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Credit and Debit Cards: What You Need to Know

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A generation ago, it wasn't all that unusual to be out for dinner with friends or at the register with a cart full of groceries and realize you didn't have enough cash to cover the bill. But today, you're likely to pull out a debit or credit card and not think anything of it.

It's hard now to imagine a time when those noncash options weren't available — especially if you were born in the 1970s or later. Credit cards have been around since the 1950s, and debit cards were introduced in the mid-1970s. By 2006, there were 984 million bank-issued Visa and MasterCard credit and debit cards in the United States alone.

Though the two types of cards may be used interchangeably, there are notable differences between them. Let's start with debit cards.

Debit cards are linked to your bank account so the money you spend is automatically deducted from your account. They provide a convenient alternative to cash, especially if you do a lot of shopping online. Debit cards can also help you budget. Use your card to pay your bills and day-to-day expenses and your monthly statement will provide a good snapshot of how much you spend per month and where it's going. There's another benefit as well: Unlike credit cards, your bank balance goes down with each debit card transaction, so you're less likely to overspend. (Many banks offer "overdraft protection" that allows you to exceed your balance. But you'll end up paying interest, and maybe extra fees, on the money you borrow from your overdraft account.)

With so many benefits to the debit card, why use a credit card at all? There are three main reasons: You can spend more than you have — or postpone paying, at least — and you typically get better rewards and better protection than you do with debit cards.

Credit cards basically allow you to use someone else's money (the card issuer's) to make a purchase while you pay the money back later. If you do so within the billing period — generally, 15 to 45 days — you can avoid paying any interest on it. The problem arises, of course, when you don't pay the balance in full and are charged interest as well. That can quickly add up. If it takes you two years to pay off a $500 balance, for example, and you're being charged 18 percent interest, you'll end up paying nearly $100 more in interest.

If you use them responsibly though, credit cards can offer other advantages. They help build your credit, as long as you pay your bills on time. Some also offer rewards that you can use to get gifts, cash back or discounts for products, services and special events. They also provide more

protection if someone steals your card or bank information. If you notice a fraudulent charge on your credit card account, you can call the card issuer, make a dispute claim, and the charge should be removed from your balance. But if thieves steal your debit card information and use it, it may take weeks for the bank to investigate your claim and replace the lost funds. In the meantime, you may have to deal with a dwindling bank balance or bounced checks.

Federal law also protects you if you need to dispute charges on a credit card, but not if you use a debit card or other forms of payment. If you paid cash or used a debit card, the retailer already has your money. So you have a lot less leverage, and there's no guarantee you'll get that money back. But if you pay for something with your credit card and aren't happy with the purchase, your card issuer can legally withhold payment from the retailer until they resolve the dispute, and you won't be charged.

Let's say you've decided you want a credit card, which one should you get? The answer depends largely on whether you plan to pay off the balance each month.

If you know you'll probably carry a balance, look for a plain-vanilla card with no annual fee and the lowest annual interest rate available. (Any interest you pay on a carry-over balance will offset any perks you could get through a rewards card.) You can compare several low-interest credit cards at creditcards.com and bankrate.com, which both provide updated information on dozens of different cards. You can also apply online for cards through either site, but limit your applications to one or two to avoid hurting your credit.

Be aware that card issuers can raise your interest rate after you've gotten the card. So check your monthly statements. (You should be aware, though, that the Federal Reserve has just passed rules that will take effect in mid-2010 limiting the card issuers' ability to raise your rate, unless you're late with a payment.)

Call the card issuer if your rate has increased to try and negotiate a lower rate, or consider transferring your balance to a lower-interest card. (Billshrink.com lets you see how much more you could earn in rewards or save with a lower interest rate if you switched to various other credit cards, based on your credit score and how much you spend each year.)

If you plan to pay your bill in full each month, seek out a card that provides rewards you actually want — whether that's cash back, frequent flier miles or points redeemable for gifts. The interest rate shouldn't matter, since you won't be carrying a balance. But look for those with no annual fee. Bankrate.com and creditcards.com also provide comparisons of cards by the types of rewards offered, among other criteria. Generally speaking, if you plan to use your card a lot, cash-back programs may be the best bet. It's easy to get the refund — either through a check or a credit on your account — and you can use that money for anything. Many large banks also offer debit cards with rewards, so it can be worth shopping around for them too. Creditcards.com also provides a comparison of different prepaid and debit cards, based on annual fees, related services and credit requirements.

For most people, using both a debit card and credit card makes sense. The key is not to spend more than you have with either. If you can do that, you'll be able to enjoy the benefits that each provide.

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