How to Reduce Debt and Live within Our Means

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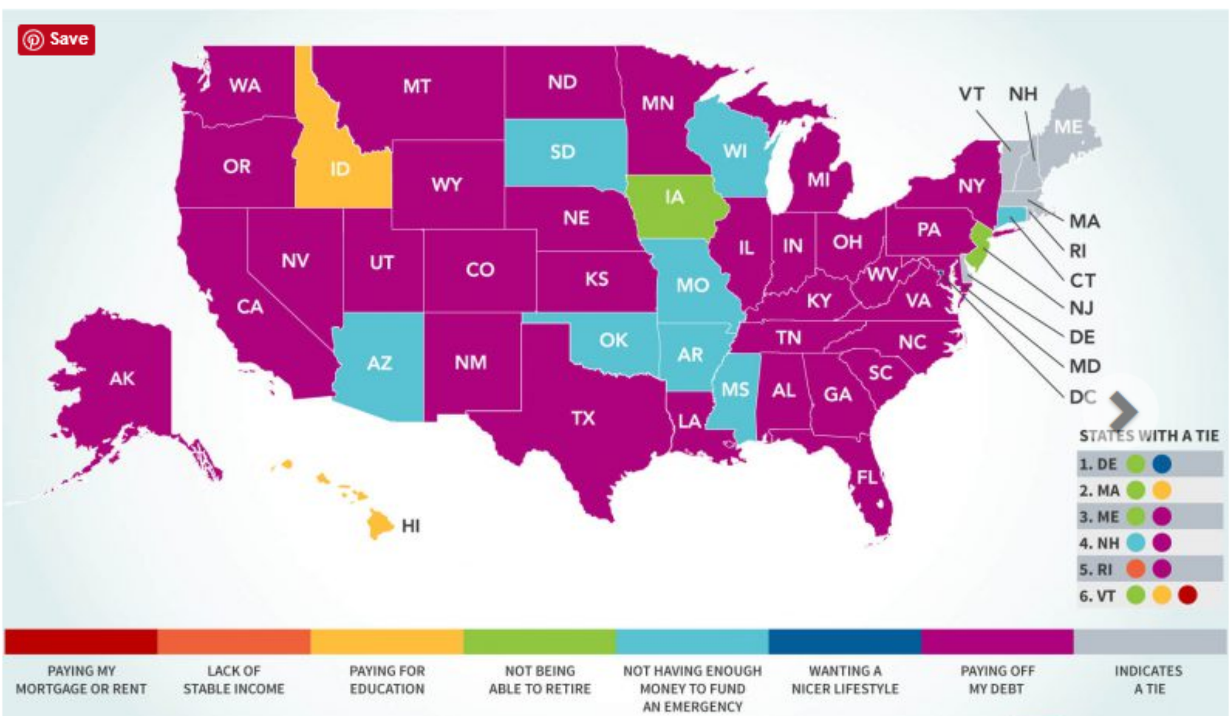
Everyone wants to improve their quality of life. Quality of life improves as we have less negative stress and more peace in our life. One area of negative stress that most people have in their lives is debt and living paycheck to paycheck. In fact, the number 1 cause of financial stress in New Mexico is "paying off debt." New Mexico has the third-highest unemployment rate in the nation, tied with Louisiana and Illinois, according to the Bureau of Labor Statistics. Without a steady income, residents might be relying on credit more or having trouble coming up with the cash to pay the debts they have. Sometimes people find themselves in debt because they don't have enough income to meet the most basic needs. Most people, however, are in debt because they spend money they don't have on wants.

The No. 1 Cause of Financial Stress in Every State

By Cameron Huddleston / August 22, 2016



George Clason once said, "*That which each of us calls our 'necessary expenses' will always grow to equal our income unless we protest to the contrary*." In other words, our expenses grow as our income grows because we believe we can spend more. Most of us look at our income and think, "If I could only make $xxx more each month, then I would be fine." But, what we find out is that once we get the raise and have the extra money, we are STILL living paycheck to paycheck and barely making ends meet. Why??? Because we don't control our spending! Improving our financial situation is usually more about decreased spending than increased income.

The Growth of Consumer Debt

The debt problem in the United States has grown dramatically over the past few decades. Between 1970 and 2010, the median family income in America increased 10 percent in *real* (or purchasing power) terms. During the same time period, total consumer debt per capita increased 119 percent in *real* terms. If you want a sobering picture of debt in the United States, go to www.usdebtclock.org, which projects debt in the United States in real time. Don't go there if you are susceptible to heart problems, because what you will see is truly heart-stopping! I visited the site on October 5, 2016 at about 3:00 PM, and this is what I saw:

- **Total Student Loan Debt: $1,386,074,261,657**
- **Total Credit Card Debt: $975,127,632,454**
- **Total Mortgage Debt: $14,108,106,892,145**
- **Total Personal Debt: $17,807,638,322,093**

As I viewed this continually updating screen, I saw the total personal debt increase by thousands of dollars every second. Personal debt is rapidly exceeding 17 *trillion* dollars (a trillion is a million millions). That's a lot! This amount translates into $54,021 of personal debt for each of the 323,281,052 people living in the United States.

The United States national debt is also growing to astronomical proportions. As of October 5, 2016, it was $19,539,926,482,257, which translates into $59,486 for each person in the United States. If you want to better understand how much debt $19 Trillion is, visit the following two sites: 1) US debt graphically depicted - http://demonocracy.info/infographics/usa/us_debt/us_debt.html and 2) How much is a trillion dollars? - https://ihtd.org/festivalguide/resources/how-much-is-a-trillion-dollars/. Here it gives multiple examples to help you understand the value of a trillion dollars. For example:

- If a person's salary is $40,000 per year it would take:
  - 25 years to earn $1 Million
  - 25 Thousand years to earn $1 Billion
  - 25 Million years to earn $1 Trillion

So if you combine personal debt with the national debt, there is enough debt for more than $113,000 for each person in the United States. We are truly a nation of debtors—both in Washington, DC and in our own homes. **So what can we do??** We discuss various solutions next.

Needs vs. Wants

Dave Ramsey said, "*It is human nature to want it and want it now; it is also a sign of immaturity. Being willing to delay pleasure for a greater result is a sign of maturity. However, our culture teaches us to live for the now. "I want it!" we scream, and we can get it, if we are willing to go into debt. Debt is a means to obtain the "I want its" before we can afford them.*" What should we do? We need to distinguish between needs and wants. What are our basic needs? Basic needs are food, shelter, and clothing. But within these basic needs, we need to be modest.

- **Food IS a necessity, but** going out to eat every day or eating expensive food is NOT a necessity. We should buy healthy, inexpensive food at the grocery store to make at home and refrain from going out to eat until we are debt free and can add the extra food cost to our budget.
- **Clothing IS a necessity, but** expensive outfits or additional outfits when we have enough clothing is NOT a necessity. Can we get by with the clothing we have until we are out of consumer debt and can save and pay cash? If we do need an item of clothing, can we purchase a good quality item at a location that is inexpensive (e.g., Walmart, Target, etc.)? When in debt we should go by the mantra "*Fix it up, wear it out, make it do or do without*."
- **Shelter IS a necessity, but** it should be a modest shelter that fits easily within our budget. Whether renting or owning, limiting the amount of our income that goes toward housing will allow us to use our finances to accomplish other financial goals. Having a home that stretches the limits of our income, restricts our choices and ability to accomplish other worthwhile financial goals.

If we can live frugally now while we become debt free and build a reserve, later we can increase our standard of living while spending less than we earn. Research, and common sense, shows that minimizing our expenses while attacking our consumer debt until we are debt free brings peace of mind. We should do all we can to decrease our expenses and increase our income while becoming debt free.

Spending Leaks

What is a spending leak? A spending leak is when we spend money on wants rather than needs. We each have multiple spending leaks every month, week, and possibly each day. Similar to how a continual drop in a bucket will fill the bucket with water over time, spending leaks will add up to an extremely large amount over time. Spending leaks can be candy, cigarettes, chips, soda, alcohol, vending machines, coffee (e.g., buying Starbucks vs. making it at home), newspapers, magazines, going out to eat (fast food or restaurants), unintended fees (e.g., late fees, overdraft fees, etc.), spending too much on cable, dish, cell phone, etc. (especially when we don't use all the channels, data, etc. to the fullest), gas (when driving more than needed), and many other ways. Spending leaks are the things that add up over time but when looking back we aren't sure where our money went. These leaks are severely limiting our ability to accomplish our financial goals; goals like getting out of debt, building an emergency fund, and saving to pay cash for a vacation, car, or other goal.

The only way to find out where your spending leaks are so you can redirect the money towards getting out of debt and accomplishing your other goals is to TRACK every expense over a month. You can track your expenses by only using your checking account (debit card or checks) and/or a credit card and using the statements, you can write everything down as you spend, or you can use a tool like Mint.com. The important thing is to track every expense, especially those expenses that are considered spending leaks. If you are like my students (who also get to track every expense for a month), you will be AMAZED at how much you spend on going out to eat and other spending leaks. Most of the time spending leaks add up to thousands of dollars per year!! If you were to LIMIT (not even eliminate) your spending on these leaks, you would find the money you need to get out of debt. Until you do this, you cannot use the excuse, "I don't have enough money."

Debt-Elimination Calendar

In order to accomplish your family's financial goals, debt elimination is imperative. What if your family is already in debt? Is there a process that can help you get out at an accelerated rate? Thankfully, there is. The following process is essential for debt-reduction:

1. Recognize and accept that you have a debt problem.
2. Stop incurring debt. Don't buy anything else on credit. Be especially careful about using home equity to pay down debts until you have your spending under control. In the words of Will Rogers, "If you find yourself in a hole, stop digging."
3. Make a list of all your debts.
4. Look for many different ways of reducing debt, not just one. Examples might include consolidating balances to a lower interest rate credit card, having a yard sale to earn money to pay down debt, taking a second or third job for a short time, or using savings to reduce debt.
5. Organize a repayment or debt-reduction strategy, such as a debt-elimination calendar, and follow it.

Many financial planners suggest organizing debts, then paying off either the most expensive debt first or your smallest balance owed first (my preference). With the smallest balance first approach, you see success as smaller debts are eliminated, which gives you more motivation to continue repaying your debts. Either of these methods can be helpful in eliminating debt. Most of the time, the difference is not significant, and either method will accomplish the same objective. **The key is to act now!**

I recommend that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor. You pay the minimum amount to all other debts and attack the first debt with the lowest balance with all extra money you have until it is paid off. Once one debt is paid off, move that money to the next debt until it is paid off, and so on until all debts are gone. The key is to continue applying the same total amount of money to your debts until all debts are gone. In other words, if you were paying $1400 toward your total debt, you would continue paying $1400 toward your debt even as credit cards, cars, personal loans, student loans, etc. were paid off until your last debt is gone (yes, include your home mortgage!). See the example below.

Table 4.2 Example Debt-Elimination Calendar ($600/month allocated to debt repayment)				
	Credit Card	Auto Loan	Student Loan	Total Payment
Interest Rate	18%	8%	5%	
Amount Owed	$2,000	$4,400	$3,600	$10,000
Minimum Payment	$20	$200	$100	$320
July	$300	$200	$100	$600
August	$300	$200	$100	$600
September	$300	$200	$100	$600
October	$300	$200	$100	$600
November	$300	$200	$100	$600
December	$300	$200	$100	$600
January	$200 (paid off)	$300	$100	$600
February		$500	$100	$600
March		$500	$100	$600
April		$500	$100	$600
May		$500	$100	$600
June		$500	$100	$600
July		$400 (paid off)	$200	$600
August			$600	$600
September			$600	$600
October			$600	$600
November			$400 (paid off)	$400
December				$600 (invested!)

An excellent tool to help accomplish either debt elimination strategy is https://powerpay.org/. This website is an easy tool that creates the elimination calendar for you and will calculate how long it will take to eliminate your debt and the overall cost savings of eliminating the debt. For most people, it saves years of debt and thousands of dollars saved in interest.

How this Applies to YOU…

Although the Unites States is in over 19 Trillion dollars of national debt and its citizens are in 17 Trillion dollars of personal debt, **YOU CAN BE DIFFERENT!!**

- Distinguish between needs and wants and identify where you can cut spending.
- Show greater maturity by delaying gratification by saving and paying cash or not making the purchase.
- Live within your means by not spending more than you earn.
- Track your spending and minimize your spending leaks.
- Create a debt-elimination calendar (use https://powerpay.org/ to help), attack your debt, and be debt free years earlier while saving thousands of dollars in interest payments.

The Bottom Line –

New Mexico, along with most other states, has "paying off debt" as the number 1 cause of financial stress. We can relieve that stress by tracking our spending, identifying and plugging (reducing) our spending leaks, spend less than we earn and live within a budget, and attack our debt with the debt-reduction calendar. As we see our debt decreasing and that we are winning financially, instead of missing the spending leaks, our financial stress will go down and we'll feel in control of our finances! We'll feel great that we are making progress towards our financial goals. This will bring more peace into our lives and into our relationships and our quality of life will increase.

To learn more about these topics, visit www.mymoney.nmsu.edu and/or contact your local extension office to talk with a Family and Consumer Science extension agent.

Using Credit Cards Wisely

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Obtaining and appropriately using credit cards is an important part of building credit. Generally, the interest rate is comparably high because the loan is unsecured by collateral. Most credit cards have a grace period. If you pay the balance in full within the grace period, the interest is forgiven. If you do not pay back within the grace period, you are liable for all the interest charged from the moment you made the purchase. The key principle to make credit cards useful for your family is to pay them off before the grace period expires, every month without fail. In fact, **I encourage you to pay your credit card bill the day you get it.** This helps you avoid interest and actually helps your credit score.

Before applying for a credit card, it is recommended that you conduct your own honest self-assessment to gauge whether or not you consider yourself qualified to be a responsible credit card holder. Credit card debt can be devastating to your family's financial health. Remember that although buying on credit means a delayed payment, you still have to pay it off. Furthermore, if you do not pay off your cards on time, you will have to pay the full amount plus large amounts of interest. It is almost always unwise to purchase anything with a credit card that you cannot pay off before the grace period expires. If you need to borrow money, it is better to get a loan with collateral so that you are saved from the high interest rates of credit cards. Think of your credit card as a more convenient version of cash: don't spend money you don't have. Pay it off regularly, perhaps the day you get the bill. Keep track of your spending to ensure you stay within your family budget. Using a financial app like mint.com can help you track credit card expenditures in real time. Those who cannot use a credit card in a responsible way should delay obtaining one until they can live by these principles.

Evaluating Credit Cards

If you carry a balance on your credit card (meaning that you *do not* pay off the balance due each month), you should select a credit card with the lowest possible annual percentage rate. Whether or not the card has a grace period is irrelevant because a grace period only applies if you pay the full balance each month. If you pay your credit card bill in full each month, you should choose a card with a grace period and a low annual fee. The APR is irrelevant because you never carry a balance. Financial websites like creditkarma.com and mint.com provide great resources for evaluating credit cards. Creditcards.com also provides useful information.

A good rule of thumb to maximize your credit score is to not apply for more than one credit card per year. Generally, we recommend having about two or three credit cards in active use at a time. When you stop using a card it is usually better to leave the account open because even though you don't use it, having the credit line open will strengthen your credit score. However, if your card has a large annual fee, it may be better to cancel the card and take a small hit to your credit score. It is often difficult to obtain your first credit card. If you are denied, you could have a parent cosign for you. You could also get a secured credit card. With this option, you have a low credit limit and make a security deposit for the amount of the limit. After you establish a history of paying off your loans, the security deposit is refunded.

Evalutating Credit Cards

The following should be considered when evaluating credit cards:

- Annual fee (ranging from zero to about $95)
- Perks (frequent flyer miles, cash back, etc.)
- Grace period (no interest is charged on new purchases if you pay your bill in full on time each month)
- APR (Interest rate charged on outstanding balances expressed as an annual percentage rate)
- Method of determining the interest rate (i.e. discount rate plus five percentage points, prime rate + 3.75 points, etc.)
- Minimum payment required

Appropriate Card Uses (Benefits and Drawbacks)

Although some popular financial advisors advocate not having a credit card at all, there are several **benefits** for having at least one credit card.

- *Emergencies*: Credit cards can be useful when you don't have cash on hand and need to pay for something immediately, such as an auto repair or an insurance co-payment.
- *Reservations*: Credit cards can be used to guarantee hotel rooms, rental cars, and other rental items. This is especially important if you travel frequently.
- *Convenience*: With a credit card, you can buy things over the phone or on the Internet. Credit cards make purchasing things very easy. They also provide you with a record of everything you spend, an important bookkeeping benefit.
- *Cash flow and timing*: If something is on sale and you know you have the cash coming in a week, you can actually buy the item before you pay for it. In this way, you can take advantage of sales. (But remember, you do not save money by spending money.)

- *Free services*: Often, credit cards offer rewards such as extended warranties, travel insurance, airplane miles, gasoline rebates, and cash rebates, which can reduce the overall cost of some items.
- *Credit score*: As mentioned previously, buying on credit and paying off your credit cards regularly is important to building a strong credit score. It demonstrates to lenders that you are responsible and capable of paying off loans. Even if you do not have a large budget, making your purchases (groceries, clothing, textbooks, etc.) via credit card will build your credit over time. Then when you go to get a mortgage loan, you will have a lower interest rate because of your good credit score.

There are also some important **drawbacks** to be aware of when using credit cards.

- *Increased spending:* You may not take as much time to think about how much you are spending when you use a credit card. Research has shown that, on average, people spend more with a credit card than they do with cash—sometimes as much as 100 percent more.
- *Losing track of spending*: It's easy to lose track of what you spend with your credit card. It requires discipline to track the charges you make.
- *Interest and other costs*: Interest charges can range anywhere from 8 percent to 25 percent. In addition to these interest charges, you must take into account compounding periods, annual fees, and other miscellaneous fees, such as cash advance fees and balance transfer fees. Because of these fees, the cost of using credit cards is often double or triple the cost of using other types of loans.
- *Obligations on future income:* Most importantly, when you use credit cards, you put obligations on future income. As you take on more debt, you not only obligate future income but you also limit future flexibility you may need if emergencies arise.

Danger Ahead

It is vital to handle credit appropriately because credit abuse can very quickly get out of hand. An alcoholic or smoker may think that one drink or one cigarette will not hurt. But soon it is two, then three, then a pack. Should any of the following danger signals occur, get your financial life together so that you can again be an effective household.

1. Are total consumer credit payments over 20 percent of your monthly budget?
2. Is an increasing portion of your income going to debt repayment?
3. Are your credit cards at or near their limit?
4. Are you always late on one or more bills?
5. Are you borrowing to pay for things you used to pay for with cash?
6. Have you taken out a new loan to repay an old loan?
7. Is your net worth decreasing?
8. If you lost your job, would you make it for 3–6 months?
9. Are creditors threatening to repossess?

If you responded "yes" to any of the above danger signals, take a moment to consider what you could do today to help yourself get back on track. If not corrected, credit-holic symptoms can quickly spiral out of control, resulting in serious financial consequences for you and your family. As an additional suggestion, review the above checklist with your spouse and discuss and resolve any problems together. If done in a spirit of kindness, this will strengthen your relationship as well as your finances!

If you find yourself becoming addicted to the lure of buying on credit but still want to build your credit score, don't cancel your accounts. Perform "plastic surgery" on your credit cards by cutting them up with scissors or running them through the shredder. That way, you won't be using the cards anymore, and keeping your account open will still build your credit score slowly over time.

What do I do if I Lose my Credit Card?

You have probably heard horror stories about credit card fraud. Here is some critical information to limit the damage in case your credit cards are lost or stolen.

1. First, inform your credit card company of the loss or theft immediately. You will then have no liability for fraudulent use. It is a good idea to have the toll-free number handy so you know whom to call. They will immediately cancel the cards you have and re-issue new cards, often sending the replacement cards the next day.
2. If your credit cards were stolen, immediately file a police report in the jurisdiction where the theft occurred. This proves to credit providers that you were diligent, and it is a first step toward a possible investigation.
3. Most importantly, call the three national credit reporting organizations (Equifax, Experian, and TransUnion) immediately to place a fraud alert on your name and social security number. This alert notifies any company checking your credit that your credit cards were stolen, and they have to contact you by phone to authorize new credit.

What is the Difference Between a Credit Card and a Debit Card?

When you use a credit card you create a loan that will be paid off later, preferably before the grace period expires. Money actually leaves your account weeks after you make credit card purchases. When you use a debit card the money for the transaction is withdrawn immediately from your bank account. In this way, debit cards are like checks—you must have sufficient money in your account when you use a debit card, or else the transaction may be declined. Debit cards can also be used to withdraw cash at network ATMs without fees (in the United States). When you use a credit card to withdraw cash out of an ATM you may incur substantial fees. Debit cards offer less protection in case of fraud than credit cards and usually do not offer reward points.

How this Applies to YOU…

When obtaining a credit card you should evaluate different cards and make an informed decision which card would work best for you (see http://www.creditcards.com/ or other sites to compare cards). Never get a card just to earn miles or points, especially if it has high annual and other fees. Never get a store card (e.g., Kohls, Dillards, Best Buy) just to get 10%-20% off your purchase! This will hurt your credit and these cards almost never have good terms.

Make sure you aren't spending more using credit than you would with cash or check. Be careful of the warning signs, and know the symptoms, that you are becoming a credit-holic. If you are spiraling out of control, take a step back to correct the spending and get back on track financially (which may include "plastic surgery").

If you lose your credit card, follow the three steps above: 1) inform your credit card company, 2) file a police report, and 3) contact the three credit reporting agencies. If you fail to act when you realize a credit card is stolen, you may be liable for unauthorized purchases.

The Bottom Line –

Appropriately using credit cards can help you build credit. If using a credit card, be sure you can pay it off in FULL every month. Be honest with yourself and if you can't use it as a tool to build credit but want it to purchase "wants," don't get a credit card. First learn how to minimize your spending to live within your means and then get a credit card. A credit card should only be used to make purchases you would make anyway via cash or check.

To learn more about these topics, visit www.mymoney.nmsu.edu and/or contact your local extension office to talk with a Family and Consumer Science extension agent.