The Best Way to Pay Off Debt: Which Debt to Pay First & More

by **John Kiernan, Personal Finance Editor** | **Jun 16, 2016**

It's common for indebted consumers to hold multiple balances with various creditors. In such a situation, it's fair to wonder which debt you should prioritize. Here are the basic steps that you should follow:

1. Stop the Bleeding: This step is crucial, as it includes two important components. First, it's important to curtail all unnecessary spending in order to devote as much financial firepower as possible to your debt situation. Second, you need to get caught up on minimum payments in order to mitigate the credit score damage that comes with being classified as delinquent.
2. Attempt to Lower Your Interest Rates: Whether through a balance transfer, debt consolidation or a debt management plan, it's important that you at least try to minimize the finance charges that you pay and thereby ease your path to debt freedom.

3. Build an Emergency Fund: Without an emergency fund of at least a couple months' take-home, even if you pay off all of your balances you'll only be a lay off or market crash away from ending up right back where you started – mired in debt.
4. Pay Off Your Highest-Rate Balances First: Some people will recommend focusing on your smallest balances, but getting rid of your most expensive debt first will save you both money and time.
5. Explore Other Debt Solutions (If Necessary): If scrimping and saving aren't enough to get you out of the hole, you may need to look into other options like debt settlement or even bankruptcy.

Now that you know the general roadmap to debt freedom, let's take a closer look at each of these objectives. Afterward, make sure to check out our Ask The Experts Section for additional insights into how to get out of debt and stay out for good.

Stop the Bleeding

Before you can get a handle on your debt, you need to get a handle on your spending. After all, if you continue the habits that got you into serious debt in the first place, you're only going to wind up with one thing: more debt. That means you're going to need a budget.

The first step is to make a list of all your current monthly expenses, including minimum payments on all of your balances as well as a small allowance for an emergency fund (more on the importance of those things in a bit). Then rank these expenses in order of importance, with clear necessities (i.e. food, healthcare and housing) obviously taking precedence over luxuries like cable packages, dining out, etc. Now, figure out your total monthly take-home and make a plan for cutting every expense that exceeds that amount from your life. After that, do a bit more cutting in order to build more savings and amass more ammunition for your assault on debt.

With a plan for your ongoing spending and saving in hand, it's time to begin catching up on any monthly minimum payments that you may have missed recently. This should be your top priority because falling behind on your obligations results in a plummeting credit score, and the more delinquent you become, the worse the credit score damage becomes. You also do not want to charge-off on any balances because that is about the worst thing for your credit standing, short of bankruptcy.

Minimizing credit score damage is crucial for a couple of reasons. For starters, bad credit is extremely expensive compared to good credit. It will cost you on every loan or line of credit you apply for, either due to the fact that you can only get sub-par terms or because you can't even get approved to begin with. This will limit your options when it comes to getting out of debt since debt consolidation and 0% rates will be much harder to come by. What's more, bad credit causes headaches in various other aspects of life. It may make it harder to rent an apartment, buy a car, find a job, or even get married.

Attempt to Lower Your Interest Rates

Lowering the interest rate on one or more of your balances is a great way to stem the tide of finance charges before you. In so doing, it will enable you to attribute more of your money to the principal balances and thereby expedite your timeline to debt freedom. You essentially have three options when it comes to reducing your interest rates.

Debt Consolidation: Debt consolidation basically enables you to pay off your existing obligations with a new loan or line of credit, thereby grouping all of your debts into a single balance and allowing you to make one monthly payment.

The primary benefits of this strategy are obviously convenience and simplicity. However, the reality is that most severely indebted consumers will not have the credit standing required to garner a large enough loan with a low enough interest rate to pursue this course of action. Consolidating your debts with a high interest loan or line of credit clearly won't do you any good, and neither will promptly falling behind on the payments for this new loan.

To learn more, check out our guide on debt consolidation.

Balance Transfer: If you've managed to maintain above-average credit standing throughout your debt travails, then you might be able to qualify for a 0% balance transfer credit card. Shifting one or more of your balances to such a card and paying them off within the no-interest introductory period will help you save a lot of money and time. A lot of people think you can only transfer credit card balances, but the truth is that you can shift most types of debt to a credit card.

Using a credit card calculator will help you determine the amount you must pay each month in order to zero your balance within the appropriate time frame. It will also help you identify the credit card that will save you the most money.

To learn more, check out our guide to balance transfers.

Debt Management: A debt management plan is an amended payment agreement that you may be able to reach with your creditors that provides for reduced monthly payments. Such payments are made possible by a lengthening of your repayment period, lowering your interest rate and the forgiveness of certain already incurred finance charges. It is very important that you do not enter into a debt management plan that you cannot comfortably handle, as this is a surefire way to alienate your creditors.

To learn more, check out our guide to debt management.

Build an Emergency Fund

Having a financial safety net is extremely important as you embark upon the road to debt freedom. It will not only give you valuable peace of mind, but it will also help you avoid losing ground if you encounter an income disruption or unexpected expense along the way. As such, it will serve as a sort of insurance for your debt repayment endeavor.

While your ultimate goal should be to build an account with about a year's after-tax income, that's obviously going to take some time to accrue, and you needn't wait until you have that full amount before taking aim at your debts. You should, however, save up a two to three months' take-home before you implement a debt elimination plan just to be safe. This money should be considered off-limits except for exceptional circumstances.

Pay Off Your Highest-Rate Balances First

There are many people out there – perhaps most notably Dave Ramsey – who believe that you should start by paying off your smallest balances first. This, they claim, will give you a feeling of satisfaction and the momentum needed to continue paying off remaining amounts owed. They are wrong.

Knocking off your smallest balances, without paying any respect to the interest rates they charge, is simply a surefire way to cost yourself money and actually increase the time it will take to become debt free. After all, you get much more psychological satisfaction from seeing your overall debt decreasing rather than having to send one fewer check per month.

The more strategic way to pay down multiple balances is to focus on the one with the highest interest rate first. More specifically, you should determine how much money you can allocate to debt payments each month, then attribute minimum payments to your low interest balances in order to stay current, and finally devote the lion's share to the balance with the highest interest rate. Then you'll continue this process for as many months as it takes to get rid of this most expensive balance.

Once your most expensive debt is out of the way, you can divert the payments previously earmarked for it to the balance with the second highest interest rate and then repeat the process until you are debt free.

Explore Other Debt Solutions (If Necessary)

All of the strategies mentioned above necessitate having the financial means to ultimately pay the full amount you owe, across all balances. None provides significant debt relief in the form of a reduced principal. As a result, if you are unable to make the monthly payments required by your current account agreements, you should consider the viability of a debt settlement agreement or, in extreme circumstances, bankruptcy.

The bottom line is that you should explore all of the options at your disposal in order to solve your debt problem. Simply waiting and hoping your situation will improve is nothing more than a good way to make things worse.

Ask The Experts: Strategies for Saving, Getting Out of Debt & Staying Debt Free

We turned to a number of experts in the field of personal finance for additional insight into the process of getting out of debt and staying out of debt for good. You can check out their responses below.

Maria A. Gistinger
Professor of Accounting at Walsh College of Accountancy and Business Administration

Back to All Experts

Do you have any tips for how people can efficiently pay off amounts owed and lead a debt-neutral lifestyle?

It seems that the conventional advice of "quit spending and start paying down your debt" isn't really relevant advice for many people that can't see a way out. By the time some people realize they are in trouble, it is too late to just merely trim costs. I would recommend generating another stream of income, particularly a second job or part-time job whose sole proceeds go to debt reduction.

What if people have multiple balances across various loans and lines of credit - how should they prioritize?

Conventional wisdom is to pay down the largest interest debt first. I would recommend paying down the debt with the smallest balance and then moving on to tackling the next largest debt. This way, you may end up paying more in interest but you are freeing up cash more quickly to tackle debt. Plus you feel a sense of accomplishment as each debt is wiped out.

While some experts might suggest forgoing credit card use, wouldn't that be a case of treating the symptoms rather than the root problem - which could perhaps be characterized as a societal addiction to overspending?

In a culture of consumer consumption, it is difficult not to get sucked into hyper-consumerism. However, you need to step back and ask yourself are all these doo-dads that you continue to buy providing you with a sense of satisfaction? Is that satisfaction worth trading your long-term financial security and independence for? Generally the answer is "no".

What are the best strategies for actually saving money? For example, should people establish automatic monthly deposits into a savings account?

Automatic deposits are a way to save without having the money pass through your hands. Another consideration is that there are many index funds that require only a $100 minimum deposit instead of the $2,500 to $3,000 minimums that many require. These hefty initial balances keep many out of the market. Charles Schwab has S&P Index Funds that small investors can get into for a $100 minimum.

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