

Sticking to Your Plan Hyperbolic Discounting and Credit Card Debt Paydown (Kuchler, 2015)

Credit cards are used to purchase goods even if there is no money available at the moment. Their ease of use it can incentivize present consumption and short-term debt. In the U.S., a median household is paying 140\$ monthly only on interest payments. A service called “ReadyForZero” can help people to create a plan to completely pay their debts. Interestingly, most users fail to meet their own expectations and plan.

One Sentence Summary

Present bias can explain why people delay debt payments and subsequently fail to pay their debts. *Naïve* agents eternally procrastinate debt payments substituting them with present consumption. But *sophisticated* agents will foresee the problem of procrastination and will pay more of their debt than *naïve* ones.

Main Findings

Why do people fail to pay their debts? Humans value the present more than the future; a phenomenon psychologists call *present bias*. If someone is hungry now, they prefer to eat an apple today than tomorrow. However, when they face long-term problems, like saving for retirement, present bias can be harmful.

Imagine the next example. Someone wants to pay a debt of 120\$ by twelve payments of 10\$ each month for a year. They pay an accumulative amount of 50\$ in firsts five months. On the sixth month, they decide that this month they need to expend extra 5\$ on a pair of shoes, thus paying only 5\$. Typically, people perceive that six months is plenty of time to make up for a 5\$. Nonetheless, on the seventh month they do the same, up until the last month. In the last month they need to pay 40\$ dollars to meet their objective. Most do not have an extra 30\$ in a single month. *Present bias*, in the sixth to twelfth month, created the incentives to not complete their original plan to pay their debt on time.

Everyone is subject to present bias, but some create ways around it. A *sophisticated* agent will know that they will not carry out their initial plan. With this knowledge, they set an automatic withdraw of 10\$ each month for a year. Making them unable to change their plan month to month. Whatever it happens, 10\$ will leave the account. This is called a commitment device, which will help the agent to complete his initial goal. On the other hand, a *naïve* agent will think he will stick change their debt payment plan. But when they need to pay, they will not and will think they can make up for it later.

Using “ReadyForZero” data the author compared the actual credit card debt payments with the provided plan. They found that *sophisticated* agents where closer to their targets than *naïve* agents. Nonetheless, most of both types failed to fulfill their payment plans. *Present bias* is the only explanation thus far to explain the joint behavior of debt payments and consumption. Credit restriction could explain a delay in debt payments, they cannot address the increased

consumption in naïve agents from increased income. Spending habits could explain consumption, but not their repayment behavior.

Concluding Remarks

In the U.S., most household's live paycheck to paycheck, the main culprit is debt - mainly credit card debt. High debt is not in itself bad. But, high levels of debt could amplify the negative effects of a bad economic cycle. This study suggested that commitment devices, like a form of automatic debt payments, can help people resist the urge to buy a new flat screen and reduce their debts.

References

- Kuchler, T., 2015. Sticking to Your Plan: Hyperbolic Discounting and Credit Card Debt Paydown. SSRN Electron. J. <https://doi.org/10.2139/ssrn.2629158>.