Saving Strategies: Buying vs. Leasing a Car

As prices of new cars continue to climb, more and more people are considering leasing as a viable financing option. Although leasing is generally more expensive than financing, there are certain advantages to leasing a vehicle. A lease will typically result in a lower initial cash outlay and lower monthly payments. But at the end of the lease, you don’t own the car.

The cost of a lease will depend on the sales price of the car, the interest rate, the lease period, and whether the lease is closed- or open-ended. An open-end lease allows you unlimited miles, but you must make up the difference between the agreed-upon resale value and the actual value when the lease is terminated. A closed-end lease imposes a mileage limit. If you drive over this amount, you will pay a per-mile surcharge. Both types of leases usually entail substantial penalties for premature cancellation.

If savings is a priority over convenience, and you absolutely must have a car but can’t afford a new one, consider purchasing a used car rather than leasing a new one. If you must have a new car, and leasing is the only way you can afford it, don’t lease as much car as you possibly can. And make sure to shop around for the best interest rate.

With the sticker price of many automobiles now exceeding $30,000, more and more Americans are considering leasing as a viable financing alternative. In general, leasing a new car will end up costing you more over time than buying one. So why do so many people lease cars? Leasing can result in a lower initial cash outlay and lower monthly payments than a typical new car purchase. Through leasing, drivers can enjoy more car for their cash. The potential cost of that luxury, however, can be high.

How a Lease Works

The cost of the lease will depend on the sales price of the car, the interest rate, the lease period, and whether the lease is closed- or open-ended. With an open-end lease, you enjoy unlimited miles, but if the resale value of the car at the end of the lease is less than the agreed-to amount, you must make up the difference. A closed-end lease imposes a mileage limit, usually 12,000 to 15,000 miles a year. If you average more than this, you'll have to pay a per-mile surcharge (typically 8 to 15 cents a mile) at the end of the lease.

The terms and conditions of the lease typically hold you responsible for the care and condition of the car. Most leases require some initial down payment, but the actual amount will vary from dealer to dealer and car to car. To see how a lease can lower your cash outlay, consider the following example: You have $2,000 in cash and your heart is set on a car stickered at $35,000. Buying the car with such a low down payment would mean monthly payments of more than $775 for four years, assuming an annual percentage rate (APR) of 6%. With a lease, however, your monthly payments could fall to just $516, assuming a 40% residual value and 6% APR.[1]

Other factors that affect the monthly payment are the vehicle sticker price and, for an open-end lease, the expected vehicle resale value. It is a good idea to negotiate the car price before asking for a lease. The higher the price, the higher the lease cost. A higher resale value will lower your lease cost, but you may end up with a large termination fee if the resale value is unrealistic.

Single-Payment Leases

Paying the entire lease amount in a single up-front payment can save you significantly on lease payments. The up-front payment reduces default risk and administrative costs, allowing the lessor to pass the cost savings along. Before choosing a single-payment lease, however, consider the potential opportunity cost of losing the use of that money in the interim. Single-payment leases are typically preferred by those leasing premium cars and who travel frequently between residences in several cities. For these individuals, making regular monthly payments on time may simply be too inconvenient.

Is a Lease Right for You?

When you lease a car, you pay only for that portion of the car that you use -- in other words, if you want it for two years, you'll pay only for two years' worth, without then having to resell the car or trade it in. If short-term use is your goal, a lease may make the most sense. However, if you will always need a car, but it doesn't have to be a new car, a lease is an expensive option.

At the end of the lease term, you'll have to replace the car with another lease, and another series of payments. When you purchase a car, you own it long after the monthly payments end.

If savings is a priority over convenience, and you absolutely must have a car but can't afford a new one, consider purchasing a used car rather than leasing a new one. While you won't have the new-car luxury, the purchase price -- and your down-payment -- will be substantially lower. And if you buy a car under six years old, you'll be able to stretch out payments over three to four years. If you buy the car from a dealer, you may also be able to purchase an extended warranty that will cover major repairs for several years, giving you some protection against buying a "lemon."

If you must have a new car, and leasing is the only way you can afford it, don't lease as much car as you possibly can. Shop around for the best interest rate. Although some dealers will not disclose the factors they use to arrive at the lease price, there are tools available that you can use to discover these variables.

Reasons Not to Lease

- Leases often set mileage allowances, with a charge for distances driven in excess of a specified maximum number of miles.
- A lease may require a degree of maintenance you might not otherwise make on a car you owned outright.
- When the car is returned, the lessee may be charged for any dents or other minor damages incurred.
- There may be substantial penalties for premature cancellation of the lease.
- The lessee is just as responsible as an owner for keeping a leased car insured with comprehensive coverage.

Points to Remember

1. A lease will cost you more than purchasing a car.
2. A lease will typically result in a lower initial cash outlay and lower monthly payments. But at the end of the lease, you don't own the car.
3. An open-end lease allows you unlimited miles, but you must make up the difference between the agreed-upon resale value and the actual value when the lease is terminated.
4. A closed-end lease imposes a mileage limit. If you drive over this amount, you will pay a per-mile surcharge.
5. Paying the entire lease price upfront can save you significantly on lease payments.

[1]*Example is hypothetical. Actual payments will depend upon specific lease terms.*