

The Effect of Credit on Spending Decisions: The Role of the Credit Limit and Credibility

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Abstract

The objective of the present research is to study consumer decisions to utilize a line of credit. The life-cycle hypothesis from economics argues that consumers should intertemporally reallocate their incomes over their life stream to maximize lifetime utility. One form of intertemporal allocation is to use past income (in the form of savings) in the future. A second form is the use of future income in the present. This can only be done if consumers have access to a temporary pool of money that they can draw from and replenish in the future—a function performed by consumer credit. However, our research reinforces prior findings that consumers are unable to correctly value their future incomes, and that they lack the cognitive capability to solve the intertemporal optimization problem required by the life-cycle hypothesis. Instead, we argue that consumers use information such as the credit limit as a signal of their future earnings potential. Specifically, if consumers have access to large amounts of credit, they are likely to infer that their lifetime income will be high and hence their willingness to use credit (and their spending) will also be high. Conversely, consumers who are granted lower amounts of credit are likely to infer that their lifetime income will be low and hence their spending will be lower.

However, based on research in the area of consumer skepticism and inference making, we also argue for a moderating role of the credibility associated with the credit limit. Specifically, we argue that the above effect of credit availability would be particularly strong for consumers who believe that the credit limit credibly signals their future earnings potential (i.e., a naïve consumer who has limited experience with consumer credit). However, as consumers gain experience with credit, they start discounting credit availability as a predictor of their future and start questioning the validity of the process used to set the credit limit. Hence, with experience the effect of credit limit on the willingness to use credit should be attenuated.

We test these predictions in five separate studies. In the first experimental study, we manipulate credit limit and credibility and pose subjects with a hypothetical purchase opportunity. Consistent with our prediction, credit limit impacted the propensity to spend, but only when the credibility was high. In the second experimental study, we rep-

licate these findings even when subjects were given information about their expected future salaries, and also show that the credit limit influences their expectation of future earnings potential. In the third study, we show that the mere availability (and increase) of current liquidity cannot explain our findings. In the fourth study, we conduct a survey of consumers in which we measure a number of demographic characteristics and also ask them for their propensity to spend in a given purchase situation. In the fifth study we use the Survey of Consumer Finances (SCF) dataset, a triennial survey of U.S. families that is designed to provide detailed information on the use of financial services, spending behaviors, and selected demographic characteristics. Results from both studies 4 and 5 provide further support for our proposed framework—credit limits influence spending to a greater extent for consumers with lower credibility: younger consumers and less-educated consumers. Across all studies we achieved triangulation by using a variety of approaches (surveys and experiments), subjects types (young students and older consumers), nature of predictor variables (manipulated and measured), dependent measures (purchase likelihood, credit card balance, new charges), and methods of analysis (ANOVA and regression), and consistently found that increasing credit limits on a credit card increases spending, especially when the credibility of the limit is high.

This paper joins a growing body of literature in marketing and behavioral decision theory that goes beyond the traditional domains of inquiry (e.g., product choice, effects of marketing mix variables) and focuses on consumer decisions relating to the appropriate use of income to finance consumption. Our framework differs from prior research on the effect of payment mechanisms on spending in two significant ways. First, we are interested in the effects of the availability of credit on spending, and not necessarily in the effect of the transaction format that is associated with each payment mechanism. Second, while prior research has studied the point-of-purchase and historic (i.e., prepurchase) effects of credit, the present research is concerned with the availability of credit in the future. Specifically, our framework is invariant to the current and prior usage of credit by the consumer.

(Consumer Credit; Credit Cards; Intertemporal Choice; Mental Accounting; Self-Control)