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Research Report

# Keeping consumers in the red: Hedonic debt prioritization within multiple debt accounts

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## Abstract

In our paper we contribute to the burgeoning literature in the psychology of debt repayment. Across three experiments, we explore the effects of the type (hedonic or utilitarian) and the timing of debt on consumers' debt repayment when managing multiple debt accounts. While prior literature has demonstrated that debtors who own multiple credit cards behave irrationally by paying down smaller balances rather than balances with higher interest rates, we found that debts incurred for hedonic purchases and in the distant past (versus proximal past) amplify this effect. The anticipated impact of debt repayment on consumption enjoyment is found to mediate this effect.


*Keywords:* Debt management; Credit card debt; Financial decisions; Debt type

## Introduction

As the number of credit card transactions has increased in recent years, so has the credit card debt of consumers. Recent credit card statistics report that 56% of the U.S. population carries a balance equal to $801 billion (Board of Governors of the Federal Reserve System, 2012). This is because many credit card owners fail to pay the full balances on their credit cards, and they eventually allow the debt to grow as their repayment rate slows.

The behavioral finance literature indicates that people do not always employ normative debt management principles. For example, Navarro-Martinez et al. (2011) and Stewart (2009) found that presenting information about the minimum required repayment lowers the repayment amount relative to an absence of such information, and thus, is counter to the intended effect of providing such information. Similarly, Amar, Ariely, Ayal, Cryder, and Rick (2011) found that people make payments towards smaller debts as opposed to highest interest rate debts because this decision offers some psychological benefits to the debtors (Gal & McShane, 2012). For example, a person with a $300 loan with a 6% interest rate and a $3000 loan with a 12% interest rate may decide to pay off the $300 loan with her first paycheck, rather than a portion of the $3000 loan with the higher interest rate. Amar et al. (2011) refer to this phenomenon as 'debt account aversion' since the desire to limit the number of open accounts overrides the financially optimal choice of paying down the debt with the highest interest rate first.

The current study extends this stream of research on the psychology of debt payment by investigating how people prioritize their debt repayment depending on the type of debt ('debt type' hereafter) and timing of debt occurrence ('debt timing' hereafter). In particular, we demonstrate that when debt is incurred for a hedonic purchase (as opposed to a utilitarian purchase) and it is realized in the distant past (as opposed to the proximal past), customers with multiple credit card debts are

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more likely to reduce the number of credit card debts rather than decrease the total cost of debt across all accounts, thus amplifying the effects reported by Amar et al. (2011). Thus, we explore the moderating effect of 'debt type' on 'debt account aversion.' For example, between a $300 loan with a 6% interest rate and a $3000 loan with a 12% interest rate, a person would pay off the $300 loan faster if it were incurred for a hedonic purchase compared to a utilitarian purchase.

Three studies contribute to our understanding of consumers' management of multiple debt accounts. First, small hedonic debts are prioritized over equally small utilitarian debts when sufficient funds exist to reduce or eliminate the small debts. This differential repayment occurs because debt incurred for a hedonic purchase weakens anticipated enjoyment of the hedonic purchase. Second, the preference for prioritizing hedonic debt over utilitarian debt persists despite making the total cost information for the debt more salient and providing real incentives to make an optimal financial decision. Third, hedonic debts incurred in the distant past are prioritized over those from the recent past, further implicating the role of anticipated enjoyment (Kivetz, 1999).

## Theoretical development

Consumers are debt averse and want to pay off debt that does not provide any further benefits (Prelec & Loewenstein, 1998). Gourville and Soman (1998) refer to this process as "benefit depreciation". That is, when the consumption benefit depreciates over time, payment feels more like a pure loss since there is no corresponding benefit to buffer the pain of repayment.

The purpose of the debt could also influence the way people pay off their debt. Debt could be incurred for purchases made with a utilitarian or hedonic purpose. By definition, utilitarian consumption provides consumers with functional benefits that are necessary and useful, whereas hedonic consumption is associated with fun and pleasure (Mishra & Mishra, 2011). Kivetz and Simonson (2002) demonstrate that the pain of payment is more pronounced for hedonic consumption (e.g., vacation) than for utilitarian consumption (e.g., insurance) because hedonic consumption is often regarded as non-essential and more difficult to justify. Also, individuals quickly adapt to enjoyable consumption (e.g., a car's heated seats), since hedonic experiences depreciate more quickly than utilitarian experiences (Wang, Novemsky, & Dhar, 2009). Hence, we predict that the presence of debt incurred for hedonic consumption (given that the benefit has already depreciated) will motivate debtors to pay down the smaller balance debt accounts faster than an equivalent debt for a utilitarian purchase.

However, what happens to debt allocation when a consumer's goal of account reduction aligns with financial incentive (i.e., when a small debt has the largest interest rate)—will consumers still prioritize hedonic debt? Since hedonic debt is more aversive than utilitarian debt, consumers may still display account aversion and prioritize hedonic debt elimination. Conversely, if repaying the small debt is financially optimal, the psychological incentive to pay down the debt may not differ enough to result in an effect of debt type. Prelec and Loewenstein (1998) suggest that when the pain of making interest payments is large relative to the pain of clearing the debt, then the debt repayment is not delayed and the debt is closed out. Thus, large interest rates on small debts will likely activate such pain that the debt will be paid, regardless of debt type. This offers a potential boundary condition for the effect of debt type on debt account aversion.

**H1**. When the smallest of multiple debts has the lowest APR, the debt incurred for a hedonic (utilitarian) purchase will be repaid to a greater (lesser) extent. When the smallest of multiple debts has the highest APR, there will be no difference in debt repayment amount based on debt type.

Since consumption enjoyment for hedonic purchases decreases faster than that of utilitarian (Nowlis, Mandel, & McCabe, 2004; Wang et al., 2009), debt for the consumption likely accelerates the reduction of enjoyment. This suggests that consumers may be more likely to pay down debts associated with hedonic purchases in order to prevent benefit depreciation. We predict that in order to prevent the debt from lowering an individual's predicted consumption enjoyment, the individual will more rapidly repay small hedonic debts.

**H2**. When the smallest of multiple debts has the lowest APR, anticipation of consumption enjoyment will mediate the effect of debt type on repayment, such that hedonic debt results in greater decrease in anticipated consumption enjoyment than utilitarian debt and thus quickens hedonic debt repayment. When the smallest of multiple debts has the highest APR, anticipation of consumption enjoyment will not mediate the effect of debt type on repayment because the financial incentive will spur debt repayment, regardless of debt type.

Hedonic enjoyment (the utility of hedonic consumption) depreciates at a faster rate than that of utilitarian between the time of consumption benefit and repayment (Patrick & Park, 2006). If retaining consumption benefit is indeed the motivation for prioritized hedonic debt repayment, hedonic debts incurred in the distant past should be prioritized over debts incurred in the recent past. Since hedonic purchases in the distant past risk greatest depreciation and pain of continued payment (Prelec & Loewenstein, 1998), these should be prioritized over recent hedonic purchases where the benefits are more concrete and salient (Trope & Liberman, 2003). Also, utilitarian debt prioritization will not change between distant and proximal past as time does not depreciate utilitarian benefits as rapidly (Kivetz, 1999).

**H3**. When the smallest of multiple debts has the lowest APR, the difference in the repayment of hedonic and utilitarian debt will be greater for debts whose consumption benefits lie in the distant relative to the proximal past. When the smallest of multiple debts has the highest APR, there will be no difference in the repayment of hedonic and utilitarian debt, regardless of the debt timing.

## Experiment 1a

Experiment 1a tests the prediction that people allocate their savings more towards paying down hedonic debt than utilitarian