NebGuide
University of Nebraska–Lincoln Extension, Institute of Agriculture and Natural Resources
Know how. Know now.
G1795

When to Use Credit and How Much You Can Afford

Kathy Prochaska-Cue, Extension Family Economist,
Sandy D. Preston, Extension Educator

Guidelines for using credit, estimating how much credit you can afford, and potential large credit uses are included in this NebGuide. Establishing a Personal Credit Limit (PCL) is explained.

When to Use Credit

Ask the following questions before using credit:

- Do I really need this item now or can I wait?
- What is the minimum amount of credit I can use?
- What is the interest rate I will pay for using credit to get this item?
- Are there additional fees besides interest which I will pay?
- What will using credit add to the total cost of the item?
- What must I give up in the future to repay this credit debt?

Limit credit use to:

- purchases that may increase in value;
- large, necessary purchases;
- true emergencies;
- purchases that can be made only with credit cards; and
- what you can pay off in total when the next credit card bill arrives.

Sometimes Debt is Good

Financial experts say sometimes debt is good, and sometimes you can go overboard avoiding it. If avoiding debt means completely depleting your cash reserves with nothing left for emergencies, using credit may be the best course of action. The trick is to learn the difference between good debt and bad debt.

Good debt is used to buy what you really need (home, car, education) but you can't afford at the time. Even with good debt, always shop around for the best deal.

Bad debt is using credit to live beyond your means or to get something you really can't afford. When you start to consider "your means" as including all of your capacity to get credit, you've slipped into the bad debt mentality.

How Much Debt Can I Afford?

Financial counselors suggest keeping total debt payments at no more than 36 percent of your monthly after-tax income. Include your mortgage payments in this calculation.

Garman and Forgue (2006) suggest another way to look at what you can afford. Consider debt payments (excluding home mortgage) as a percentage of take-home pay. If current total debt is:

- 10 percent or less of after-tax income, you're in the **safe debt limit** range. Take on additional debt cautiously.
- 11-15 percent may be a **safe limit for some people**. Additional debt probably should not be added.
- 16-20 percent means you are **fully extended**. Hope no emergency arises.
- 21-25 percent is **overextended** and you're probably worried about debts.
- More than 25 percent is **disastrous**. You may feel desperate, and consider bankruptcy.

Establish Your PCL (Personal Credit Limit)

A **PCL (Personal Credit Limit**) is the dollar figure reflecting the total amount of debt you're comfortable having at any time. To develop your own PCL, consider your personal economic situation.

How stable are your income sources? What financial changes are you facing in the near future such as college education for children, retirement, marriage, birth, death, or divorce? What other large purchases will you need to make soon (car, major appliance or piece of equipment, home remodeling, a different house)? Do you have large expenses most people don't have, such as health or job expenses not reimbursed by either your employer or insurance company; tuition for private school; maintaining several vehicles?

Think also about the non-financial aspects when setting your PCL. Your own personality, especially your personal tolerance for being in debt, may mean you can tolerate a lower or higher PCL than someone with the same financial situation as yours. Just remember it's a sure sign you've exceeded your PCL if debt keeps you up at night or you're late making payments. If you find yourself in this situation, pay some of your debt off as quickly as possible.

If you're part of a couple, you may each have your own individual PCL but it's even more important to have a joint PCL. Negotiate and compromise until you develop your joint PCL.

Special Considerations for Major Necessities

Large, major purchases such as a home, car, or children's education require special consideration.

Home. Most people cannot pay cash for a home. When buying a home, the primary concern after the home's cost is how much to use for a down payment. To make this decision, consider how much is in your cash reserves for emergencies, what is expected from earnings on savings and investments, future income, future large expenses, and how long you intend to stay in your present home. If you don't intend to live in your house until it's completely paid for, focus on what you truly can afford in monthly payments.

Car. Is paying cash for a car wise? What can your savings earn? If it's a higher rate than what you'll pay for a loan (adjusting for what you'll pay from the interest earned in income taxes), take out the loan. Keep the length of the loan as short as possible especially if you use a home equity loan to buy a car.

Children's education. Financial planners generally suggest if it's a choice between funding children's education and your own retirement, choose retirement and borrow, if you need to, for the education when the time comes. Children may potentially have more income for loan repayment. This is especially true if there are younger siblings who will also need an education. Shop around for the best loan. That may be in the student's name, not the parents'. And the student may be able to get better financial loans than can the parents.

Keys for Wise Credit Use

If savings will earn more than a loan will cost, then it may make sense to leave your money in savings and take out a loan for something you could pay for outright.

Keep payments up to date. Send payments with plenty of time to beat the deadline.

Develop your own PCL (Personal Credit Limit). Use it to monitor credit use.

If you can't pay your bills on time, notify creditors before you miss a payment to make new arrangements for repaying.

Resource

Garman, E. T. & Forgue, R. E. (2006). Personal finance (8^{th} ed.). Boston MA: Houghton Mifflin Co.

This publication has been peer-reviewed.

UNL Extension publications are available online at *http://extension.unl.edu/publications*.

Index: Financial Management
Credit and Debt
Issued November 2007