Less Is Core: Consumer Debt Repayment and the Budget Constraint Paradox

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How does financial constraint affect debt repayment behavior? Using a sample of indebted consumers, we find that higher levels of financial constraint are predictive of meeting both short-term financial goals and the long-term goal of paying off debt. Paradoxically, consumers with less money are more likely to repay their debts.

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Less is Core: Consumer Debt Repayment and the Budget Constraint Paradox

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EXTENDED ABSTRACT

How does financial constraint affect debt repayment behavior? Do tighter budgets lead to greater difficulty in paying off debt, or do they increase self-monitoring and self-regulatory effort? Well-known personal finance experts such as Suze Orman and Dave Ramsey instruct debtors to cut up their credit cards, but does restricting resources actually improve the likelihood of debt repayment? When consumers who have credit card debt budget their income, they face a tradeoff between the immediate reward of spending versus the delayed reward of paying off debt. Continuing to borrow allows consumers to prioritize immediate rewards over delayed rewards. We propose that cutting up credit cards or closing credit card accounts leads to improved focus on the goal of debt repayment and that this effect is greater for consumers under higher levels of financial constraint (or with less unbudgeted “discretionary” income).

Our research was conducted with the cooperation of a non-profit consumer credit counseling service (CCCS) based in California. More than 2 million Americans receive financial counseling from a non-profit credit counseling organization each year, with 700,000 currently enrolled in a debt management program (DMP) (Cunningham 2013). Despite the widespread use of DMPs, research on their effectiveness is scarce. A debt management program is typically a five-year program, during which program members make monthly debt payments to the CCCS, which then pays off the creditors. Members receive credit counseling and several sessions of financial education upon beginning the program and then normally have little contact with the counselors other than making payments. While all DMP members lose access to credit, they enter the program with varying levels of debt, income, and expenses and thus have varied levels of discretionary income left over after their mortgage payment, bills and other necessities are covered. Participants are admitted to the program only if they are judged to require more help than just budgeting current resources better and additionally, if they and their counselors believe they have sufficient resources to make payments in a DMP.

With cooperation from the CCCS, we conducted a survey with a subset of their DMP clients. One hundred respondents received an email with a questionnaire link once each week for 12 weeks. Questions each week included items about temptations encountered, responses to temptation, and if they met their financial goals for the week. In addition to the questionnaire, we obtained client-level data on initial budgets and program outcomes. In particular, we have access to data from all 10,755 clients who enrolled in the DMP between 2000 and 2013. For each of these clients, we know the date of enrollment, their initial debt balance, and the date and reason for program exit, if observed. Successfully completing the DMP consists of continuing to make monthly payments until all debts are eliminated. Of the 10,755 observations, 20.5% (2,213) of the clients successfully completed the program, taking an average of 42.8 months. It should be noted that some clients leave and choose to make debt payments on their own, whereby any eventual success or failure to eliminate their debt is not observed in our data.

In addition to the data on program performance, we also have data on the monthly budgets that clients constructed with their credit counselors during their intake session, as well as demographic information. After controlling for debt balance, household income, and expenses, we can compare how the level of discretionary income available to the DMP member—which represents the extent to which they are under financial constraint after losing access to credit—affects their persistence in the program.

Using a unique longitudinal dataset consisting of a sample of clients of a non-profit debt management program (DMP), we find that 1) tighter budgets are predictive of meeting short-term financial goals ($\beta = .017, p < .05$) and 2) tighter budgets lead to an increased likelihood of successfully completing the multi-year DMP and meeting the long-term goal of repaying debt ($\beta = -5.19e-05, p < .01$). These findings suggest that, paradoxically, consumers with less “discretionary” money are more likely to repay their debts.

In addition to the timely contribution to the understanding of debt repayment behavior, this research makes several theoretical contributions. First, although studies have demonstrated that financial constraints are associated with increased self-control (Wertenbroch, Soman, and Nunes 2001) as well as increased money management practices (Karlsson 2004), this research is the first to show that imposed financial constraints can increase debt repayment behavior. Second, previous research has focused mainly on improving the budgeting practices of “normal” consumers by increasing the accessibility of the consumption-avoidance goal (Krishnamurthy and Prokopec 2010) or creating partitions between accounts (Cheema and Soman 2008). In focusing on indebted consumers, we extend experimental research showing that payment mechanisms and credit limits can affect spending control (Soman 2001; Soman and Cheema 2002) by demonstrating that this effect is greater when budgets are tighter. Third, extant studies on goal precommitments have primarily focused on self-imposed precommitments, such as setting aside money for a vacation (Kivetz and Simonson 2002). We contribute to this literature by exploring a precommitment that is externally imposed. Although participants choose to enroll in a DMP, they often do so because of calls from creditors and difficulty paying monthly bills. Fourth, credit scoring models generally assume that consumers with greater capacity (i.e., repaying ability) represent a lower lending risk (Thomas 2000). We show, however, that consumers who are in enough financial difficulty to seek help from a DMP and who appear to have greater capacity to repay their debts can actually be riskier debtors with a higher likelihood of default. Finally, we examine financial constraint in the context of a compliance-dependent service (CDS) (Dellande, Gilly, and Graham 2004), as our data are from clients enrolled in a long-term debt repayment program. This is the first study to examine an extrinsic source of motivation (Nyer and Dellande, 2010) in completing a CDS.

REFERENCES


Cunningham, Gail (2013), Personal Communication, November 1, 2013.


