How To Determine How Much Can You Afford to Spend on a Vehicle

By Daniel Jones

You would like to buy that new luxury car or monster 4-wheel drive SUV. But that may not be the best thing for you and your family. So how do you determine the price range of a car you can afford?

A rule of thumb is that your monthly car payment should not exceed 20 percent of your monthly net income. If you own two vehicles and make payments on both, the total should not exceed 20 percent of your monthly net income.

Begin by calculating your monthly net income (your "take-home pay") and subtracting all your expenses. The money that is left is about what you have for a monthly payment on a car (remember you will have to pay insurance and registration fees, too).

Once you know your monthly net income, you can estimate:

- The monthly payment you can comfortably afford
- How big a down payment you can make
- Which price range to shop in

Knowing these three numbers is important. Then, when you enter into negotiations, you won't lose your head and buy a car you can't afford.

Estimating Loan Payments

Once you know how much you can afford, you can begin to estimate your monthly loan or lease payments. If you are confused about whether to buy or lease, you should talk to an accountant or tax advisor about the advantages of leasing or buying for your specific situation. There are different advantages for people in different situations.

The difference between leasing and buying is simple. When you're leasing, you are renting the car for a limited amount of time, then returning it. When you buy the car, you are making monthly payments to own it eventually. While there is some justification for having high loan payments, high lease payments should be avoided.

Knowing your approximate monthly payment before you enter the dealership helps you pre-determine the type of vehicle and price range you can shop for. It also helps you direct the car sales staff toward a vehicle you can afford. Typically, if the salesperson has some direction they can help you find a vehicle you will enjoy driving and one that you can afford.

Making A Budget - This is absolutely essential. It's the only smart way to prepare to buy a car. You need to know how much money you can spend without compromising your finances. First determine your income, then your expenses without an automobile. Subtract your expenses from your income. What's left is your disposable income, or the amount available for entertainment, travel, and automotive expenses. Don't forget, these expenses will include the hidden costs of car ownership detailed below.

0% Financing - Many manufacturers are offering the best deals in history, providing your have excellent credit and finance through the automaker's captive finance company. If you qualify, take advantage of these incredible financing deals, they might vanish at any time. Unfortunately many new car purchasers won't qualify for the lowest (0%) rate so it is also a good idea to have a recent report on your credit rating.

Borrowing Money - Unfortunately borrowing contributes to the high prices of cars: by simply spreading out the purchase price over a longer period of time, car manufacturers have been able to slowly raise the average price of a new vehicle over $23,000 in 30 years, from $2,500 in 1970 to $25,500 in 2000. Although inflation accounts for some of this increase, the rise would have been much less if all new vehicle purchasers paid cash. Longer financing periods (60 & 72 month loans are common) enable many people to buy larger or more luxurious vehicle than they can really afford. The long loan term includes far more interest than shorter ones. It is best to pay cash but if you must borrow, be aware. Banks will want a history of your work experience, a history of your previous residences, and history of good credit (paying bills on time, etc). Banks can easily make your financial situation seem better than it really is, and qualify you for a loan that will be a burden to repay. Banks calculate your ability to borrow from your debt-to-income ratio, considering only your rent and credit obligations. They base approval on a debt-to-income ratio of 40% or lower. Disposable income is a better way to budget for a purchase, as it takes into account all of your expenses.

Interest - Borrowers must have a good credit history in order to motivate lenders to part with their money at a reasonable rate. A multitude of factors beyond your control affects the basic interest rates, but your credit history is the most significant contributing factor. A person with an excellent repayment history (no late payments) is considered a good credit risk and may enjoy a rate as low as 7%. Another person buying a similar vehicle could pay as much as 20% if their credit history is poor. Keep in mind that interest is in addition to the original price, and can add as much as 35% to your total cost.

If you have no credit history or your report is poor, you will be required to have a co-signer or personal guarantor for your loan. Technically the co-signer is taking the loan out for you, but you are making the payments. If you find yourself in this situation, make sure you can make the payments on time, as ruined friendships and dysfunctional family situations could result from poor credit behavior. Successful repayment of a co-signed loan will not benefit your credit history unless the co-signer sends the lender a notarized letter stating that you made the payments and deserve credit for completion of the installment plan.

Down Payments - Most people will need a down payment (for a loan) or capital reduction payment (for a lease) in order to qualify for the loan or lease. By reducing what you owe your payment will be lowered, so make as large a down payment as you can possibly afford.