A Tale of Two Plastics

A few years ago, deciding how to pay for your purchases was simple: cash, check or charge. These days, debit cards have revolutionized the way Americans pay for their purchases. Consumers can now avoid the daily hassles involved with cash and checks and have their funds come directly out of their checking accounts. But is this modern day convenience all it's cracked up to be or should you still be using your credit card?

The following highlights some of the differences between the two and can help you decide how to pay for your next purchase.

Credit

Where would most shoppers be without credit? After all, many use their credit cards to purchase items they can't afford to pay for outright with cash. Instead, they pay for their purchases over time with a finance charge being accrued every month. Sound ugly to you? It can be - not to mention expensive. But if you're a responsible consumer, a credit card can offer many conveniences.

First, credit cards are universally accepted at 18 million locations around the world and rarely will you be asked for additional identification when using them.

Second, credit cards offer more security in case of theft or loss. Since your debit card is a direct pipeline into your checking account, credit cards are a safer alternative because federal law guarantees stronger protection for credit cards than debit cards if lost, stolen or used fraudulently. In fact, your maximum liability is only $50 if there is any unauthorized use before the card is reported lost or stolen.

Next, some credit cards offer extra incentives, such as frequent flyer miles or cash rebates. But these advantages can quickly be reduced or outweighed entirely if an annual fee applies to the card. For example, if you charge $2,000 per year to the card, earning one mile per dollar spent, it will take you 10 years to reach the 20,000-mile plateau that earns a free ticket. However, if the card carries an annual fee of $50, that free ticket actually costs you $500.

Finally, the flexibility involved with credit cards can be hard to ignore. If you can afford to pay your balance in full each month, most credit cards allow you to have a free loan for 40 days while you earn interest on your money in a checking or money market account. At the end of your billing cycle, you simply pay off your balance and look forward to 40 more days of free float. If you fail to pay your bill in full, however, you face being drowned in a sea of rapidly accumulating debt.

Debit

Debit cards, on the other hand, are an entirely different payment tool and are rapidly catching on, with more than 100 million currently in circulation. But just why are they so popular?

Debit cards are a safer alternative than carrying cash and more convenient than writing checks. Much like an ATM card, you can use a debit card to withdraw cash. But a debit card can also be used to make purchases. The difference is that when a purchase is made, the funds come right out of your checking account, as opposed to a credit card where you're not actually paying money until the bill is due at the end of the month. That's why a debit card can be an invaluable tool for learning sound money management - the money must actually be in your account prior to purchase.

In addition, each debit card purchase made represents a credit card purchase not made. This is a good thing. Day in and day out, investors make purchases that linger on their credit card statements for months, often accruing finance charges long after the item purchased has found its way to the local dump. Don't fall prey to the same mistake. By using a debit card, you will never incur interest charges unless you dip below an overdraft line of credit tied to your checking account.

On the flip side, however, debit cards do carry more risk than credit cards. If your card is stolen, a thief can go on a spending spree with the money in your checking account. And although federal law limits your liability to $50 if you notify the bank within two days of discovering the missing card, the bank has up to 20 days to put the money back into your checking account. You would be held accountable for any missing funds until then.

Although each card offers its distinct advantages and disadvantages, it is important to be sure the choice you make is the right one. If you're unsure about what type of plastic you should choose when paying your bills or making purchases, please contact your financial advisor or accountant.

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