PSYCHOLOGY OF MONEY

The Verdict Is In: Tackle Smaller Debts First

By Martha C. White | Aug. 16, 2012 | 16 Comments

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Financial experts have long debated the best strategy for paying down debt. Some advise paying off debt in the order of APR, taking on the loan with the highest interest rate first. With this approach, you reduce the amount spent on interest charges every month and free that cash up to chip away at the rest of your debt. Others, including personal finance guru Dave Ramsey, advise tackling your smallest debt first, regardless of the interest rate; when that's entirely paid off, you move on to the next smallest, and so on. Which approach is better?

Well, Ramsey's "snowball" method eliminates the total number of different debts faster, but in fact it is also likely to result in paying more in interest over the duration of the debt reduction plan. So the smarter approach, then, is to first pay off the debt with the highest interest rate, right?

Actually, wrong. In light of the results of a new academic study, science has weighed in on the issue, and it turns out Ramsey is right. People who pay off the smallest debt first are more likely to be successful at eliminating all of their outstanding balances.

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This isn't really logical. It make more sense, mathematically, to target your debts in descending APR order. But people aren't logical. A new paper by two associate marketing professors in Northwestern University's Kellogg School of Management explores the psychology of motivation that kicks in when we're working towards a long-term goal like debt elimination.

The two researchers, David Gal and Blake McShane, studied the records of thousands of people who participated in credit-card debt settlement programs and took a look at the results of their efforts to become debt-free. The study compared people who used the "snowball approach" recommended by Ramsey and others with those who took the "rational approach" of first paying off the cards with the highest interest rates. Consumers who utilized the less rational "snowball" method were more likely to actually eliminate credit-card debt.

"You're seeing the human element in this aspect of personal finance," says the paper's lead author, Gal, explaining why a strategy that theoretically should cost more money in the long run due to higher interest payments is more successful. “We conclude that there is evidence that the mere existence of achievable subgoals motivates early goal persistence,” the study says.

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To Ramsey and others, it doesn’t matter if a debt-payment strategy is entirely rational or not. What matters is if it works. “What I have learned is that personal finance is 20% head knowledge and 80% behavior,” Ramsey explains on his website. “You need some quick wins in order to stay pumped enough to get out of debt completely.”

Motivation ebbs and flows throughout the process of striving for any accomplishment. Snagging a “small victory” by completing any distinct portion of your overall goal (in this case, paying off individual debts) acts as a sort of motivational “booster shot.” It gives us proof that our efforts are paying off, and instills confidence that we can accomplish what we’ve set out to do.

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“There’s a lot of research that suggests perception of progress towards a goal is motivating,” Gal says. “Even if you don’t make absolute progress, that perception of progress is motivating.”