What Is the Difference Between "Good Debt" and "Bad Debt"?

Debt is no longer a four-letter word. Debt is simply the amount of money you have borrowed from a lender or creditor.

However, there is a difference between good debt and bad debt.

Understanding good debt

Debt can be a good thing when you're borrowing money to go to school or when you're taking out a mortgage. Even credit card debt can be good-if you show a consistent history of borrowing money and paying it back on time. Good debt shows a lender that you know how to manage the debt you carry and that you are a person to whom they can lend money with a reasonable amount of risk.

Lenders will report your debts and payments to the credit reporting agencies. When you establish a history of making your payments on time, your credit history will get stronger, and that will translate into a higher traditional credit score.

The financial benefit of having good credit is that you will be able to borrow larger sums of money with lower interest rates and on more favorable terms. Banks and other lending companies use your credit score to determine the risk factor for loaning you money. Credit scores can also be used to gauge your level of responsibility with money when employers and landlords request your credit history.

Understanding bad debt

Bad debt, on the other hand, may include high levels of credit card debt with no available credit. If you owe a collection account, make late payments or have unpaid accounts, you also have bad debt. Bad debt can be anything that shows that you don't know how to manage the money you borrow.

For example, paying for items with a credit card but failing to pay back the credit card company on time or for less than the full amount will create bad debt. And, if you carry too much debt on any one card, creditors will see that as a negative.

Bad credit may limit the amount of money you can borrow and raise your interest rates. With a bad credit history, banks and companies may be more hesitant to lend you money because of your track record.

In addition, employers and rental companies may look at your credit report - they can't just take your word when you say you will pay your bills on time or be a responsible employee. In the end, your credit report will be the only thing they will see that indicates your history of good or bad debt and payment history.