The Reward for Cash-Reward Credit Cards: Higher Bills, More Debt

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In theory, cash-reward credit cards seem great: Card holders get 1%, and occasionally 5% back for purchases. The system seems like it provides automated discounts and instant savings. The problem is that the way the incentives work, consumers who spend more are "rewarded" with more cash back. And guess what happens? Consumers spend more with these cards, and the rewards rarely ever outweigh the additional amount spent. The net result with a $25 monthly cash back reward, for instance, is that the average consumer's credit card bill is $79 higher, and $191 more in credit card debt is piled up monthly.

These figures come from researchers at the Federal Reserve Bank of Chicago, who studied and compared thousands of credit card accounts, some with cash back, some without (read the full study here).

On the surface, it would seem like credit card issuers are foolishly giving away money with cash-reward cards, and that a cardholder getting 1% or 2% back is reaping in easy money. The reality is much different. Simply put, the study says:

The main objective of the card companies is to increase card spending that may result in cardholder's debt in the future.

And based on the figures, the card companies achieve wild success in this objective. More spending. More debt. But hey, you get those occasional $50 cash-back checks in the mail! At least, that is, if you remember to keep track of your rewards and order the check—because these programs typically don't give you cash back automatically.

What's not exactly clear cut is whether the increase in spending and debt is because cardholders are spending more overall, or simply that they've shifted their spending from one card to another card with cash back. The study's conclusion states:

Our analysis suggests that cash-back rewards positively and significantly affects spending and debt accumulation. However, overall spending and debt accumulation measured by total credit card balances at the credit bureau remains constant or increases slightly suggesting that cardholders substitute spending and debt from other credit cards.

For the consumer, getting cash back is of course better than getting nothing—but only if you don't increase your overall spending due to the perverse incentives inherent in cash-back cards. Spending a dollar to get a penny back doesn't make sense.

But what if you were spending the dollar anyway? Then it seems silly to not get the penny-per-dollar reward. The problem is that it's all too easy for consumers to justify extra spending with credit cards. Studies show that you're likely to spend 12% to 18% more with a card compared to cash. And when you're vaguely aware that every item you pick up shopping gives you a little more cash back, well, then you're even more likely to place more stuff in your shopping cart.