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Credit Advantages, Disadvantages and Common Types

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

Explores common uses of consumer credit, debt consolidation and leasing considerations.

Credit is something everyone uses. Every time you use the telephone or turn on a light or the air conditioning, you're using credit just as you are every time you use a credit card or take out a loan.

Credit represents an agreement to receive goods, services or money now and pay for them in the future.

Only you can decide how to spend your money and whether you will use credit. These decisions should be based on your ability to repay credit debt, not just on what you want to buy at the moment. To help you decide whether to use credit, consider the advantages and the disadvantages of credit.

Advantages of Credit

Using credit has some advantages.

Convenience. Using credit cards when you travel or shop is more convenient than carrying cash. It also provides a handy record of transactions. Using a credit card also may give you some bargaining power if there is a dispute or disagreement involving a purchase.

Use other people's money. During the time between when you buy something with credit and when you pay the bill, you're actually using someone else's money rather than your own cash.

Meet emergencies. Unexpected costs such as car repairs or health needs can be met quickly with credit.

Use something while you pay for it. You can enjoy using something you need as you pay for it.

Get something you can't afford now. If you can't afford to pay cash for a car or other large purchase, using credit allows you to get it now.

May get better service on something bought on credit. If you haven't paid for something entirely and a problem arises, it may be easier to get the service needed.

Take advantage of sales. If you truly have a need for something on sale and don't have the cash to get it, credit allows you to get it now.

Establishes a credit history. Buying something on credit with some creditors (even when you can afford to pay cash for it) means you have a credit record.

Disadvantages of Credit Use

Using credit also has some disadvantages.

Credit almost always costs money. You have to decide if the item is worth the extra expense of interest paid, the rate of interest and possible fees.

It can become a habit and encourages overspending. By simply having a credit card available, a person is likely to spend more when shopping than when paying cash for everything.

Overuse of credit leads to a poor credit record. A poor credit record means you will find it more difficult and more expensive to get future credit.

Comparison shopping may be discouraged. If you have credit available, you may be more likely to buy now rather than shopping around to find the best buy.

Reduces future buying power. Future income is tied up in credit payments. If you use credit, part of everything you earn in the future will go toward what you bought in the past.

Extra fees add to the total cost. Credit card companies are collecting higher late and over-the-limit fees which add to the total cost of credit. Pay attention to due dates and total amount charged to avoid these added costs.

Common Kinds of Consumer Credit

Common kinds of consumer credit include service credit, closed-end or installment credit, and open-end or non-installment credit. Two special kinds of credit are debt consolidation loans and leasing.

Service credit includes utility bills for telephones, gas, and electricity. Health providers give credit for health care. Such service usually must be paid in seven to 30 days or late fees are added. Future service may not be given if debt is not paid or is paid late.

Closed-end or installment credit is credit where you repay the amount owed in a specific number of equal payments (usually monthly). Some closed end credit contracts involve a single payment due on a set date. Car loans, mortgage loans, and installment loans for appliances or other large purchases are examples. Installment credit usually involves some form of collateral. For example, if you don't repay your car loan, you can lose the car since it is the collateral for the loan.

Open-end or non-installment credit occurs when credit is given before any transaction occurs. Collateral is not required. You can charge up to the limit on your account. Credit cards and open-end lines of credit are examples.

Debt Consolidation Loans

Approximately one-fifth of loans granted by consumer finance companies are for debt consolidation. With a debt consolidation loan, you exchange several smaller debts with varying due dates and interest rates for a single large loan with one interest rate and one monthly payment.

The monthly payment is usually a lower amount than the total amount of the monthly payments for the original debts. The interest rate may be lower than the rate you were paying on at least some of the original debts, but the time period for repaying your debts with a consolidation loan is now longer so more interest will be paid. While a debt consolidation loan offers relief from debt payments in the short run, it extends the repayment further into the future. Research shows that people who take out debt consolidation loans are more likely to add additional debts with their new-found financial relief, pushing them even further into a financial hole.

Consider a debt consolidation loan only if you have the will power to not add more debt until the new loan is completely paid.

Leasing

In recent years, leasing, especially for vehicles, has become a more acceptable form of credit. With leasing you are essentially renting whatever you lease since ownership remains with the lease grantor. To get the best lease price, always talk about buying through the negotiation process. Once you have a purchase price, then ask what leasing would cost.

Five leasing terms are important:

- ***Capitalized cost*** includes the price the dealer pays for the car plus what is paid to finance the purchase. This is the figure to use when comparing leases from different dealers.
- ***Capitalized cost reduction*** is all money paid on the lease when it begins including down payment or value of trade-in. The money factor of the lease measures the interest rate used in calculating lease payments.
- The ***annual lease rate*** can be used to compare the annual percentage rate (APR) on a car loan.
- The ***residual value*** is the projected value of the car at the end of the lease.
- Leases commonly include other charges such as an ***acquisition fee*, *disposition fee* or a *termination fee***. Always include all fees when making any cost comparisons.

Whether leasing is financially sound depends on your situation. A few years ago Kiplinger's Personal Finance Adviser stated that "unless you are the type who wants new wheels every couple of years, buying probably makes more sense." Bottom line: Do the math and make your own decision.

Resources

Garman, E. T. And Forgue, R. E. (2006). Personal Finance (8th ed.). Boston MA: Houghton Mifflin Co.

Kapoor, J. R., Dlabay, L. R. and Hughes, R. J. (2007). Personal Finance (8th ed.) Boston MA: McGraw-Hill Irwin Companies.

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