

Office for Financial Success – Financial Tip of the Week

A service of the Personal Financial Planning Department
College of Human Environmental Sciences
University of Missouri-Columbia

ELIMINATING DEBT (Psychological vs. Financial Methodologies)

Is one way better than another to get rid of debt? The answer to your question will likely differ depending on who you're asking.

"FINANCIAL" METHOD. Nearly every 'financial' person will advise that debts should be paid off in a particular order: start with highest interest rate and move to the lowest interest rate (done by rolling the payment from one debt to another as debts are paid off). While this method makes perfect sense from a mathematical point of view, more and more people are finding that there is another method [often overlooked] that works better on their psyche.

PSYCHOLOGICAL METHOD. This system of debt repayment, often referred to as the "debt snowball," organizes one's debt from the smallest balance to the largest balance. This method is not likely to save the most money or time (as the interest rates are not likely to align in that manner), but it is very empowering and motivating to many people to see progress quickly. Focusing on the smallest balance first will accomplish this end.

In both of these methods, pay the minimum amount on all debts except for the "focus" debt (smallest balance in psychological method; highest interest rate in financial method); pay as much as possible on the focus debt until it is eliminated and then approach the next debt in the list with similar intensity.

I'm not arguing against the merits of the financial method as outlined above. Obviously, if someone has the discipline to adhere to the plan, you'll save the most time and the most in interest expenses. The psychological method merely takes a seemingly more "human" approach to finances that suggests that people will be more likely to stick with their 'financial diet' if they see some 'debt pounds' come off quickly ... that is what *Personal Finance* is all about – doing what works best for you. After all, the point is getting out of debt [the end], not the means to the end. How you decide to do it is much less important.

Check out the following Excel spreadsheet if you want to play around with the methods ... <http://financialsuccess.missouri.edu/snowball.xls>