Saving vs. Paying Off Debt

It can be tricky to strike a balance between saving and paying off outstanding debt. Your income and expenses will determine how much you can direct towards savings and debt each month. Once you have a general sense of what that number is, there are some general guidelines you can apply to your decision-making process. However, there is no one-size-fits-all answer and if you are planning for other major life events, such as buying a house, your priorities will likely change.

Keep in mind, you should always make your minimum debt payments before directing funds toward other financial goals such as building an emergency fund or saving for retirement. Failure to make your minimum debt payments can damage your credit score and trigger late fees.

SAVE FOR AN EMERGENCY FUND

An emergency fund is generally the best first step in most situations. If you do not have an emergency fund and an unplanned bill lands on your lap, you will most likely be forced into a position of borrowing the money. This means you will rack up more debt – whether you need to repay a friend, family member or credit card company.

You should consider establishing an emergency savings account that would cover 3 to 6 months of your core living expenses. This account should only be used for unexpected medical expenses, emergency home maintenance, etc. With long-term disability policies, the waiting period is typically 3 months, so the emergency savings fund would also be available to cover expenses during that period, if necessary.

Consider a high yield savings account for your emergency savings. Most online banks have a high yield savings account option that pays a higher interest rate than traditional bank savings accounts.

MAXIMIZE THE MATCH IN YOUR EMPLOYER'S RETIREMENT PLAN

Many employers match a portion of their employee's 401(k) contributions to encourage them to save for retirement. If your employer offers a 401(k) match, you should contribute enough to get the full match. Otherwise, you are essentially leaving free money on the table. For example, if your employer offers a dollar-for-dollar match on up to 3% of your salary, you should contribute at least 3%. This will give you a combined annual contribution of 6%.

Even if you are not in a position to contribute more than the match amount, the impact of compounded investment returns will put you in a much better position than delaying saving.

CONTRIBUTE TO A HEALTH SAVINGS ACCOUNT (HSA) IF YOU ARE ELIGIBLE

An HSA is only available to individuals that are insured through a high deductible health plan. Although an HSA's primary purpose is to serve as a savings account to offset the cost of high-deductible health plans, they can become a retirement savings strategy if you leave your account balance untouched until retirement. HSAs have a triple tax advantage. The contributions reduce your taxable income, grow tax-deferred and can be withdrawn tax-free if used for a qualified medical expense. Prior to age 65, money distributed for any purpose besides medical expense reimbursement will be taxed and incur a penalty. However, after the age of 65, the money can be accessed and used for any purpose without facing a tax penalty—although withdrawals will still be subject to federal and state taxes. It is important to note you should only consider implementing this strategy if you are comfortable paying medical costs out-of-pocket.

TACKLE HIGH INTEREST RATE DEBT

Generally, you should focus on eliminating debts with the highest interest rates such as credit cards. For starters, credit card interest can add up quickly. If you are paying the minimum payment each month, you are likely paying mostly interest. This means it will take you longer to wipe out your credit card debt. Consider paying more than the minimum payment each month, or paying the balance in full, to avoid paying hefty amounts of interest and digging yourself into a financial hole.

SAVE FOR OTHER GOALS

Once you have established an emergency savings fund, maximized the match in your employer's retirement plan and eliminated or have a plan in place to pay down your high interest rate debt, you could then begin saving for other goals—such as a down payment for a home, your children's college education or a wedding. You may want to consider sorting your priorities into short, medium, and long-term goals and then sprinkle them in along with the rest of your goals based upon their applicable time frame. Keep in mind that the funds needed for your short-term and mid-term goals should generally be liquid and easy to access.

CONTRIBUTE BEYOND THE MATCH IN YOUR EMPLOYER'S RETIREMENT PLAN

If you start saving in your 20s, you should aim to save at least 12% to 15% of your pre-tax income each year. It is important to note that this is just a general guideline. There are a variety of factors that will impact your savings goals including the age you plan to retire and how much you wish to spend during retirement. Consult with a financial planner to run a financial plan and determine how much you should aim to save in order to achieve your financial goals.

ELIMINATE OTHER DEBT

Other debt includes your mortgage, home equity loan, student loan and car loan. Generally, the best course of action when deciding between paying off debt and investing is to compare your annual after-tax interest rate against your projected after-tax rate of return on investments. If your debt interest rate is lower than your expected rate of return from investing, you should consider investing. If the opposite is true, you might focus on paying off your debt first. For example, if your mortgage interest rate is 4% and expected rate of return is 7%, you should consider investing since your investment earnings are projected to exceed your interest savings from paying off your debt faster.

It is important to factor in the tax implications of each option. When you file your tax return, you can claim the larger of the standard deduction or your itemized deductions. The Tax Cuts and Jobs Act nearly doubled the standard deduction and limited the state and local taxes deduction to a total of $10,000. As a result, most individuals take the standard deduction and do not see any tax benefit to interest paid on mortgages.

Additionally, consider the tax benefit of interest paid on student loans. You can deduct the lesser of $2,500 or the amount of interest paid on qualified student loans that were used for higher education expenses. However, the deduction phases out at higher income levels.

Finally, there are some general guidelines to consider in setting your priorities. For instance, you could consider adopting a blended approach and splitting your disposable income between your savings and debt. Although it would take longer to build your retirement savings and eliminate your outstanding debt, you could work towards achieving both goals at the same time, which may provide you with peace of mind. Regardless of which route you take, however, it will be important to evaluate your financial goals to determine which is more important and tailor your financial plan accordingly.