writing out a \$300 check dated for the next payday, ten days in the future. So it costs \$45 to borrow \$255 for ten days, which works out to be 17.65% interest just for the ten days (not an annual rate, that works out to be over 644%!). If an emergency hits and it is cheaper to pay the \$45 than the costs of the emergency, consumers are often thankful they can get this loan. Unfortunately, what often happens is that the loan becomes somewhat permanent, with the borrower paying another \$45 each payday just to renew the loan. **In only six paydays, you can easily wind up paying a total of \$270 for interest and still have to repay the original \$255 that was borrowed.**

Bankruptcy is Tempting, But Usually Doesn't End The Debt Trap

Bankruptcy has become very popular as a perceived escape from the debt trap. Careful planning and some sacrifice is usually a better solution in the long run, because it will change the spending habits that actually began the problem. The high interest and fees of many debts, mentioned earlier in this article, do compound the problem and make it hard to escape once the downward spiral has begun. Bankruptcy, without a change in habits, will often lead to a new set of debts replacing those discharged in the bankruptcy, thus continuing the debt trap.

The Solution – Careful Planning, Sacrifice, and Repaying The Costliest Debt First

Start with careful planning and record keeping. If you're married, do this planning together!

- (1) Make a list all of your debts and obligations, including total payoff amount, monthly payment, interest rate, and other fees that may apply to each item. When you have completed the list, put them in order with the most expensive item first, then the second most expensive, and so on. Add the fees to the interest to determine the full cost of each item on the list.
- (2) Make another list with two sections. In the first section list all your certain sources of income each month. In the second section list each necessary monthly living expense you have, but don't include any of the past debts or obligations from the first list. Total both of these sections. The difference between the two is the amount you can use each month to pay the items in the debts and obligations list (see item (1) above).
- (3) If you can, pay the minimum payment on each item in list (1) above, and then take all the remaining money in step (2) and apply it to the most expensive item to pay it off as soon as possible. You will often find that it can be paid in just a few months by focusing on this one debt. You will feel tremendous with this one small burden being gone!
- (4) Once the most expensive debt is paid, review the list again to see if any of the fees have changed. Repeat the process in step (3) to pay off the new costliest debt, which will give you another wonderful feeling of accomplishment and reinforce your new resolve to become debt free.
- (5) If you don't have enough money to make all the minimum payments in step (3), contact each creditor, explain your situation, and work out temporarily lower payments with those who will do so. Many of them would rather get something on a regular basis than be ignored, and will be willing to work with you, especially if you reinforce this by actually making each month's new agreed payment on time.
- (6) Keep a detailed record of everything you spend every day for the next 90 days.** This is the most important step of all. You will be amazed at all the places your money is going that you didn't realize, and will develop a passion for finding less expensive ways of doing things. It will become almost fun for you to do this! As you see progress each month in reducing your daily spending, get a glass jar and put the money you didn't spend in it.
- (7) Each month take the money in the glass jar (see step (6) above) and add it to your payment on the costliest debt (see step (3) above) to pay it off quicker. When that debt is gone, it will be like getting a raise equal to the amount you were paying each month!
- (8) Keep looking for ways to save money. There will be some sacrifice involved, but I promise the relief you will begin to feel even after 90 days will make the sacrifice well worth it! Review your tax planning and see if there are things you could change that would result in paying less tax. Check if refinancing debts at lower interest rates are an option for you. See if you can share rides on occasion and split the cost. Try using a TV antenna instead of cable. Buy a carton of ice cream and have a treat at home while finding entertainment there instead of going out. (Be sure to turn the phone off while you do this so you actually have a quality experience with your family.) Read the paper, magazines, or books at the library instead of buying them when practical. Experiment with your menus to find tasty items that cost less. (As you keep track of your spending, you will be amazed how much you can save by preparing meals from scratch rather than eating out, buying pre-packaged food, or buying soft drinks on the go).

The more you ponder how to do these things, the more great ideas will come!

- (9) Smile! Realize you can do this!

Important Note!

The information in this article is intended to inform you of some of the opportunities provided in the tax laws or elsewhere. It is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional! Please call or e-mail me (dougbeecher@yahoo.com) if you are not my client and would like a free initial 30-minute consultation to discuss your personal situation and how the tax laws might benefit you.

Please contact me with questions you'd like to have answered in a future article.

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