Leveraging Psychological Insights to Encourage the Responsible Use of Consumer Debt

Hal E. Hershfield¹, Abigail B. Sussman², Rourke L. O’Brien³, and Christopher J. Bryan²
¹University of California, Los Angeles, ²University of Chicago, ³University of Wisconsin–Madison

Abstract
U.S. consumers currently hold $880 billion in revolving debt, with a mean household credit card balance of approximately $6,000. Although economic factors play a role in this societal issue, it is clear that psychological forces also affect consumers’ decisions to take on and maintain unmanageable debt balances. We examine three psychological barriers to the responsible use of credit and debt. We discuss the tendency for consumers to (a) make erroneous predictions about future spending habits, (b) rely too heavily on values presented on billing statements, and (c) categorize debt and saving into separate mental accounts. To overcome these obstacles, we urge policymakers to implement methods that facilitate better budgeting of future expenses, modify existing credit card statement disclosures, and allow consumers to easily apply government transfers (such as tax credits) to debt repayment. In doing so, we highlight minimal and inexpensive ways to remedy the debt problem.

Keywords
consumer debt, behavioral economics, psychological interventions, public policy, judgment and decision making

Incorporating the Future
People have difficulties thinking about the future: They view their distant selves as strangers (Bryan & Hershfield, 2012) and fail to consider their changing tastes over time (Loewenstein, O’Donoghue, & Rabin, 2003). It is perhaps unsurprising, then, that consumers often act in ways that prioritize the present (e.g., overspend today) and leave negative consequences for the future (e.g., large debt burdens). Recent research suggests some factors that make it difficult to escape this debt cycle: People underpredict their future expenses (Peetz & Buehler, 2009, 2012) and overspend on unusual items that are often interventions that are psychological rather than pedagogical in nature. (See Table 1 for a summary of these interventions as well as the barriers they are meant to overcome.)
considered in isolation (Sussman & Alter, 2012). The latter is especially problematic given the large costs associated with these exceptional purchases over time. The inverse is also true: People have the tendency to overspend when they receive income that can be considered exceptional (e.g., a tax refund; Arkes et al., 1994), neglecting to realize that such frivolous spending year after year can have a significant negative effect on their overall wealth. Interventions that help people accurately understand future expenses and income may thus minimize current spending and future debt.

Given that hundreds of billions of dollars flow from the government to households annually, such transfers may be an ideal setting for policymakers to implement interventions that help people meet budgeting goals. These interventions should help consumers plan for the future by incorporating exceptional expenses into budgeting tools and spreading spending across time.

Our first policy recommendation is to match behaviorally informed budgeting tools with the receipt of government transfers. First, government should follow the lead of major financial institutions in using text messages to alert benefit recipients when the account balance associated with a transfer is low or that an unusually large transaction has been made. Second, cash transfers such as Social Security could be marketed as “rebate cards” in an effort to encourage saving.

A second intervention would target the largest lump sum payment most American households receive each year: the tax refund. People are faster to spend windfall gains than ordinary income (Arkes et al., 1994) and are more likely to treat a single large annual payment as a windfall than several smaller repeated payments. Rather than delivering tax refunds in a lump sum, we recommend breaking up payments into multiple streams—for example, as 12 prepaid credit cards. Even if all 12 prepaid cards were delivered at the same time, dividing the payment into 12 units could imply that the refund should not be spent at once, but rather over the course of a year (Soman & Cheema, 2011). Further, because consumers save more when a tax refund is framed as a return to the status quo (i.e., “rebate”) rather than a sudden influx of money (i.e., “bonus”; Epley & Gneezy, 2007), the cards could be marketed as “rebate cards” in an effort to encourage saving.

### Improving Credit Card Statements

Recent legislation has tried to aid consumers by providing them with more information on their credit card statements. Namely, the CARD Act of 2009 dictated that credit card statements include payment warnings detailing not only how long it would take to pay off the balance if only the minimum payment were made, but also the suggested payoff amount that would result in the credit card balance being paid off over a period of 3 years. By one estimate, the CARD Act saved consumers approximately $11.9 billion per year (Agarwal, Chomsisengphet, Mahoney, & Stroebel, 2014).

However, this additional information has the potential to influence repayment in unanticipated ways (e.g., through anchoring processes; Stewart, 2009). Indeed, aspects of the CARD Act can potentially lead customers astray: People unduly gravitate toward paying the 3-year amount rather than the minimum or the full balance (Agarwal et al., 2014), because they view this 3-year amount as a strong suggestion for what they should pay (Hershfield & Roese, 2015). This legislation helped consumers who were previously paying less than the 3-year amount but caused a reduction in the fraction of account...
balances that were previously paid in full (Wang & Keys, 2014). As a result, we recommend that policymakers instruct credit card companies to remove the 3-year payment warnings for consumers who regularly pay more than the 3-year amount and increase the warning amount (e.g., state a 2-year payment warning) for those who regularly pay less.

**Encouraging Debt Repayment**

Prior research has demonstrated that people often create categories for money (i.e., mental accounts) and that this categorization constrains its use (e.g., reserving $1 in your right pocket for certain purchases and $1 in your left pocket for others; Thaler, 1985, 1990). This process can cause people to treat savings and debt as distinct financial categories rather than to integrate them into overall wealth (Sussman & Shafir, 2012). In some cases, this categorization can lead consumers to misguidedly take on high-interest rate debt, while simultaneously holding money in low-interest bearing savings accounts (Gross & Souleles, 2002; Sussman & O’Brien, 2014). Existing government infrastructure focused on building savings often reinforces this artificial separation. Policymakers could encourage wealth maximization by broadening the scope to include debt repayment. We envision at least two ways to achieve this goal.

First, current tax policy actively subsidizes saving behavior (e.g., through a tax-deferred saving platform). These policies communicate the problematic idea that when it comes to saving money versus paying off debt, saving is always the right thing to do (i.e., an injunctive norm; e.g., Cialdini, 2003). But, many of the credits designed to promote saving could easily be expanded to provide similar tax benefits for paying down debt and could specifically target high interest consumer debt. Such policies might not only help make debt repayment as salient as saving money for the future, they could also neutralize the existing norm.

Second, small tweaks to the tax filing process could enable consumers to remit a portion of their tax refund to repay debt directly, just as U.S. consumers are now able to split their refund among multiple savings vehicles. More broadly, the recent transition to electronic systems for making government payments (e.g., direct deposit) provides an opportunity to implement scalable behavioral interventions to reduce debt and improve financial well-being. Consumers currently control where these funds are deposited (e.g., a bank account), but they do not have the option of an automatic payment to a debt account. This structure encourages consumers to preserve the mental segregation of asset and debt accounts and makes them less likely to direct the money toward debt repayment once it has been received. We thus recommend that consumers be given an option to deposit government funds directly toward credit card accounts. Doing so could help consumers by opening the “channel factor”—making debt repayment easier by eliminating the seemingly trivial but meaningful barriers that make behavior more difficult (Lewin, 1951).

**Summary of Policy Implications**

People have a tendency to underpredict future expenses, rely too heavily on values presented on billing statements, and fail to take into account overall wealth by categorizing debt and saving into separate mental accounts. Drawing on insights from recent psychological research, we make five key policy recommendations to overcome these obstacles: (a) pair government transfers with budgeting tools that remind consumers when they are overspending relative to their own guidelines and explicitly incorporate exceptional expenses, (b) split tax refunds into separate payments, (c) revise suggested alternative payment warnings on credit card statements, (d) provide tax credits for debt repayment, and (e) allow consumers to apply government funds directly toward debt repayment. It is our hope that these suggestions will go a long way toward encouraging the responsible use of consumer debt.

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**Note**

1. If tax refunds were directly deposited into consumers’ bank accounts, an alternative would be to implement an opt-out system in which consumers receive their tax refund via monthly direct deposits, rather than a single installment.

**References**


