Credit Cents

How Much Debt Is Too Much?

We have all asked ourselves "Can I really afford this?" before making a major purchase. How we answer that question can have far-reaching impacts. An unaffordable cash purchase can wreck a budget for months. An unwise credit purchase, however, can have devastating effects for many years.

Credit and charge accounts

Before you hand the next sales clerk your credit or charge card, make sure your future income will cover your bills. Your monthly payments for debts—other than mortgages—should be less than 15 to 20 percent of the pay you actually take home, after taxes. Another common guideline: Limit your credit payments to a third of what's left after you've paid your basic living expenses. The worksheet below will help you.

Housing

It's equally important to keep your payments for housing and vehicles in line. Our dream home and a luxury vehicle would be nice, but could we really afford to repay those debts? To decide how much to spend on a home, refer again to the worksheet. This time, from your monthly take-home pay, subtract all of your basic living expenses except what you currently spend for housing. The dollar figure you get is what's available for your mortgage and the extra costs of maintaining a home.

Several rules of thumb can keep you from becoming "house poor." Don't get weighed down with housing costs that tie up too much of your income:

- Your total monthly cost for housing (mortgage, taxes, utilities, maintenance, and insurance) shouldn't exceed one-quarter to one-third of your monthly take-home pay.

For example: if you take home $2,000 each month, your housing cost shouldn't exceed $500 ($2,000 x 0.25) to $660 ($2,000 x 0.33).

- The sales price of your house shouldn't be more than 2 to 2½ times your before-tax annual income.

For example: if you take home $30,000 a year before taxes, the cost of your house shouldn't exceed $60,000 ($30,000 x 2) to $75,000 ($30,000 x 2.5).

If you have a large down-payment, it is best to use the first rule when estimating how much you can spend on housing.

Lenders use two other rules of thumb to estimate the maximum housing payment you can afford and to decide how much they will lend you. Be sure the amount you qualify for fits into your personal budget. Too often, lenders are willing to loan you more money than you can comfortably afford to pay back.

How to calculate what you can afford in monthly credit payments

1.	**Monthly take-home pay:**	$__________
2a.	**Basic living expenses:**	$__________
	Mortgage/rent	$__________
	Transportation/vehicle	$__________
	Utilities	$__________
	Food	$__________
	Clothing	$__________
	Medical expenses	$__________
	Savings	$__________
	Other	$__________
2b.	**Total basic living expenses**: (Add all items in 2a.)	$__________
3.	**Subtract line 2b from line 1:**	$__________
4.	**Divide line 3 by 3**. This is the dollar amount you can safely spend on monthly credit payments.	$__________

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- **Front-end ratio:** The cost of your house payment, including real estate taxes and home owner's insurance, shouldn't exceed 25 to 31 percent of your before-tax annual income.

> Using this method and an average of 28 percent, a couple that makes $43,000 might qualify for a mortgage of about $12,040 ($43,000 x 0.28) per year or $1,003 per month.

- **Back-end ratio:** Your total monthly debt payments—mortgage, real estate taxes, insurance, auto loans, and all other debts—shouldn't exceed 33 to 41 percent of your before-tax monthly income.

> Using this method and an average of 37 percent, the same couple might qualify for any loan that doesn't push their total monthly debt payments over $1,325 (their monthly income of $3,583 x 0.37).

Vehicles and other major purchases

A general guideline when buying a vehicle is that you shouldn't spend more than 15 percent of your before-tax annual income for transportation. This includes your vehicle payment, insurance, gasoline, and maintenance. A down payment can help you lower the cost of your loan, so consider saving before you purchase a vehicle.

It's important to understand your income and expenses before committing future earnings to repaying debt. Remember that it's not enough to simply cover today's costs. To tide yourself over an illness or job loss, you'll also need emergency savings. Experts suggest setting aside enough money to last two to three months.

Make sure you don't get in over your head. Before taking on debt, always plan carefully. Know how much debt is too much.

Author: Marsha Lockard, University of Idaho Extension Educator, Jerome County