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### III. DEMAND FOR CONSUMER CREDIT

Previous chapters showed that credit use by individuals is as old as recorded history and its regulation is just as old, but credit today labeled "consumer credit" became widespread domestically in the United States only in the twentieth century and especially after World War II. The National Commission on Consumer Finance undertook its review of consumer credit conditions fifty years after modernization of consumer credit began in the 1920s, and full maturation had taken place in the early postwar era. At the outset of the 1970s, the Commission produced a list of recommendations for updating existing credit processes and regulations to help consumers, the relevant institutions, and the legal environment to work better together.

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The National Commission on Consumer Finance (NCCF) did not spend a great deal of time in its 1972 Report discussing underlying individual economic motivations for consumer credit use, known in economics as 'credit demand.' Apparently, the Commission believed that by this time the reasons were fairly obvious. The Commission found that some credit use was by "necessitous" borrowers down on their luck (and often without much discretionary income, i.e., often poor), but most modern consumer credit use was much more mainstream. The Commission's Report reflected the economic theory of consumer credit that had developed during the credit-modernization period and it recorded the empirical evidence.

Serious economic study of consumer credit began over a century ago, around the time of the beginnings of the "modern period" in the 1920s. To preview the discussion in the current chapter, at that time economists determined that consumer credit was more than a means of merely advancing the pleasures of household consumption; rather indeed, consumer credit at that time it also supported household capital formation.

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There are two major benefits for consumers from encouraging capital formation through credit use. First, credit use facilitates purchase of goods and services like housing, vehicles, appliances, home repairs, and educations that provide a return over time from their services. Second, credit use enables consumers to adjust consumption patterns over time including over their entire life cycle to a preferred pattern. It enables purchases like housing and durable goods and services at younger ages when they provide high rates of return for those who have not yet acquired such assets. Necessary

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saving can take place through repayments when incomes have risen. This provides a clear life-cycle effect in credit use where it is most frequently used by the young and use fades a bit with aging. To economists, this is known as a life-cycle effect.

Empirical evidence shows that most consumer credit use arises with household spending to acquire capital goods that provide benefits over time: acquisition of consumer durable goods and services like transportation assets (vehicles), appliances and furniture, home repairs and modernizations, substantial hobby and recreation items, higher education, and mitigation of emergencies. Purchases of this kind involve more than merely current consumption. Instead, they are precisely the kinds of purchases that provide ongoing household services producing additional future benefits, not merely shifting consumption from the future to the present as commonly believed in the past. Consumer investments such as these provide a return in preferred consumption over time that can easily exceed the cost of the credit used in acquisition. Investments that provide a positive return amount to household capital. They are analogous to industrial capital assets, and are wealth and welfare enhancing.

There is a visible life-cycle effect in the purchase of such assets and the accompanying use of consumer credit: Credit use is more frequent among younger consumers (especially those married with children at home). This is the time in the life cycle when asset holdings and household capital typically are low and the rate of return upon acquiring them is high. It also is the time when ready credit availability likely is lowest due to family incomes that have not yet grown, and families have not yet demonstrated to potential lenders the ability to manage credit use successfully. High return and low credit availability in such situations explain why credit demand can exceed supply from mainstream suppliers and how some households at certain times are willing to use higher-cost alternative credit products, even such forms as payday loans discussed further in Chapter 5.

As households mature, they typically reduce debt use gradually and often transition from borrowing to lending, investing funds by lending to banks and other financial intermediaries like insurance companies and pension providers (including IRA trustees) through various savings products. These institutions then lend the funds to businesses, governments, and other consumers. The process of lending to institutions to lend to others is conventionally called "saving," but it should be recognized that it is simply another way in which households make investments that generate a positive return. In this case, the return is through interest payments, life insurance protections, pensions, and other benefits of savings products received from the institutions.

Empirical studies over many decades have confirmed this simple but powerful neoclassical economic model that the primary use of consumer credit by most families is to make productive investments

rationally that generate a positive return over time. In this sense, most consumer credit usage is similar to the reasons why businesses use credit. This chapter reviews the neoclassical model of consumer demand and the empirical evidence that has validated it over time. The chapter then briefly discusses behavioral economics approaches to consumer credit demand, a novel theory that questions the neoclassical consensus that has dominated the field since its inception a century ago.

#### Reasons for Credit Use

The NCCF was aware of the economic theory and evidence that had developed, which was by no means new even in its time. Concerning specific reasons for credit use, the NCCF stated in its *Report* (page 5): "The reasons for this increased use of consumer credit may be found in the natural adaptation of consumer and business changes to changes in the ability and willingness of consumers to incur debt, as well as to a continued shift toward the ownership of assets." In the next few paragraphs the Commission mentioned a number of specific factors. They included increasing and more stable household incomes in the postwar period, increased urbanization of the population, changing population age distribution toward younger families, more women in the workplace necessitating changes at home, and enhanced willingness of creditors to lend. The Commission also discussed trends in the sale of household durable goods and then closed this section by returning to the importance of increased asset ownership (p. 6):

The shift to asset ownership also reflects a decision by consumers to substitute the use of consumer-owned capital goods for the use of commercially-owned capital goods. Thus the purchase of an automobile substituted, perhaps unfortunately, for daily fares on street cars and buses, the home washing machine and dryer for payments at the laundromat, and the television set for the admission price to movies and other forms of entertainment. Even if the auto or appliance were purchased on credit, the monthly installments paid for it over a much shorter interval than the period of time over which services were received. In addition, quite often consumers also gained significant returns on their investment.

These motivations are intuitive as well as consistent with economic theory and empirical evidence. By itself, however, acquisition of investment assets (or satisfying necessitous situations) is not the complete answer to the question of underlying economic motivation leading to consumer-credit use. There actually is more to the story. As indicated, economists have thought about the essentials of this motivation for more than a century.<sup>1</sup>

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<sup>1</sup>For the early development of theory in this area, see Irving Fisher, *The Rate of Interest: Its Nature, Determination, and Relation to Economic Phenomena* (New York: Macmillan, 1907), Irving Fisher, *The Rate of Interest* (New York: Macmillan, 1930), and

For descriptive purposes, it is common to say that consumers use consumer credit for such and such a purpose, most notably for purchase of costly assets. Nonetheless, a little reflection quickly shows that buying autos, household repairs and furnishings, major hobby items, and educations is only part of the fundamental economic behavior that gives rise to these classifications of debt. There is also another part.

Rather, it is useful to recall that a significant component of the underlying, basic economic demand motivation for consumer credit use is the desire by consumers to change both the size pattern and the timing of their resource inflows and outflows, especially the investment outflows. Credit markets arise to change the lumpiness of the patterns, particularly of the outflows for purchasing housing and durable goods or for necessities, and to bring *household capital investment* transactions forward in time to the present instead of far off in the future.

In more detail, most purchases on credit could be accomplished by accumulating cash first and then buying the item later, but this often is not the time pattern consumers prefer. Significantly, for many goods, accumulating cash first could mean doing without the item or paying for more expensive substitute services for a period that might amount to years, both of which are costly. For instance, delaying purchase of a vehicle while saving enough cash to make a cash purchase means doing without the convenience of available transportation, possibly limiting places to live, and paying for expensive transportation substitutes in the meanwhile. Not managing some emergency situation could prove even more costly. Waiting to make these asset adjustments is frequently not going to be the preferred option in societies where there is an alternative. The types of credit we observe in the marketplace in large part come about because they are the least costly ways of providing an acceptable alternative.

Specifically, inflows from salaries and wages that comprise the income of most employed workers in a modern economy typically are quite regular for most consumers (even for many hourly workers), and credit offers the opportunity to smooth the outflows. Lumpiness in outflows can occur during the course of the period between paychecks,

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especially Edwin R. A. Seligman, *The Economics of Installment Selling: A Study in Consumers' Credit* (New York: Harper, 1927, two volumes). The foundational economics is discussed in considerably more detail than here in Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki *Consumer Credit and the American Economy* (Oxford and New York: Oxford University Press, 2014), Chapters 3 and 4, and in many references there. See also Gregory Elliehausen, "Behavioral Economics, Financial Literacy, and Consumers' Financial Decisions," in Allen E. Berger, Philip Molyneux, and John O. S. Wilson, *The Oxford Handbook of Banking* (Oxford: Oxford University Press, 2019), Chapter 25. For discussion of cultural aspects of development of consumer credit in the twentieth century and its institutions, see especially Lendol C. Calder, *Financing the American Dream: A Cultural History of Consumer Credit* (Princeton: Princeton University Press, 1999) and in other historical references noted in this Taskforce report in a footnote in Chapter 2 above.

but it certainly will occur during the course of longer periods like a year, within a particular life cycle stage, or over a consumer's or family economic unit's whole lifetime.

For example, for many families expenditures increase during selected seasons like vacation periods, back to school time in September, and around the year-end holidays. Then in some years there also are bigger, investment-type purchases, such as an automobile or a new home. A few years later there may be need for another auto or a larger home and later still for college educations for children. Purchase of a vacation home or a large recreation item like a boat may occur once or twice in a lifetime. Home repair or modernization may be important at some points. Sometimes there also are emergencies.

Credit facilitates all these transactions by enabling households to use future regular inflows for the saving necessary to pay for lumpy expenditures made today. Consumers have shown that they are willing to pay a price in the form of interest and finance charges for the possibility of changing the time pattern of saving to a preferred one: acquiring the relevant asset and the return advantages it provides now, thereby obviating the need for costly substitutes, delay, inconvenience, and even delayed gratification while undertaking the sometimes lengthy and disciplined savings process.

This picture of inflow and outflow/expenditure patterns illustrates how it often is not really correct to say that credit arises solely for the purpose of purchasing specific investment items. The purchases could often be made anyway, just on a different schedule. The accumulating (saving) could be done first, although this would also mean postponing the benefits of the investments (or not solving the emergency situation) and often paying for substitutes in the meanwhile, often for a long time, both of which are costly. The correct interpretation is that credit markets arise to increase consumers' overall well-being by changing the time pattern of both saving and expenditure outflows (typically for lumpy, large purchases) to a preferred one.

The classification by usage problem is especially obvious in the example of an individual purchasing a \$35,000 automobile or truck on credit but who simultaneously holds \$35,000 or more in a savings account, IRA, 529 college savings plan, or some other financial asset. In some significant sense this individual is not really using credit only to purchase the vehicle. Rather, the underlying motivation for credit use is to avoid some combination of not buying the car or truck now and entailing costs in not being able to undertake transportation, not giving up some other important purchases either, not paying taxes and penalties for liquidating assets held in retirement accounts, and not reducing reserves stored in other financial assets. Risk-averse consumers may well prefer not to reduce their reserves, which are valuable to them, and replacing them is costly and takes time. For many individuals, credit availability through good credit standing can also serve as at least a partial substitute for extensive advance and

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Rob Levy & Joshua Sledge, Ctr. for Fin. Serv. Innovation, *A Complex Portrait: An Examination of Small-Dollar Credit Consumers*, at 6 (2012).

[[HYPERLINK "https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/01/31163518/A-Complex-Portrait-An-Examination-of-Small-Dollar-Credit-Consumers.pdf"](https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/01/31163518/A-Complex-Portrait-An-Examination-of-Small-Dollar-Credit-Consumers.pdf) ]

Center for Financial Services Innovation became the Financial Health Network in 2019, check the Fin. Health Network's about page, <https://finhealthnetwork.org/about/> (last visited Nov. 16, 2020.)

precautionary savings. In other words, credit availability obviates the need to do things consumers think are disadvantageous, like giving up substantial current consumption in order to make large purchases or periodically running down financial reserves, while still matching the pattern of outflows (payments) better to inflows (paychecks).

Certain kinds of credit associated with specific sorts of investment purchases arise because they permit changing the flow pattern in the least-cost manner. Credit is often associated with automobile purchase transactions, for example, because the associated expenditure is large and since relatively large amounts of credit at relatively low cost are readily available to those who are willing to offer the auto or truck as collateral for the loan. Such loans are so common that "automobile credit" has become a large industry by itself. Credit generated in the process of making home improvements and buying automobiles, durable goods, and educations, and a variety of other transactions including payment of taxes, debt consolidation, etc. which are all well-known types of consumer credit. Advertising for each usage is common and many financial institutions memorialize these distinctions by separate departments and personnel, even separate subsidiaries and companies.

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For the most part, most official figures of the volumes of credit for many "uses" are no longer assembled by the government's statistical mills, largely for the conceptual reasons mentioned, and because of the practical difficulties with collecting necessary data from creditors to generate meaningful statistical aggregates according to consumers' use of the credit.<sup>2</sup> The only practical way to produce an estimate of consumer credit purposes is to design statistically reliable surveys of consumers like the Surveys of Consumer Finances, ask respondents about their credit experiences, and then in some manner extrapolate from their experiences to the broader public using statistical weighting procedures (see Chapter 2 of this Taskforce report for further discussion of the Surveys of Consumer Finances and some findings about credit use).

#### Neoclassical Economic Theory of Consumer Credit Demand

Consistent with these ideas as indicated above, neoclassical economics, sometimes referred to as "mainstream economics," began formal exploration of consumer credit use in the early part of the twentieth century. It soon produced a body of testable hypotheses that have stood the test of time.

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<sup>2</sup>In the past, the Federal Reserve Board collected information on amounts of consumer credit by usage in its monthly survey of credit volume at granting institutions, but the Board discontinued the usage collection decades ago, except for automobile credit and student loans. Before that time, the monthly surveys asked lending institutions to report credit according to whether it was for automobiles, durable goods, home improvement, or other, but even classifying credit into a few broad categories became increasingly difficult with the advent of open-end credit like revolving credit cards where lending institutions knew little or nothing about specific uses of the accounts.

As with use and production of other goods and services, underpinnings of neoclassical economics arise from the central concepts of demand and supply. In neoclassical economics, demand for anything arises from its usefulness or "utility." Supply, in turn, depends on production costs and the potential opportunities for gains over production cost (profits) among potential suppliers. Interaction of demand and supply in markets produces exchange at prices reflecting the utility and production-cost characteristics of the products exchanged. Prices tend toward equilibrium where demand equals supply. Competition can lower prices to the lowest level consistent with covering production costs and profitability just sufficient to bring capital into the industry.

Economists have examined these notions of demand, supply, prices, equilibrium, and competition for decades, even centuries for some products. In these explorations, few areas have a richer history than credit demand and supply. Analysis of credit and credit markets has become a major mainstream area of economics known today as "finance." And so, this chapter looks first in further detail at the basic question of the motivations for using consumer credit in the first place, the concept of credit demand in mainstream financial economics.

The next chapter then discusses credit supply, but not before the second part of this chapter moves to some recent ideas about the range of motivations that might influence credit demand. This latter discussion arises from suggestions for possible enrichments to mainstream economics that have arisen from a branch of the field known as behavioral economics. Suggestions from behavioral economics concerning credit use have not always been demonstrated empirically, however, as discussed further in the next section.

Today, most close observers of consumer credit find that its demand arises from its usefulness. Much of it clearly serves useful purposes by allowing individuals to purchase and use capital goods and services while simultaneously undertaking the saving to pay for them through the loan repayments. For many individuals, this allows a change in timing of capital purchases to a more favorable schedule. Importantly, it also avoids the necessity of purchasing expensive substitutes in the meantime while the saving is taking place. People could take often-expensive urban and suburban mass transit to work for years, for instance, while also foregoing the mobility they prefer by saving first rather than using auto loans. Likewise, they could exercise the high opportunity cost of years with a lesser-~~skill~~/paying (and possibly less satisfying) job while saving for college instead of employing a student loan.

The modern formal economics of credit use essentially began with the classic works of Yale University economist Irving Fisher in the early twentieth century (Fisher 1907, 1930). Subsequently extended to consumer credit by Seligman (1927), Hirshleiffer (1958), and Juster

and Shay (1964), Fisher's work provides the basic framework of the neoclassical economic theory of consumer credit use.<sup>3</sup>

The basic idea of the mainstream theoretical explanation for credit demand derived ultimately from Fisher is that individuals have available to them opportunities that provide a desirable future return. Examples include consumer durable asset purchases that provide a return over a future period. Opportunities also include services, like investing in human capital development such as educations, and cost-reducing actions that mitigate the effects of emergencies.

These opportunities permit individuals to invest current resources to provide a return over time while saving for the purchase through loan repayments. The optimal amount of investment is undertaken when the rate of return on the next investment (declining as the more promising investments are undertaken earlier) just equals the available interest rate on the next investment (rising as lender risk increases).

Investments that provide a return over time use current resources, however, possibly large amounts of them. If individuals prefer more current consumption than allowed by the remaining resources still available from current income, consumer credit permits them to borrow resources to finance the assets and still maintain preferred levels of current and future consumption through employing future saving to make the repayments. In other words, as they undertake the investment process that requires current resources and interferes with current consumption, they can borrow against future income in a way that advances both goals: 1) facilitating household investment with its returns and 2) preferred pattern of consumption.

Development of this theory demonstrated that the optimal investment decision with borrowing opportunities available can involve greater levels of investment and higher returns than otherwise. It also permits a more highly-valued intertemporal pattern of consumption than the optimal investment without borrowing opportunities. This important result for consumer credit (discussed first by Seligman in 1927) countered the widespread belief held in the late nineteenth and early twentieth centuries, and still existing today in some quarters, that all or much of consumer credit use is merely profligacy, and essentially an attempt to live beyond one's means. (Sometimes the profligacy notion of consumer credit used to be called disparagingly by some economists and other observers the "home economics" theory of consumer credit that saving should always take place first.)

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<sup>3</sup>See Irving Fisher, *The Rate of Interest* (1907 and 1930), op. cit., Edwin R. A. Seligman, *The Economics of Installment Selling*, op. cit., Jack Hirschleifer, "On the Optimal Investment Decision, *Journal of Political Economy*, August, 1958; and F. Thomas Juster and Robert P. Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation* (New York: National Bureau of Economic Research Occasional Paper Number 88, 1964).

Of course, there are exceptions to this general rule that credit use is not necessarily profligate, as there are to almost any such general statement. It is easy enough to cite examples of individuals who borrow when they probably should not. Some bad outcomes are even predictable in advance when repayment commitments visibly become too large for a satisfactory outcome.

But other bad outcomes from credit use come about because of events that arise only subsequently to the credit decision and were not predictable at the outset. They include credit failures that arise from economic problems such as job loss or other emergencies that reduce or eliminate expected future income. This involves the concept of risk. To limit these situations, creditors themselves have an interest in preventing too much credit expansion: Losses can ensue when credit for any individual becomes too high (even any credit amount greater than zero for some potential borrowers). Creditors guard against such situations by requiring initial equity in assets (through down payments), raising the price of credit as risk increases (higher interest rates), and by limiting credit all together at some point (credit rationing).

Most consumers may not fully think about or understand all the components of the credit demand process outlined, but the economic theory derived ultimately from Fisher and Seligman is consistent with empirical evidence. Evidence shows that much of consumer credit use comes about in the process of acquiring consumer assets that provide a return over time. Such credit generation includes automotive credit, student loans, durable goods and large recreational goods credit, and credit involving home repairs and modernization. All of these involve larger purchases that provide a return over time with payment patterns that do not eliminate current consumption either.

Another component of credit generation involves mitigating emergencies. Reducing or solving an emergency situation amounts to an investment addressing some cost-causing event, for example an automobile repair need or a health emergency. Eliminating or mitigating the emergency situation without also drastically changing the pattern of current consumption can reduce costs of the emergency, again providing a net positive return over time due to the reduced costs. In the case of a health emergency, the cost reduction (return) versus not fixing the problem could be substantial. In any of these events, focusing only on the cost of the credit without looking at the return is incomplete.

Another empirical finding described in Chapter 2 and mentioned earlier in this chapter is that consumer credit use is more frequent among younger consumers, especially younger families with children, than among older consumers. Younger consumers have had less time and older consumers a longer time to undertake investments and acquire productive consumer assets including transportation and educations. This suggests that the younger consumers will often find remaining investment opportunities with higher returns than older consumers, and

younger consumers will often be more willing to borrow to change the pattern of future consumption than their older compatriots. This has led to a life-cycle formulation of the pattern of consumer credit use.

Analysts such as Hirshleifer (1958) and Juster and Shay (1964) followed in Fisher's and Seligman's footsteps by relaxing some of the theoretical contentions especially relevant to consumer credit in the earliest manifestations of neoclassical finance theory. Hirshleifer explored the situation where rates that consumers can borrow are higher than rates at which they can lend. This led to the conclusion that there are situations when consumers will borrow (rate of return is greater than their borrowing-cost rate), lend (rate of return is less than their lending rate), or do neither (rate of return is between their borrowing rate and lending rate). All of these possibilities are observable among differently-situated consumers, with the younger ones most likely willing to borrow. Hirshleifer also explored the implications of rising borrowing rates for consumers as they take on more debt. He concluded that rising rates would reduce the amounts of investments and borrowing as rates rise, but this was consistent with the theory.

Even armchair empiricism suggests the reasonableness of Hirshleifer's conclusions. Many individuals will borrow when presented by attractive opportunities (returns are high), but they are less likely to continue borrowing at higher debt levels because interest rates rise and the protection of current consumption is smaller due to greater repayments. That is, the underlying rates of return become lower due to higher interest rates and repayments. At some point rates of return no longer exceed borrowing costs and new investment ceases. Consumers in this situation may neither borrow nor lend or they may lend in financial markets or through financial institutions. Thus, looking at the consumer borrowing life cycle, borrowing at a young age, then later limiting borrowing, and eventually switching over more to lending rather than borrowing as rates of return on further investments fall reflects the situation of many consumers as they age.

Juster and Shay's further extensions of the theory accounted for contract terms that reflect the unwillingness of many consumer lenders to finance the entire cost of consumer durables (i.e. they require down payments) and the existence of specialized lenders offering small amounts of unsecured credit at relatively high interest rates. Their conclusions also are consistent with empirical experience.<sup>4</sup>

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<sup>4</sup>This is the same Robert P. Shay of Columbia University who was an economic consultant and, in effect, the Chief Economist of the National Commission on Consumer Finance in 1971-2. F. Thomas Juster was a specialist in human capital formation and was Director of the large Institute for Social Research at the University of Michigan where much of the early research work on psychological and behavioral analysis of credit demand took place around the same time. Both were veterans of the National Bureau of Economic Research (NBER), then in New York and now in Cambridge, Massachusetts, where Shay had been full-time head of the consumer-credit research program in the 1960s and Juster the NBER's president.

Other than credit cards, consumer credit is generally offered on an installment basis, with a repayment schedule of periodic (typically monthly) payments that amortize the loan principal plus interest. Common automobile loans, student loans, and unsecured personal loans take this form. Since the funds for repayment depend on the consumer's uncertain ability to have available future income for payments, lenders commonly limit the amount of credit and adjust repayment terms. On nonrevolving credit that was the common sort of consumer credit available when Juster and Shay were writing, creditors limited the amount of credit by requiring an initial down payment and a repayment term that was less than the expected economic life of the asset.

In their addition to lending theory, Juster and Shay discussed the possibility that a range of different lenders would develop in the marketplace, based upon their willingness to make riskier loans and charge higher lending rates. Consumers who prefer more credit than primary (low cost) lenders are willing to offer them, or who are unable to borrow at all from these primary lenders because of risk, may be able to borrow from supplemental lenders who provide additional credit at rates higher than market rates of primary lenders.

Looking at the marketplace today, there are many lenders that provide credit to riskier borrowers than prime borrowers. They include various kinds of subprime lenders such as higher-rate subprime credit card and auto lenders, small-loan companies, and payday lenders, among others (see Chapter 5 for further discussion of them). Supplemental lenders' willingness to extend additional credit is not unlimited either, however. Consumers may sequentially increase borrowing from additional lenders who are willing to accept greater default risk, but the amounts are ultimately limited because ultimately no lender will make loans that are certain to default without compensation.<sup>5</sup> This is the basis of the idea of credit rationing (credit rationing is also discussed further in Chapter 5).

Much has changed since Juster and Shay were writing in the early 1960s. For instance, advances in information availability through credit reporting agencies (CRAs, widely known as "credit bureaus") and in the technology to manage and analyze large amounts of information have improved ability of creditors to assess risk, making them on balance more willing to lend. Credit reporting through the credit bureaus is now much closer to comprehensive and new information about individuals with little prior credit experience is under exploration. This has the potential to make overall predictions of future payment performance better still. Development of generic credit scores by the credit bureaus has made statistical evaluation relatively inexpensive and readily available to virtually all lenders. Marketplace

**Commented [SY(11):** Might include the time element. They are not only comprehensive but seem to provide relatively current info (when working correctly), which facilitates lending.

<sup>5</sup>See also David S. Bizer and Peter M. DeMarzo, "Sequential Banking," *Journal of Political Economy*, February, 1992.

competition has also relaxed lenders' equity requirements, as terms to maturity have lengthened for credit advances and down payment requirements have grown smaller and less frequent. Today, many consumers are more able to finance a greater proportion of household investment through primary (low-rate) lenders like automobile and credit-card lenders than in the past. Competition of lenders on a variety of margins including price, availability, and non-price terms is discussed further in Chapters 6, 7, and 8.

At the same time, there are more secondary (higher-rate) lenders who are willing to lend supplementary amounts beyond the willingness of primary lenders. The National Commission on Consumer Finance extensively studied the operations, costs, and credit supply of one group, traditional installment cash lenders (known then as small loan companies or licensed lenders). There were pawnshops at the time of the NCCF, but they were uncommon enough in many places that the Commission barely mentioned them. There also were considerable amounts of consumer credit available from retail stores and dealers and the Commission discussed retail-store credit at some length. This latter kind of consumer credit has dwindled greatly over the decades since then with the growth of bank credit cards.

Today, unsecured credit on bank credit cards is more widely available, and many borrowers now use them in the manner that they used unsecured personal loans from finance companies in the past.<sup>6</sup> Competition has extended availability of bank credit cards to many consumers who in the past would have had difficulty qualifying for them. Because bank-card rates are generally lower than other unsecured consumer-credit rates, unsecured credit is now available to more consumers at a lower cost than in the past.

Nonetheless, there also are more pawnshops nationwide than existed at the time of the NCCF, and also whole new classes of secondary lenders. They include so called "payday lenders" and vehicle-title lenders (sometimes called title pawns). Despite better technology and relaxed standards among primary lenders, there still are many individuals unable to borrow from low-cost primary lenders who necessarily rely upon secondary lenders or who have no institutional credit available at all, including from secondary lenders.

Chapter 2 of this report showed that interaction between relative benefits and costs of credit has led to a lot of credit use over time. Further, although there is always a lot of discussion about conditions where credit arrangements go wrong, the Surveys of Consumer Finances show that the difficult cases are not in the majority. For instance, in the 2019 survey, 12.3 percent of consumers with any debt indicated

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<sup>6</sup>See Bizer and DeMarzo, 1992, "Sequential Banking," op. cit. and Dagobert L. Brito and Peter R. Hartley, "Consumer Rationality and Credit Cards," *Journal of Political Economy*, April, 1995.

being behind in any payments in the previous year but only 4.6 percent behind by 60 days.<sup>7</sup> Undoubtedly, at least some of these accounts paid off and produced a positive outcome, even if slow. According to the 2019 Survey, 2.0 percent of households had declared bankruptcy in the previous five years. This is not to minimize the woe that results for individuals who stumble in using consumer credit, but rather to point out that these cases are not the norm. Taken as a whole, evidence does not suggest an increase in the proportion of distressed borrowers over time, and discussion on Chapter 2 above showed that aggregate repayments on consumer credit relative to household income have not increased in the past four decades (see Figure 2-3).

Measuring rates of return on consumer assets empirically is difficult in large part because circumstances and needs of credit-using consumers vary so widely, and outcomes differ as well. It seems difficult to argue, though, that returns can be anything other than positive for the most part, as theorized by Seligman, Hirschleiffer, and Juster and Shay. For consumers themselves, it seems that benefits and costs of credit use are too well known not to be the part of consideration and deliberation by credit users in most cases.

It is not especially difficult for consumers to contemplate the potential benefits and costs of credit use. This would be especially true following their initial experiences, and evidence shows that following initial experiences, most consumers continue to use consumer credit over their life cycles. On the cost side, Truth in Lending, passed in 1968 and implemented the following year, was an attempt to simplify cost understanding. Evidence shows that many consumers use this information in the ways they prefer, annual percentage rates (APRs) for larger amounts of credit for longer periods of time, and dollar finance charges for small amounts for shorter periods (see discussion in Chapters 5 and 7 below).

Seligman discussed flows of utilities from consumer investment in durable goods as early as 1927, and there have been attempts at direct empirical measurement at least since the time Juster and Shay were writing. For instance, in 1964 Poapst and Waters published their estimates of rates of return on consumer durable goods in the prestigious *Journal of Finance*.<sup>8</sup> Using methodology basically similar to how an investment analyst would study a commercial investment opportunity, they estimated rates of return on an automatic washer and dryer and a television set "for different rates of usage and periods of investment" (p. 673). Costs of acquisition and operation were estimated with care and their equations showed that discounted returns were quite high with reasonable estimates of usage and length of

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<sup>7</sup>Neil Bhutta, et al., "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, September 2020, pp. 28-9.

<sup>8</sup>J. V. Poapst and W. R. Waters, "Rates of Return on Consumer Durables," *Journal of Finance*, December, 1964.

ownership. This would encourage household investment in durable goods using credit under many common circumstances. In their words, "Under such circumstances, the relatively minor variations in consumer loan interest rates that general monetary policy might be able to produce are not likely to markedly alter the volume of consumer investment" (p. 677).

The NCCF was aware of their approach and commissioned Professors Dunkelberg and Stephenson of Stanford University Business School to examine it further.<sup>9</sup> In addition to looking at discounted flows of returns and costs together as a financial analyst would do (and Poapst and Waters did), they explicitly also discussed how discounted net returns would also determine the pattern of acquisition of durable goods, namely, those with highest returns would likely be purchased first. They noted that this order could vary substantially among different consumers and households due to preferences and could vary over time, depending upon life-cycle stage. Due to the difficulties of ascertaining individual preferences, Dunkelberg and Stephenson directed their attention first to discounted net returns for a washer and dryer under varying usage conditions, similar to Poapst and Waters.

They then used their own analysis of returns on this particular pair of consumer durable goods as a benchmark. They found (like Poapst and Waters) that returns on an owned washer-dryer could be quite high in many cases and they concluded that returns on some other durable goods must be even higher. They discussed how estimates of rates of return for all durable goods in all circumstances would be difficult to make, but that ownership patterns suggested that many other goods, like refrigerators, were even more important than washers and dryers. If they were more important, this meant they provided even higher discounted returns (data on appliance holdings of families were from the 1967 Survey of Consumer Finances). Dunkelberg and Stephenson acknowledged and discussed the analytical difficulties with this conclusion (such as differences between home owners and renters), but in their words findings "suggest that such an approach could provide considerable insight into the purchasing behavior of consumers, when combined with data about the cost and availability of capital for various population subgroups" (p. 46).

In 2001 Elliehausen and Lawrence provided simple simulations of potential returns on consumer purchases and concluded that they could be welfare enhancing even at payday-loan rates. For discussion, they assumed the example of an individual in need of a \$200 payday loan of two weeks for a fee of \$30 (APR of 391 percent). But public transportation to employment and additional time spent is also

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<sup>9</sup>William C. Dunkelberg and James Stephenson, *Durable Goods Ownership and the Rate of Return*, Technical Studies of the National Commission on Consumer Finance, Vol. VI (Washington: Government Printing Office, 1975).

expensive, and under reasonable representations of such incurred costs, it was easy enough to show that the loan to repair the car now would be welfare enhancing on the basis of a financial analyst's calculation of net present value. This would argue for the financial choice to borrow and make the repair.<sup>10</sup>

More recently, analysts at Georgetown University used an approach similar to Poapst and Waters, Dunkelberg and Stephenson, and Elliehausen and Lawrence to rank colleges according to graduates' returns from attendance/graduation, taking college costs and student loan costs into account.<sup>11</sup> Although similar in underlying methodology to the earlier studies, the Georgetown study also includes simplified description of the underlying approach for those less familiar with financial analysis.

On the first page of the Introduction, the authors lay out the essence of the issue about credit: "However, while much has been written about student debt, not all debt is bad.... In addition, they [students] should consider the net present value (NPV) of their potential earnings, weighing the costs of investing in college now against the potential gains over time." The report goes on to use data from the U. S. Department of Education's College Scorecard, its online database providing information on earnings and debts of attendees at post-secondary schools across the country, to rank these institutions by net return on investment.

The approach in the education study is basically the same as undertaken by Poapst and Waters and Dunkelberg and Stephenson, but with much more extensive data. The methodology of any such study requires care in properly stating gains and costs, and all these studies discuss what they have done. The Georgetown study necessarily works with medians whereas the earlier studies of durable goods looked more at the range of individual outcomes under varying circumstances rather than medians. The education study also provides footnotes to some other related studies with some differences in their underlying estimating equations (like employing different discount rates). But for the purposes here, the interesting aspect involves its basic conclusions, even though changing the underlying data assumptions could lead to some variations in the specifics of the outcomes.

In particular, the conclusions are certainly more favorable and optimistic than the conventional wisdom. It seems there exists a widespread view that there is a student-loan debt "crisis" due to high costs and unfavorable economic outcomes associated with much of higher education today. Certainly, the nature of medians is that they are the

<sup>10</sup>Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand* (Washington: Georgetown University Credit Research Center, Monograph Number 35, 2001).

<sup>11</sup>Anthony P. Carnevale, Ban Cheah, and Martin Van Der Werf, "A First Try at ROI: Ranking 4500 Colleges," Georgetown University Center on Education and the Workforce, 2019. Other studies referenced there have also used the same basic approach.

center of the range of outcomes. There necessarily are going to be better and worse outcomes than the medians. Some will be much worse (and some much better). But the notable finding of the study is positive net present value of graduating at virtually *all* of the institutions, even given the possibility of taking on debt: "Our findings buttress the idea that college is a worthwhile investment. Moreover, we take the position that college should be seen as a long-term investment" (p. 4).

Clearly, investors in such undertakings (students and parents) should consider the potential benefits and costs, as with any investment. They certainly also should consider the likelihood that the student will finish the course. Even then, this is not to say that an outcome much worse than the median might occur in individual situations. Potential variation in outcomes involves the concept of risk, which is a characteristic of all investments. And certainly, no one ever liked a debt, due to undertaking an investment or not, but this does not mean the investment should not be undertaken.

To summarize, the message in this section of this report chapter is that development of the neoclassical economic theory of consumer credit suggests a number of important ideas and that empirical evidence is consistent with them:

1) Consumers will be willing to borrow, depending upon rates of return and cost of borrowing available to them. For many households, using debt to finance certain purchases is a rational investment that provides an implicit rate of return that exceeds the cost of finance.

2) Borrowing will tend to be related to household investment undertakings like purchase of durable goods, acquiring human capital, capital improvements and repairs, and emergencies when credit use can be cost saving (or sometimes even life-saving).

3) There would be a life cycle effect in credit use, since rate of return would be higher in most cases for younger consumers who have not developed a stock of assets and who have limited savings and lower incomes they typically will have later in life.

4) Since credit involves an unknown future, there are risks in using it.

5) There will be both primary (lower-rate) and supplementary (higher-rate) lenders that develop (in the absence of regulation to the contrary, discussed further in Chapter 5).

6) Secondary lenders supplement available credit for some borrowers and provide it to others for whom credit is not available from primary lenders.

7) There is also risk in lending and so there is an absolute lending limit even for secondary lenders due to economic credit

**Commented [SY(12):** Consider moving this last section to the beginning, to show the reader where you are headed. You can still summarize, again, perhaps in shortened, series form. Just a suggestion.

rationing. This means that there are some individuals who have only higher-rate credit available or no institutional credit available at all. Credit rationing is discussed further in Chapter 5.

Empirical evidence is broadly consistent with these conclusions but this does not mean these conclusions complete the theory of demand for household credit or that they are not controversial. The next section looks at this question in still more detail.

Behavioral Theory and Neoclassical Economic Theory  
of Consumer Credit Demand

Todd has said he will provide a draft of this next section.