Good Debt vs. Bad Debt

By Lisa Smith (Investopedia)

Debt, for many people today, is simply a fact of life. It's the way they pay for just about everything from big-ticket items like homes and cars to daily purchases like gasoline and chewing gum. At its most basic definition, debt is simply an amount of money borrowed by one party from another. Under this definition, debt sounds neither good nor bad. A closer look at the subject provides a more sophisticated way of both viewing indebtedness.

GOOD DEBT

There's no better example of the old adage "it takes money to make money" than good debt. Good debt helps you generate income and increases you net worth. Four notable examples of good debt include:

1. Technical or College Education

Education has long been synonymous with success. In general, the more education an individual has, the greater the person's earning potential. Education also has a positive correlation with the ability to find employment opportunities. Better educated workers are more likely to be employed in good-paying jobs, and tend to have an easier time finding new opportunities should the need arise. An investment in a technical or college degree is likely to pay for itself within just a few years of the newly educated worker entering the workforce. Over the course of a lifetime, educated workers are likely to rack up a return on investment measuring in the hundreds of thousands of dollars.

2. Small Business Ownership

Making money is the whole point to starting a small business. Earning income is a primary benefit of entrepreneurship, with being your own boss also a positive result of the endeavor. Not only can you avoid reliance on a third-party to hire you and give you a paycheck, but your earnings potential can be directly improved by your willingness to work hard. With a bit luck, you can turn your drive and ambition into a self-sustaining enterprise and perhaps down the line, an initial public offering (IPO) that results in major wealth.

3. Real Estate

There are a variety of ways to make money in real estate. On the residential front, the simplest strategy often involves buying a house and living in it for a few decades before selling it a profit. Residential real estate can also be used to generate income, by taking in a boarder or renting out the entire residence. Commercial real estate can also be an excellent source of cash flow and capital gains for investors.

4. Investing

Short-term investing provides an opportunity to generate income, and long-term investing may be the best opportunity most people have to generate wealth. The wide variety of available investments from traditional stocks and bonds to alternatives investments, commodities, futures and precious metals (just to name a few) provides an array of choices for just about every need and every risk tolerance.

NO GUARANTEES

While good debt may seem like a great idea, it is important to realize that even the best ideas don't always work out as intended. A second look at those four "good debt" categories underscores the point.

The Downside of Higher Education

In and of itself, an education is not a guaranteed ticket to wealth and success. A field of study must be chosen carefully, as not all degrees and designations offer equal opportunities in the marketplace. Difficult economic conditions must also be taken into consideration, as lucrative career opportunities will be more difficult to obtain during economic downturns. Workers who are unwilling to relocate to areas where their skills are in demand or unwilling to accept low-paying, entry-level jobs may find their degrees don't deliver the expected returns.

The Risks of Small Business Ownership

Like any business venture, small businesses run the risk of failure. Hard work, a good game plan and a little bit of luck may all be necessary to help you fulfill the dream of working for yourself.

The Real Estate Money Pit

Until just a few years ago, buying real estate seemed like a guaranteed win for most homeowners, as price appreciation over time was more the norm than not in good neighborhoods. Downward fluctuations in global real estate prices have taught many homeowners that price appreciation is not guaranteed. On the other hand, real estate taxes, homeowners association fees and home maintenance costs last forever.

Investing

Investing can be a complex and volatile process. Just as fortunes can be made, they can also be lost. Do-it-yourself investing isn't the right path for all investors, and even hiring help doesn't guarantee a positive result.

BAD DEBT

While even "good debt" can have a downside, certain debts are downright bad. Items that fit into this category include all debts incurred to purchase depreciating assets. In other words, "if it won't go up in value or generate income, you shouldn't go into debt to buy it." Some particularly notable items related to bad debt include:

1. Cars

Vehicles are expensive. New cars, in particular, cost a lot of money. While you may need a vehicle to get yourself to work and to run the errands that make up everyday life, paying interest on a car is simply a waste of money. By the time you leave the car lot, the vehicle is already worth less than it was when you bought it.

Put your ego aside and pay cash for a used car, if you can afford to do so. If you can't, buy the least expensive reliable vehicle you can find and pay it off as quickly as you can. Buyers who insist on living beyond their means and financing a new car should look for a loan with little to no interest on it. While you'll still be spending a large amount of money for something that eventually depreciates until it is worthless, at least you won't be paying interest on it.

2. Clothes, Consumables and Other Goods and Services

It's often said that clothes are worth less than half of what consumers pay to purchase them. If you look around a used clothing store, you'll see that "half" is being generous. In addition to clothing, vacations, fast food, groceries and gasoline, these are all items commonly bought with borrowed money. Every penny spent in interest on these items is money that could have been used more wisely elsewhere.

3. Credit Cards

Credit cards are one of the worst forms of bad debt. The interest rates charged are often significantly higher than the rates on consumer loans and the payment schedules are arranged to maximize costs for the consumer. Keeping a balance on a credit card is rarely a good idea . . .

Conclusion

There is certainly an argument to be made that no debt is good debt. Unfortunately, few people can afford to pay cash for everything they purchase. With that in mind, a motto of "everything in moderation" is the right approach to take where debt is concerned. Remember, even "good" debt has a potentially bad downside.