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Why we can't stop spending (Part II)

By Matthew McClearn | April 05, 2011

(Part two of a four-part series. For part one, ' The New Consumer,' click here.)

Sub-optimal behaviour

Why are we spending our way toward oblivion? About this time of year, many of us have not yet forgotten our solemn vows to cease snarfing doughnuts and to visit the Stairmaster more often. It's a question of self-control, and our current spending and debt levels suggest a collective loss of it. Yet our failure to live up to our financial resolutions is not simply a matter of surrendering to Dionysian impulses.

Rather, it stems from a complex interplay of untenable financial pressures on some households, coupled with widespread cognitive and behavioural shortcomings that lead well-intentioned people to make profoundly bad decisions. And our federal government has encouraged it. Amid fresh reports that Canadians have finally 'got the message' and are trimming consumption and debt, it seems likely we're already past the point of no return.

Classical economists assume consumers are impressive indeed, and this stems from their love affair with a creature as elusive as the New Consumer himself: *Homo economicus*. This creature looks a lot like *Homo sapiens*, but behaves differently. He's unflappably rational. A calculating decision-maker, he invariably seeks to maximize utility while minimizing effort. And his iron willpower allows him to act always in his long-term interest. Picture Spock, minus the altruism and work ethic.

Homo economicus would likely not act contrary to his stated intentions -- unless, that is, he had no choice. And truth be told, some Canadian households are in dire straits. Just before the recession, Sauve studied what the bottom quintile of income earners forgo. He found they spend half of what the highest earners do at restaurants. They seldom own a home, and only half of them own a vehicle. They spend almost nothing at recreational facilities, seldom attend hockey games, buy notably fewer electronics and spend less time at the bar. Their children almost never attend summer camp. They rarely have Internet access at home. No jewelry. No life insurance. This is what frugality looks like.

Unsurprisingly, low-income households were among those hardest hit by the recession, and were more likely to report significant increases in debt. Also, 'more and more employed persons are going to the food bank,' reports Sauve, 'and they're going there because maybe their partner lost their job, or they went from a high-paying job to a low-paying job. More people are in a tight situation.' It's easy to see how 400,000 lost jobs would damage household balance sheets, particularly among the most vulnerable. But this is a relatively small group. The Certified General Accountants Association of Canada (CGA-Canada) calculates that only about 7% of households are near the brink under current economic conditions. 'They have modest income, and the majority of it is paid toward their food, shelter and basic necessities,' explains Anthony Ariganello, CGA-Canada's president. What about the rest?

Lamenters sometimes frame household finance issues as essentially moral -- that somehow, modern consumers collectively surrendered to hedonism and squandered their paycheques on Coach handbags and Lexus sport utility vehicles.

A few years back, Harvard law professor Elizabeth Warren (now also a special adviser to the U.S. Consumer Financial Protection Bureau) railed against this accusation. She argued that for a generation, America's middle class had been caught in a vise of stagnant incomes and rising expenses. 'The economic rules have changed,' Warren said, 'leaving millions of hard-working, play-by-the-rules families caught in a battle for economic survival.' Many survived because women entered the workforce, occasioning a sharp rise in the number of double-income households. (This is also true in Canada.) But the lot of one-income households worsened markedly. Perhaps this helps explain why some middle-income households continue falling behind.

Still, it seems most Canadian households have at least some resources with which to improve their lot. A survey by Statistics Canada in 2009 found that the average household spends 64.4% of its income on personal taxes, food, shelter and transportation combined -- the so-called necessities. But it also blows nearly $1,500 a year on smokes and booze, $260 on gambling and more than $4,000 on recreation. This suggests plenty of discretionary spending that could be directed toward saving and debt repayment. What gives?

Truth be told, most economists regard *Homo economicus* as a useful approximation to plug into their models, not a representation of how individuals actually behave. Even classical economists sometimes doubted whether it was safe to assume real people were so cunning and calculating. We can see it with a hypothesis called Ricardian equivalence. Classical economist David Ricardo posited that if citizens observed their government issuing more bonds, they'd reduce spending in anticipation of higher subsequent taxes when those bonds had to be repaid. In other words, they'll behave no differently than if taxes rose immediately. Ironically, Ricardo himself suspected people lacked such foresight.

Today, with people across the developed world saving little as their governments borrow copious amounts, his doubts seem well-founded. Other aspects of modern financial behaviour seem equally suboptimal. Recently, CGA-Canada surveyed consumers on the interest rate charged on their credit card balances. 'More than half had no clue,' says Ariganello. 'They thought they were paying 3% to 4% because that's what the prime rate was. Most are actually in the double-digit range, often the high teens.'

This suggests astounding ignorance. Regrettably, many broader studies have concluded that Canadians (and, for that matter, other nationalities) are shockingly ill-equipped to make sound financial decisions. Indeed, the federal government became sufficiently concerned that in 2009 it convened the Task Force on Financial Literacy. Its public consultations, held last year, found broad consensus that 'many Canadians lack some or all of the skills, knowledge and confidence necessary to be financially literate.'

Sumit Agarwal, an economist with the Federal Reserve Bank of Chicago, studied the link between cognitive abilities and what he calls 'suboptimal behaviour.' For example, American cardholders frequently receive offers to transfer their existing balances onto a new card, on which they will pay a lower 'teaser' interest rate for some months. The hitch is that higher interest rates are levied on new purchases. Homo economicus would take the teaser rate but keep making new purchases on his old card. However, many borrowers don't recognize the optimal strategy until they see high interest charges on subsequent bills. (Agarwal calls this 'balance transfer mistake.') Others never learn.

In a paper last year, Agarwal reviewed data from a major financial institution of people who'd responded to such offers, and how they'd behaved. He linked that data to military personnel who'd completed the Armed Services Vocational Aptitude Battery test, which scores language, mathematical, mechanical and other knowledge and skills. Agarwal discovered that those with low math scores were significantly more likely to make a balance transfer mistake. (Other skills seemed less relevant.) Agarwal also studied mistakes involving lines of credit, with similar results. Maybe we just suck at math.

It's probably more complicated than that. Students of behavioural finance attempt to humanize *Homo economicus* by factoring in psychological and sociological forces. One important quirk is our observed bias toward immediate gain over long-term benefits, known as 'discounting.' Empirical evidence suggests we put enormous weight on instant gratification. Experiments have shown that if subjects are offered $50 now, or $200 five years from now, most grab the cash immediately. We do better as rewards move farther into the future -- subjects offered $50 in 10 years or $200 in 15 years are much more likely to wait for the higher amount. Some behavioural theorists claim that if you graph it out, our preferences over time resemble a hyperbolic curve. This helps explain why St. Augustine wanted God to make him chaste, just not yet -- and why so many Canadians spend more than they say they want to.

Tomorrow, in part three of our four-part series "Why we can't stop spending," we look at how government policy has aided and abetted Canadians' slide into unsustainable debt.