

What is debt? The difference between good debt and bad debt

What is debt? Simply put, it's when you owe money. However, it's a little more complicated than that, as debt can generally be divided into "good" debt and "bad" debt.



"Good debt is debt that is taken out as part of your overall financial strategy in order to increase your wealth. Bad debt is debt that is taken out to help you spend beyond your means or to make impulse purchases," says Jeff Schwartz, executive director, Consolidated Credit Counseling Services of Canada.

"Ideally, you should strive to have no debt and live a cash only lifestyle. When you do take out debt, make sure that it falls into the "good" category and that there is an active plan to pay it back in a reasonable time frame" says Schwartz.

Remember, taking out debt of any kind makes you financially vulnerable. Here are some tips on how to reduce that vulnerability and take advantage of the asset growth of "good debt".

Mortgages: when good debt can be bad debt

Taking out a [mortgage](#) is an excellent example of good debt. Most people aren't able to go out and pay for a house in cash, so they put forth a cash down payment and mortgage the remaining amount. Typically, real estate grows in value over time, so your overall net worth will grow as you pay down the mortgage.

Avoid taking out too large of a mortgage though. Housing values go up and down depending on the market conditions. If you've got a substantial mortgage and you are forced to sell your home you could be looking at taking a loss.

Put down a large down payment or scale back on your desired housing type to keep costs in line. Make sure that you put money aside in emergency savings to help with home repair and maintenance costs, so you don't have to incur more debt as a homeowner.

Invest in your education, but keep costs at a minimum

Taking on debt to further your education is considered "good" debt because generally speaking, increasing your education means increasing your earning potential.

Avoid taking out too much student debt though, because it will impact you for years to come after you are done school and may even cause you to delay achieving financial milestones. Set a strict budget during your student years and try to work part-time during school to help cover costs before you turn to debt.

Don't get tricked by car loans

Technically, car loans fall into the “good” debt category because they are secured by an asset. However, cars depreciate in value quite rapidly. If you take out too large of a car loan or extend the car loan over too long a period, you are looking at bad debt with an asset that actually provides you with negative equity (i.e. you owe more than you own).

Consider buying used and never extend your loan beyond 36 or 48 months. If the payments are too high during that time frame, go with a less expensive car.

How to avoid “bad” debt

Use cash wherever you can, even if it is for [big ticket](#) items. If you defer your bigger purchases (furniture, electronics, etc.) until you've got the cash saved up, you can avoid the burden of debt altogether.

Also never use credit as a way of extending your household budget to spend beyond your means. This is the worst kind of debt that will catch up to you in a hurry and be difficult to repay.

Discover your individual score to help assess your current financial fitness level by taking a quick [Financial Fitness Test](#)

For more information on this and other financial literacy and credit issues, visit the [Money and Finances - Canada.ca](#) and [iiCanada Financial Literacy](#) resources page OR the [Jamati Budget Lounge](#), a web-based financial education centre that has been set up exclusively for our Jamat through Consolidated Credit Counselling Services of Canada, a national non-profit organization. The Jamati Budget Lounge offers unbiased debt-counselling service and offers alternatives to help people get their debts under control. In addition to offering solutions to alleviate and eliminate debt, the site also focuses on financial education and understanding. Strategies include teaching basic, but vital concepts such as how to: budget; understand credit; and manage money. The toll-free number **1-844-329-3834** has also been set up for our Jamat to speak to a trained credit counsellor from Consolidated Credit in English, French or Farsi on a confidential basis.

Although all communications will be confidential, any connections via the [Jamati Budget Lounge](#) or via the toll-free number to Consolidated Credit will be tracked for statistical purposes.