



**Leveraging Psychological Insights to Encourage the Responsible Use of Consumer Debt**

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## Leveraging Psychological Insights to Encourage the Responsible Use of Consumer Debt

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**Abstract**

US 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: 1) make erroneous predictions about future spending habits, 2) rely too heavily on values presented on billing statements, and 3) categorize debt and saving into separate mental accounts. To overcome these obstacles, we urge policy-makers 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.

## Leveraging Psychological Insights to Encourage the Responsible Use of Consumer Debt

US consumers currently hold \$880 billion in revolving debt, with a mean credit card balance of nearly \$6,000 (Board of Governors of the Federal Reserve System, 2014a, 2014b). The typically high interest rates on such debt can impede productive consumer spending and investment, such as homeownership. Many intractable factors, both economic (e.g., high interest rates and low wages; Zafar, Livingston, & VanDerKlaauw, 2014) and psychological in nature (e.g., scarcity; Shah, Mullainathan, & Shafir, 2012) undoubtedly contribute to this problem. However, a variety of psychological forces that are amenable to intervention also affect consumers' decisions to take on debt. Specifically, people make erroneous predictions about future spending habits, rely too heavily on values presented on billing statements, and categorize debt and saving into separate mental accounts. The presence of these context-based psychological barriers suggests that policies designed to counter them may help ameliorate the problem.

Although there are many types of debt, we focus on revolving debt (e.g., credit cards). Given that the evidence for the success of financial education is mixed (e.g., Fernandes, Lynch, & Netemeyer, 2014), we propose 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).

### 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), leaving negative

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3 consequences for the future (e.g., large debt burdens). Recent research suggests some factors that  
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5 make it difficult to escape this debt cycle: people under-predict their future expenses (Peetz &  
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7 Buehler, 2009, 2012) and overspend on unusual items that are often considered in isolation  
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9 (Sussman & Alter, 2012). The latter is especially problematic given the large costs associated  
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11 with these exceptional purchases over time. The inverse is also true: people have the tendency to  
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13 overspend when they receive income that can be considered exceptional (e.g., a tax refund;  
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15 Arkes et al., 1994), neglecting to realize that such frivolous spending year after year can have a  
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17 significant negative effect on their overall wealth. Interventions that help people accurately  
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19 understand future expenses and income may thus minimize current spending and future debt.  
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25 Given that hundreds of billions of dollars flow from the government to households  
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27 annually, such transfers may be an ideal setting for policy-makers to implement interventions  
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29 that help people meet budgeting goals. These interventions should help consumers plan for the  
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31 future by 1) incorporating exceptional expenses into budgeting tools and 2) spreading spending  
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33 across time.  
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37 Our first policy recommendation is to match behaviorally informed budgeting tools with  
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39 the receipt of government transfers. First, government should follow the lead of major financial  
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41 institutions in using text messages to alert benefit recipients when the account balance associated  
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43 with a transfer is low or an unusually large transaction has been made. Second, cash transfers  
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45 such as Social Security could be paired with a free app that allows individuals to monitor their  
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47 spending. Most important, we suggest that any such budgeting tool (e.g., mint.com) should  
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49 include a budget category for expenses that are considered out of the ordinary. Doing so could  
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51 promote accurate budgeting for a class of expenses that may be difficult to predict in isolation,  
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53 and even lower spending on exceptional items (Sussman & Alter, 2012).  
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3 A second intervention would target the largest lump sum payment most American  
4 households receive each year: the tax refund. People are faster to spend windfall gains than  
5 ordinary income (Arkes et al., 1994), and are more likely to treat a single large annual payment  
6 as a windfall than several smaller repeated payments. Rather than delivering tax refunds in a  
7 lump sum, we recommend breaking up payments into multiple streams; for example, as 12 pre-  
8 paid credit cards<sup>1</sup>. Even if all 12 debt cards were delivered at the same time, dividing the  
9 payment into 12 units could imply that the refund should not be spent at once, but rather, over  
10 the course of a year (Soman & Cheema, 2011). Further, because consumers save more when a  
11 tax refund is framed as a return to the status quo (i.e., “rebate”) rather than a sudden influx of  
12 money (i.e., “bonus”) (Epley & Gneezy, 2007), the cards could be marketed as “rebate cards” in  
13 an effort to encourage saving.  
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### 29 **Improving Credit Card Statements**

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31 Recent legislation has tried to aid consumers by providing them with more information  
32 on their credit card statements. Namely, the CARD Act of 2009 dictated that credit card  
33 statements include payment warnings detailing not only how long it would take to pay off the  
34 balance if only the minimum payment were made, but also the suggested payoff amount that  
35 would result in the credit card balance being paid off over a period of 3 years. By one estimate,  
36 the CARD Act saved consumers approximately \$11.9 billion per year (Agarwal,  
37 Chomsisengphet, Mahoney, & Stroebe, 2014).  
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48 However, this additional information has the potential to influence repayment in  
49 unanticipated ways (e.g., through anchoring processes; Stewart, 2009). Indeed, aspects of the  
50 CARD Act can potentially lead customers astray: people unduly gravitate toward paying the “3-  
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57 <sup>1</sup> If tax refunds were directly deposited into consumers’ bank accounts, an alternative would be to implement an opt-  
58 out system in which consumers receive their tax refund via monthly direct deposits, rather than a single installment.  
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3 year” amount compared to the minimum or the full balance (Agarwal et al., 2014), because they  
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5 view this 3-year amount as a strong suggestion for what they should pay (Hershfield & Roese,  
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7 2015). This legislation helped consumers who were previously paying less than the 3-year  
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9 amount, but caused a reduction in the fraction of account balances that were previously paid in  
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11 full (Wang & Keys, 2014). As a result, we recommend that policy-makers instruct credit card  
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13 companies to remove the 3-year payment warnings for consumers who regularly pay more than  
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15 the 3-year amount, and increase the warning amount (e.g., state a 2-year payment warning) for  
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17 those who regularly pay less.  
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### 20 21 22 **Encouraging Debt Repayment** 23

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25 Prior research has demonstrated that people often create categories for money (i.e.,  
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27 mental accounts) and that this categorization constrains its use (e.g., reserving \$1 in your right  
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29 pocket for certain purchases and \$1 in your left pocket for others; Thaler, 1985, 1990). This  
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31 process can cause people to treat savings and debt as distinct financial categories rather than to  
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33 integrate them into overall wealth (Sussman & Shafir, 2012). In some cases, this categorization  
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35 can lead consumers to misguidedly take on high-interest rate debt, while simultaneously holding  
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37 money in low-interest bearing savings accounts (Gross & Souleles, 2002; Sussman & O’Brien,  
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39 2014). Existing government infrastructure focused on building savings often reinforces this  
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41 artificial separation. Policymakers could encourage wealth maximization by broadening the  
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43 scope to include debt repayment. We envision at least two ways to achieve this goal.  
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49 First, current tax policy actively subsidizes saving behavior (e.g., through a tax-deferred  
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51 saving platform). These policies communicate the problematic idea that when it comes to saving  
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53 money versus paying off debt, saving is *always* the right thing to do (i.e., an injunctive norm)  
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55 (e.g., Cialdini, 2003). But, many of the credits designed to promote saving could easily be  
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3 expanded to provide similar tax benefits for paying down debt, and could specifically target high  
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5 interest consumer debt. Such policies might not only help make debt repayment as salient as  
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7 saving money for the future, but could also neutralize the existing norm.  
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10 Second, small tweaks to the tax filing process could enable consumers to remit a portion  
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12 of their tax refund to repay debt directly, just as U.S. consumers are now able to split their refund  
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14 among multiple savings vehicles. More broadly, the recent transition to electronic systems for  
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16 making government payments (e.g., direct deposit) provides an opportunity to implement  
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18 scalable behavioral interventions to reduce debt and improve financial well-being. Consumers  
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20 currently control where these funds are deposited (e.g., a bank account), but they do not have the  
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22 option of an automatic payment to a debt account. This structure encourages consumers to  
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24 preserve the mental segregation of asset and debt accounts and makes them less likely to direct  
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26 the money towards debt repayment once it has been received. We thus recommend that  
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28 consumers be given an option to deposit government funds directly towards credit card accounts.  
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30 Doing so could help consumers by opening the “channel factor”—making debt repayment easier  
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32 by eliminating the seemingly trivial but meaningful barriers that make behavior more difficult  
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34 (Lewin, 1951).  
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### 40 41 **Summary of Policy Implications**

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43 People have a tendency to under-predict future expenses, rely too heavily on values  
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45 presented on billing statements, and fail to take into account overall wealth by categorizing debt  
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47 and saving into separate mental accounts. Drawing on insights from recent psychological  
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49 research, we make five key policy recommendations to overcome these obstacles: 1) pair  
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51 government transfers with budgeting tools that remind consumers when they are overspending  
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53 relative to their own guidelines and explicitly incorporate exceptional expenses, 2) split tax  
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3 refunds into separate payments, 3) revise suggested alternative payment warnings on credit card  
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5 statements, 4) provide tax credits for debt repayment, and 5) allow consumers to apply  
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7 government funds directly toward debt repayment. It is our hope that these suggestions will go a  
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9 long way toward encouraging the responsible use of consumer debt.  
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**Table 1.** Psychological barriers undermining successful financial outcomes and suggestions for overcoming them

Problem	Solution	Example Policy Recommendation
Mispredicting future income and spending	Highlight recurring nature of one-time events for consumers	<ul style="list-style-type: none"> <li>• Match government transfers with budgeting tools (e.g., Mint.com) that explicitly incorporate exceptional expenses</li> <li>• Split tax refunds into 12 separate payments</li> </ul>
Relying too heavily on suggested payment amounts contained in credit card statements	Modify anchors presented to credit card customers	<ul style="list-style-type: none"> <li>• Remove 3-year payoff amount for consumers who regularly pay more than it</li> <li>• Increase 3-year payoff amount (e.g., to a 2-year payoff amount) for consumers who regularly pay that amount or less</li> </ul>
Separating saving and debt into separate mental accounts, and prioritizing saving over debt repayment	Put debt repayment on an even playing field with building savings	<ul style="list-style-type: none"> <li>• Provide tax credits for debt repayment</li> <li>• Allow existing government transfers to be applied to debt repayment</li> </ul>

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