

# The Best Way to Pay Off Debt: Which Debt to Pay First

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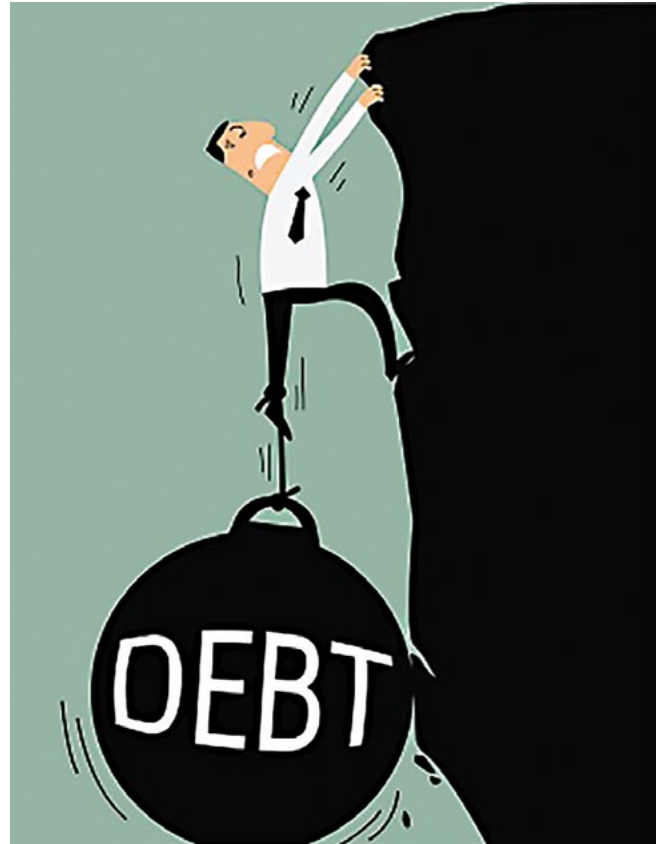
It's common for indebted consumers to hold multiple balances with various creditors. In such a situation, it's fair to wonder which debt you should prioritize. Here are the basic steps that you should follow:

- 1. Stop the Bleeding:** This step is crucial as it includes two important components. **First**, it's important to curtail all unnecessary spending in order to devote as much financial firepower as possible to your debt situation. **Second**, you need to get caught up on minimum payments in order to mitigate the credit score damage that comes with being classified as [delinquent](#).
- 2. Attempt to Lower Your Interest Rates:** Whether through a balance transfer, debt consolidation or a debt management plan, it's important that you at least try to minimize the finance charges that you pay and thereby ease your path to debt freedom.
- 3. Build an Emergency Fund:** Without an emergency fund of at least a couple months' take home, even if you pay off all of your balances you'll only be a lay off or market crash away from ending up right back where you started – mired in debt.
- 4. Pay Off Your Highest Rate Balances First:** Some people will recommend focusing on your smallest balances, but getting rid of your most expensive debt first will save you both money and time.
- 5. Explore Other Debt Solutions (If Necessary):** If scrimping and saving aren't enough to get you out of the hole, you may need to look into other options like debt settlement or even bankruptcy.

## Stop the Bleeding

Before you can get a handle on your debt, you need to get a handle on your spending. After all, if you continue the habits that got you into serious debt in the first place, you're only going to wind up with one thing: more debt. That means you're going to need a budget.

The first step is to make a list of all your current monthly expenses, including minimum payments on all of your balances as well as a small allowance for an emergency fund. More on the importance of those things in a bit. Then rank these expenses in order of importance, with clear necessities,



i.e. food, healthcare and housing, obviously taking precedence over luxuries like cable packages, dining out, etc.

Now, figure out your total monthly take home and make a plan for cutting every expense that exceeds that amount from your life. After that, do a bit more cutting in order to build more savings and amass more ammunition for your assault on debt.

With a plan for your ongoing spending and saving in hand, it's time to begin catching up on any monthly minimum payments that you may have missed recently. This should be your top priority because falling behind on your obligations results in a plummeting credit score, and the more delinquent you become, the worse the credit score damage becomes.

You also do not want to charge-off on any balances because that is about the worst thing for your credit standing, short of bankruptcy.

Minimizing credit score damage is crucial for a couple of reasons. For starters, bad credit is [extremely expensive compared to good credit](#). It will cost you on every loan or line of credit you apply for, either due to the fact that you can only get sub-par terms or because you can't even get approved to begin with. This will limit your options when it comes to getting out of debt since debt consolidation and 0% rates will be much harder to come by.

What's more, bad credit causes headaches in various other aspects of life. It may make it harder to rent an apartment, buy a car, find a job, or even get married.

## Attempt to Lower Your Interest Rates

Lowering the interest rate on one or more of your balances is a great way to stem the tide of finance charges before you. In so doing, it will enable you to attribute more of your money to the principal balances and thereby expedite your timeline to debt freedom. **You essentially have three options when it comes to reducing your interest rates.**

I. **Debt Consolidation:** Debt consolidation basically enables you to pay off your existing obligations with a new loan or line of credit thereby grouping all of your debts into a single balance and allowing you to make one monthly payment.

The primary benefits of this strategy are obviously convenience and simplicity. However, the reality is that most severely indebted consumers will not have the credit standing required to garner a large enough loan with a low enough interest rate to pursue this course of action.

Consolidating your debts with a high interest loan or line of credit clearly won't do you any good, and neither will promptly falling behind on the payments for this new loan.

II. **Balance Transfer:** If you've managed to maintain above average credit standing throughout your debt travails, then you might be able to qualify for a [0% balance transfer credit card](#). Shifting one or more of your balances to such a card and paying them off within the no-interest introductory period will help you save a lot of money and time.

A lot of people think you can only transfer credit card balances, but the truth is that you can shift most types of debt to a credit card.

Using a [credit card calculator](#) will help you determine the amount you must pay each month in order to zero your balance within the appropriate time frame. It will also help you identify the credit card that will save you the most money.

III. **Debt Management:** A [debt management plan](#) is an amended payment agreement that you may be able to reach with your creditors that provides for reduced monthly payments. Such payments are made possible by a lengthening of your repayment period, lowering your interest rate and the forgiveness of certain already incurred finance charges.

It is very important that you do not enter into a debt management plan that you cannot comfortably handle as this is a surefire way to alienate your creditors.



## Build an Emergency Fund

Having a financial safety net is extremely important as you embark upon the road to debt freedom. It will not only give you valuable peace of mind, but it will also help you avoid losing ground if you encounter an income disruption or unexpected expense along the way. As such, it will serve as a sort of insurance for your debt repayment endeavor.

While your ultimate goal should be to build an account with about a year's after tax income, that's obviously going to take some time to accrue, and you needn't wait until you have that full amount before taking aim at your debts.

You should, however, save up a two to three months' take home before you implement a debt elimination plan just to be safe. This money should be considered off limits except for exceptional circumstances.



## Pay Off Your Highest Rate Balances First

There are many people out there, perhaps most notably Dave Ramsey, who believe that you should start by paying off your smallest balances first. This, they claim, will give you a feeling of satisfaction and the momentum needed to continue paying off remaining amounts owed. **They are wrong.**

Knocking off your smallest balances, without paying any respect to the interest rates they charge, is simply a surefire way to cost yourself money and actually increase the time it will take to become debt free. After all, you get much more psychological satisfaction from seeing your overall debt decreasing rather than having to send one fewer check per month.

The more strategic way to pay down multiple balances is to focus on the one with the highest interest rate first. More specifically,

- **you should determine how much money you can allocate to debt payments each month,**
- **then attribute minimum payments to your low interest balances in order to stay current, and finally,**
- **devote the lion's share to the balance with the highest interest rate.**

Then you'll continue this process for as many months as it takes to get rid of this most expensive balance.

Once your most expensive debt is out of the way, you can divert the payments previously earmarked for it to the balance with the second highest interest rate and then repeat the process until you are debt free.

## Explore Other Debt Solutions (If Necessary)

All of the strategies mentioned above necessitate having the financial means to ultimately pay the full amount you owe across all balances. None provides significant debt relief in the form of a reduced principal. As a result, if you are unable to make the monthly payments required by your current account agreements, you should consider the viability of a [debt settlement agreement](#) or, in extreme circumstances, [bankruptcy](#).

The bottom line is that you should explore [all of the options at your disposal](#) in order to solve your debt problem. Simply waiting and hoping your situation will improve is nothing more than a good way to make things worse.





## Ask The Experts: Strategies for Saving, Getting Out of Debt and Staying Debt Free

We turned to a number of experts in the field of personal finance for additional insight into the process of getting out of debt and staying out of debt for good. You can check out their responses below.



**Charles A. Barragato**  
*Research Professor of Accounting  
at Stony Brook University*

### What if people have multiple balances across various loans and lines of credit. How should they prioritize?

The starting point would be to first classify the loans into those that produce tax deductible interest and those that do not. Generally speaking, you want to pay down those loans that bear the highest interest rates and are not eligible for a tax deduction.

Interest on consumer debt, credit card and personal lines of credit is not tax deductible. Mortgage interest on your primary residence and interest on home equity lines of credit are generally tax deductible.

### What are the best strategies for actually saving money? For example, should people establish automatic monthly deposits into a savings account?

In my view, establishing an automatic payroll withdrawal or other systematic withdrawal into one's savings or investment account is a solid strategy. With regard to investment accounts, e.g., mutual funds, using the systematic monthly withdrawal approach does double duty.

On one hand it gets the savings process started and on the other hand it also employs the concept of dollar cost averaging. Of course, savings through company sponsored retirement programs is also another effective technique, especially if the employer provides some form of matching contribution.



**Terry Grant**  
*Professor of Accounting at  
University of South Alabama*

### Do you have any tips for how people can efficiently pay off amounts owed and lead a debt neutral lifestyle?

Carrying a balance on credit cards is one of the biggest personal finance mistakes. Credit card interest rates are typically around 18% per year, much higher than other consumer debt such as car loans (1% to 5%), mortgage loans (3% to 5%), or personal lines of credit which can be less than 10%.

If a debtor has credit card balances, the first step to eliminating this burden is to recognize its relative high cost. Next, consumers should prioritize elimination of credit card debt by committing to pay far more than the required minimum monthly payment.

To effectively make this work, a simple household budget should be prepared so monthly discretionary income can be calculated. Applying a substantial portion of discretionary income to the credit card balance, along with greatly restricted use of the card until the balance is eliminated, will vastly accelerate its extinguishment.

Once credit card debt is eliminated, the consumer should carefully budget the amount they charge each month rather than continuing to freely use the card and get a big negative surprise when the bill arrives. Otherwise, the cycle will repeat.

### What if people have multiple balances across various loans and lines of credit. How should they prioritize?

Debt repayment should be prioritized on the basis of interest rates. That is, pay off the debt with the highest interest rate first.

### What are the best strategies for actually saving money? For example, should people establish automatic monthly deposits into a savings account?

The easiest way to save money is through automatic payroll deduction. That is contributing each pay period to an IRA. These contributions will not be missed as they never appear in your net payroll deposit. Additionally, IRA contributions are contributed pre-tax. That is, the amounts contributed to an IRA are not subject to state or federal income taxes at the time the income is earned.

Since these contributions come off the top of the contributor's wages, the tax savings accrue at the wage earners highest, or marginal, tax rate. Income taxes are only assessed on IRAs when the funds are distributed.

Most people will be in a lower income tax bracket at retirement so IRA withdrawals are taxed less in retirement. In addition to an IRA, monthly contributions to a savings account can be handled through automatic transfers from a checking account. Although there are no tax savings, this is still a good way to accumulate funds for emergencies and other contingencies.

