How to Pay Off Debt—and Save Too

Balancing paying off debt and saving can be tricky. Here's a step-by-step guide.

Key takeaways

- ✓ **Save for an emergency—consider saving enough to cover 3 to 6 months of expenses.**
- ✓ **Consider a health savings account if you're eligible, and contribute to your workplace retirement plan.**
- ✓ **Pay down debts with the highest interest rate first.**

Student loans, credit card balances, car loans, and mortgages—oh, my. You probably have a variety of debt—most people do. So which should you focus on paying off first? And how can you save at the same time?

Of course, make sure to pay at least the minimum required—and on time—to keep all loans in good status. After all, defaulting on credit cards, car loans, student debt, or home mortgages can destroy your credit rating, and risk bankruptcy.

Assuming you are meeting those primary obligations, here's a guide to help you pay off debt while saving for emergencies and long-term goals like retirement. It may seem counterintuitive, but before you tackle debt, make sure you have some "just in case" money and save for retirement.

Before you tackle debt, pay yourself first. Make sure you:

- Use tax-advantaged accounts like a flexible spending account or a health savings account if you have a high deductible health plan. That lets you pay for medical bills using pre-tax money.[1]
- Save enough in a workplace retirement savings plan to get the match from your employer—that's "free money."[2]
- Set aside some cash for emergencies.

1. Pay this debt down first: high-interest credit card balances

It can be easy to run up a large credit card balance. And once you do, it's not easy to pay it off. The minimum payments are typically low, which means you are paying mostly interest, so it will take much longer to pay off the balance. And it will cost you more. So if you can, consider paying more than the minimum each month.

Avoid using a credit card to finance a purchase.

Avoid using a credit card to finance purchases. Why? In some cases, it could double the cost of the purchase. Say you buy a $2,000 flat screen TV on a credit card with a 15% interest rate. If you make only the minimum monthly payment, it would take you more than 17 years to pay off the original debt.[3] You would pay the lender more than $2,500 in interest—essentially doubling the cost of the TV.

On the other hand, if you are diligent about paying off your entire balance monthly, you may want to consider a cash-back rewards card. That way, your credit card purchases can actually help you accomplish other financial goals.

Quick tip: Check your credit card statement to see how long it will take you to pay off the balance—and how much it will cost you—if you make only the minimum payment.

2. Pay this debt down next: private student loans

Private student loans for college carry higher interest rates than government student loans, in general. Currently, rates on private student loans range between 5% and 14% compared with 2.75% for government undergraduate student loans.[4, 5] You may be able to deduct the interest on a student loan, however, but only up to $2,500 a year, and only if you are a single filer earning less than $85,000 or $170,000 for married filing jointly for the 2019 tax year. If you make more than that, you can't deduct the interest.

In general, it is a good idea to pay down student debt above 8% interest as a rough rule of thumb. What you really want to do is compare your expected after-tax investment return (if you invested the money) with the student loan interest rate. If your student loan is at 9%, paying off your loan is like getting a risk-free return of 9% on your investments. All this can get pretty complicated so you may want to consult with a professional financial planner. This is especially true when this debt is not tax-deductible.

3. Pay monthly minimum on government student loans, car loans, mortgages

These loans have lower interest rates, and some offer tax benefits. That's why it generally makes sense to make only the minimum monthly payments on them. For instance, mortgage interest is deductible for federal tax purposes. Homeowners can deduct the interest paid on mortgages up to $750,000 for homes purchased after December 15, 2017. For mortgages taken out before December 15, 2017, interest paid on mortgages up to $1 million may be deducted. Interest rates have been at historical lows, right now around 3% for a 30-year fixed loan. Car loans are about 4.75% for a 60-month new-car loan.

Government undergraduate student loans are currently 2.75%, and the interest may be tax-deductible.

A word about student loan debt: Most college graduates have various types of debt—and various interest rates. Here are some general guidelines.

- **Pay down:** As we said earlier, it makes sense to pay off high-interest debt (private student loans above 8% interest) first, especially if you cannot deduct the interest.
- **Toss up:** It may be beneficial to pay down medium-interest-rate debt, such as Direct PLUS and Direct Unsubsidized loans for undergraduate and graduate students, in certain situations and not others. Many factors can affect this decision, such as current and future tax rates, how comfortable you are with risk, and your goals.
- **Pay monthly minimum:** Low-interest-rate debt, such as Direct loans for undergraduates and Perkins loans, or medium-interest-rate debt (see above) that is tax-deductible, may not need to be paid down early because of the tax benefits and low interest rates.

If you are disciplined about making payments, you may want to extend low-interest government student loans to lower your minimum payments and use the savings to pay down higher-interest-rate loans faster. (The government allows you to consolidate and extend most government student loans at your current interest rate.) However, you may end up paying more interest because the time period is much longer. Contact your loan servicer for information.

Quick tip: If you have federal student loans, you may qualify for income-based repayment plans or public service loan forgiveness plans. If you don’t qualify for a loan forgiveness program, refinancing your loan could be a money-saving option.

Keep going

Paying off debt is important. It can be difficult to save when a big chunk of your money is going toward debt repayment. That's why it's important to have a plan to get out of debt—it can save you money in interest and ultimately help you save more and reach your goals faster.