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Credit in the Family Budget

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Consumers use credit widely throughout the United States. Many people don't even give much thought as to whether they should use it. The buy-now, pay-later philosophy has become a way of life, and, for many people, has resulted in serious financial difficulties.

The pluses and minuses of credit

When carefully used, credit can have some financial benefits. A look at the advantages and disadvantages of using credit can help determine when the use of credit is appropriate.

Advantages

1. Goods and services can be used while you are paying for them.
2. Delaying payment for some goods and services will give you a greater share of your current income to use for other purposes.
3. Installment credit can become a form of budgeting for some persons. It can discipline them to meet certain expenses regularly.
4. Many credit transactions are more convenient and are safer than using cash. There is no need to carry large amounts of cash, and credit makes it easy to take advantage of sales.
5. Credit can improve service on unsatisfactory merchandise or make returning merchandise easier. Merchants may be more receptive in making adjustments on open accounts because returns can be credited to the account instead of requiring a cash refund.
6. Credit can be helpful in short-term emergencies, car repairs and medical expenses.
7. Credit establishes your credit record.

Disadvantages

1. It is easy to overextend spending when using credit and harder to resist impulse purchases.
2. Delaying payment decreases the amount of future income you have to spend. When you use credit, you are living on money you expect to have in the future. If future expectations do not materialize, you may be unable to repay debts as scheduled.
3. Using credit means extra costs. The finance charge is the most obvious cost. But lost interest on money that could have been saved is also a cost, as is the loss of a possible cash discount.
4. In using credit, you may not shop around for the best buy and may pay more than necessary.
5. The ease of buying and returning merchandise on credit may encourage you to shop less carefully or fail to plan your purchases.
6. Goods purchased on credit may be lost if they are not paid for as contracted. If goods are repossessed because of non-payment, you lose the money previously paid for them.
7. Misuse leads to a poor credit rating.

Should you buy on credit?

Whether or not to use credit is a decision that requires careful examination. Before buying, look at your total financial picture including current income and expenses as well as future goals. Look at the effect of the monthly payments on your current budget.

Evaluate the impact of the loss of future income on your goals and the opportunity for using the money for other things. Before buying anything on credit, ask yourself the following questions.

- Do I need this now?
- How much will I pay for credit?
- Can I make the payments?
- Is it worth the extra cost and risk?
- What will I have to give up to pay for it?

General guidelines for using credit suggest borrowing only to finance an investment such as a home or education. However, consumers often use credit to buy expensive, fairly durable items such as a car or home furnishings.

Food, clothing, transportation, entertainment and other daily family living expenses should come out of current income. If bills can be paid without incurring finance charges, short-term credit for daily living expenses might be acceptable because of convenience. However, ask the retailer for a cash discount. If one is available, you will save money by paying cash.

Other situations where credit might be useful include:

Emergencies. Medical bills, accidents or unemployment may drastically change your financial picture, and credit may be a means of getting your family through a temporary financial crisis.

Seasonal sales or specials. Credit can be used to take advantage of sale prices when the additional cost of using credit still results in a truly good sale price. As with all sale purchases, you need to remember that items on sale are a bargain only if they are needed.

Free use of the lender's money. When you can charge an item and delay payment for some time before finance charges are assessed, it is to your advantage to use credit. But be sure you will have the money to make the payment when due.

Inflation and rapidly rising prices. Rapidly increasing prices provide incentive to buy on credit. The motivating force is buying while prices are lower and repaying debts with "cheaper dollars." In this case, the borrower is gambling that interest rates will be less than the increase in prices. This could result in over-commitment.

How much credit can you manage?

The use of consumer credit is not always a matter of affordability, but rather a matter of priorities. You must decide whether the immediate gratification of buying something before you have the money is worth the extra cost of credit. Buying on credit now will delay reaching other goals in the future.

The amount of debt a family can manage depends upon the amount and reliability of income and total financial obligations. General rules are of limited value. Some families cannot afford any monthly payments while others are able to make payments on several accounts.

Use the ***20/10 Rule*** when trying to decide how much debt your family can handle. This rule advises not to borrow more than 20 percent of your annual after tax income, and your monthly payments should never exceed 10 percent of your monthly after tax income.

The general rule of limiting your consumer debt payment to no more than 20 percent of your take-home pay is frequently interpreted as meaning that it is all right to keep your debt payment level at about 20 percent of your take-home pay. Suddenly the maximum advisable debt level has become the norm for safe debt level.

While it is true that you may be able to make the installment payments without experiencing great sacrifice, this practice is not sound financial planning. A better practice is to use the money saved by **not** using credit and apply it to financing future goals. This will help shorten the time needed to accumulate the money to realize your goals.

However, if it is necessary or desirable to use credit, shop around for the best buy. Look for the lowest annual percentage rate and most favorable contract terms. Make as large a down payment as possible and make the installment payments for the greatest amount that can be comfortably accommodated in your budget. These strategies all work to lower the cost of using credit.

If you are already using credit, evaluate your present situation. How much are you paying in finance charges each month? Would that amount help you realize another goal sooner? Is the instant gratification received from buying on credit worth the extra cost? Are your debts creating problems for you? Warning signs that you have reached or are near your upper debt level include:

- Your debts make you feel uncomfortable.
- You rely more heavily on overtime or a second job to pay your bills.
- You pay only the minimum amount due on charge accounts.
- You put off paying one creditor to pay another.
- You manage to save very little or nothing at all and have an inadequate emergency fund.
- You dip into your savings to pay bills.
- You use credit to pay off everyday expenses.
- You use the cash advance feature on your credit cards or take out another loan to pay your bills.
- You get past due notices with bills.

For assistance in decreasing credit obligations, ask for MU publication GH 3342, *Repaying Credit Debts and Loans.*

Helpful Web sites

University of Missouri Outreach and Extension, http://missourifamilies.org

MU Extension publications: http://muextension.missouri.edu/explore

Federal Consumer Information Center: http://www.peublo.gsa.gov

Federal Trade Commission: http://www.ftc.gov

National Foundation for Credit Counseling: http://www.nfcc.org

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