

Unit 3, Lesson 18

Activity 1

Buying on Credit

A world of scarcity forces people to choose among competing alternatives. Naturally, people try to pick the alternative that provides the greatest expected benefit at the lowest expected cost. Sometimes alternatives have such high costs that they are quickly rejected.

Because the calculation of benefits and costs focuses on expected, future consequences, it is difficult to identify all of them accurately. This makes it important to do the best we can and to use what we know about costs and benefits. Consumers often fail to do this.

Directions: Read each of the three cases that follow. Review the stated alternatives each person has identified and determine the expected costs and benefits for each. After reviewing your cost and benefit calculations, make a recommendation as to what the person in each case should do.

CASE ONE

For her 18th birthday, Katie Jackson has received gifts of cash totaling \$75. All the birthday cards that had money in them said, in effect, “Go out and buy something you’d really like to have.” Katie wants to do just that. At her favorite department store, Katie eyes a leather skirt. “It is perfect,” she says as she looks for the price tag. The tag shows that the price is \$275. But wait a minute: it is on sale for 50 percent off! “That is a sizeable discount,” says a voice from behind the blouse rack. A salesperson is speaking; she continues: “And besides that, if you open a credit-card account at our store now, you will get 10 percent more off all of your purchases here today.” Katie wonders what her best choice is. She knows that she has \$500 in her college-fund savings account, and she could use money from this account to cover the cost of the skirt.

A quick review of the store’s credit application reveals a 21 percent interest rate charged on unpaid balances, a 30-day grace period, and a late fee of \$35.

What are the alternatives for Katie? What are the costs and benefits of each alternative? What should she do?

Alternatives for Katie

- Don’t buy, seek a cheaper skirt.

Costs _____

Benefits _____

- Buy, but don’t apply for a credit card; use savings to pay for the balance.

Costs _____

Benefits _____

- Buy and apply for the credit card, using credit for the purchase.

Costs _____

Benefits _____

- Buy on credit and pay \$75 on the balance, carrying over the rest.

Costs _____

Benefits _____

- Buy on credit and pay the balance when the bill arrives, using the birthday money and savings.

Costs _____

Benefits _____

What decision do you recommend for Katie? Explain briefly.

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CASE TWO

In two months Willie Wheels will graduate from the University of South Dakota with a Business Administration degree. He knows that as soon as he gets a real job his first big purchase will be a new car. He is not sure what brand or model he will buy, but he believes the new car will cost him about \$25,000. Willie has no money left in his savings account, and he owes \$15,000 on his school loans.

Although Willie has not landed a job yet, he has had some good interviews, and his buddies (all with lower grade-point averages) have gotten jobs paying about \$36,000 per year to start. Just for fun, Willie stops by the local Honda dealer and sees the car of his dreams, with a CD player, moon roof, leather seats, a V-6 engine, spoiler, and aluminum wheels. A quick look at the window sticker puts Willie in sticker shock. The manufacturer's suggested price is \$29,500. That includes set-up and delivery, but not the six percent sales tax and license fee of \$150.

"You're in luck," says the car salesperson. "Honda has just put a \$2,500 rebate on this model for in-stock inventory. And I see you're wearing a USD letter jacket. Will you graduate soon?" Without waiting for an answer, the salesperson continues: "I'll also discount the price by \$500 for you as a first-time college-graduate buyer, and if you plan to graduate this spring that is close enough." Willie begins to think this purchase might be possible, but still he isn't sure. "I don't have any money for a down payment, and I won't be on the job for another two months," he says. "You're in luck, again," the friendly dealer explains; "this dealership has a no-money-down, payments-don't-start-for-90-days plan, and we can finance your loan at 3.9 percent for 48 months. If you need more time, we have an 8.9 interest rate for 60-month loans."

As Willie begins to consider the purchase, he remembers the need to determine the real interest rate in determining costs and benefits. His economics professor mentioned in class that the economy will most likely experience a five percent rate of inflation for the foreseeable future.

What are the alternatives for Willie? What are the costs and benefits of each alternative? What should Willie do?

Alternatives for Willie

- Turn tail and run!

Costs _____

Benefits _____

- Buy the car, using a 48-month loan.

Costs _____

Benefits _____

- Buy the car, using a 60-month loan.

Costs _____

Benefits _____

- Consider the cheaper model: no \$2,500 rebate, but a base price of \$19,850; all other incentives are the same.

Costs _____

Benefits _____

What decision do you recommend for Willie? Explain briefly.

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CASE THREE

Mr. and Mrs. Jones have taken the big step and purchased a new home. It is the fulfillment of their dreams: a modest two-story home in the suburbs. Mr. and Mrs. Jones are both employed; together they earn \$70,000 per year. The down payment on the house has emptied their savings account. Unfortunately, they have just learned that their new house comes with all appliances except for a clothes washer and dryer. This fact somehow slipped through the cracks in their earlier negotiations over the house, and now buying a washer and dryer has become a top priority, especially because Mrs. Jones is expecting a child in three months.

As Mr. and Mrs. Jones drive home to their apartment — soon to be their former apartment, since they plan to move into their home this weekend — they see a huge SALE sign in the window of an appliance store. Mr. Jones steers the car into the parking lot. As they walk toward the store, he and Mrs. Jones both eye the “Visa Card Welcomed Here” sticker affixed to the door.

Sure enough, the showroom floor is stocked with a full array of washers, dryers, and washer-and-dryer combinations. Big ones, little ones, top loaders, front loaders, various colors, stainless steel models — wow! Because Mr. Jones usually does the laundry, he looks at all the combos carefully and identifies two he thinks will work. The first set has a smaller capacity, is white in color, and has a one-year parts-and-labor warranty; it costs \$579. The second set has a larger capacity, comes with a stainless-steel tub and has a three-year parts-and-labor warranty. This combo is on sale for \$849, and it also comes with a free, mail-in silver service set valued at \$129. “You can’t go wrong on either set at these prices,” comments the salesperson. “Free delivery, and the company picks up the sales tax if you buy today.” Mrs. Jones pulls Mr. Jones aside; they discuss the fact that they don’t have cash for the purchase, and they are confident that if they applied for a secured loan the request would be denied because of the large debt they are already carrying with their home mortgage. “But we could use the new Visa card we just received in the mail,” says Mr. Jones; “there is no balance on that card.”

Mr. and Mrs. Jones must pay interest at a rate of 21 percent on unpaid credit-card balances. The minimum payment is five percent of the balance each month.

What are the alternatives for Mr. and Mrs. Jones? What are the costs and benefits for each alternative? What should they do?

Alternatives for Mr. and Mrs. Jones

- Don’t buy, use the laundromat.

Costs _____

Benefits _____

- Buy the \$579 combo and charge it on Visa

Costs _____

Benefits _____

- Buy the \$849 combo, charge it on Visa, and be sure to send for the free silver service.

Costs _____

Benefits _____

What decision do you recommend for the Joneses? Explain briefly.
