

Credit Card Use and Abuse: A Veblenian Analysis

Robert H. Scott, III

There is an overwhelming amount of consumer credit card debt in the United States. Revolving credit card debt is close to \$900 billion, and has increased at an average annual rate of almost nine percent over the past ten years. The average United States household has eight credit cards, which are used to charge nearly \$2 trillion in goods and services annually. This became possible when an institutional failure led to reduced regulations on credit card lending. Consumers, for their part, have borrowed heavily using credit cards. Frequently, consumers use credit cards inappropriately and spend beyond their means accumulating inessentials that they cannot reasonably afford. Neoclassical economic theory is ineffective at explaining why credit card borrowing continues to reach record levels; and, more importantly, it fails to recognize that credit card debt is a problem requiring attention from regulatory agencies. Thorstein Veblen's social institutional theory of consumption better explains why credit cards continue to grow in popularity and why revolving credit card debt will keep rising unless different policy perspectives and lending practices are adopted.

The Emergence of Credit Card Debt

Credit cards were invented in post-industrial revolution America just before World War I, and coincided with a general rise in the issuance of consumer credit for many types of goods and services. The first credit cards were issued by retail stores and oil companies to increase sales and make customer identification easier. Until the early 1980s, most people thought of credit cards as a luxury payment method afforded only by good credit standing and responsible borrowing. However, something important changed to allow the modern credit card industry to emerge. That change was the Marquette Decision. Arguably, the modern credit card market did not exist until the

The author is an Assistant Professor of Economics and Finance at Monmouth University, West Long Branch, NJ 07764-1898; Email: rscott@monmouth.edu; Phone: 732-263-5532. This paper was prepared for presentation at the Annual Meeting of the Association for Evolutionary Economics, Chicago, IL, January 5-7, 2007.

early 1980s, when credit cards were effectively deregulated. Credit card issuers until this time were constrained by state and federal usury laws that placed tight restrictions on the interest rates banks could charge on their credit card loans. However, the U.S. Supreme Court's December 1978 Marquette Decision paved the way for elimination of price regulations (Ausubel 1991; Watkins 2000, 921-2). The general ruling stated that only the usury ceiling of the state in which the bank is located, and not that of the state in which the consumer is located, will restrict the interest rate banks can charge. The banks were then free to move their credit card operations to states where there were no (or limited) usury laws (Ausubel 1991, 52). States such as South Dakota and Delaware became popular depots for banks' credit card operations because they had slack usury laws (Mandell 1990; Watkins 2000).

Since the Marquette Decision, credit cards have exploded in use, supply, and demand (Watkins 2000, 922). On the demand side, there are 1.5 billion credit cards in circulation in the United States. According to data provided by the Federal Reserve (2006a; 2006b), in 2005, households spent over one percent of their income servicing credit card debt, which is more than double what it was ten years previously. On the supply side, credit card issuers mass mailed over six billion credit card offers to United States households in 2005, which marked an increase of over 500 percent since 1990. This practice along with that of blindly issuing credit card checks are collectively known as *carpet bombing* – a term appropriately borrowed from the military to describe complete destruction of an area with gravity or incendiary bombs.

The institutional changes that led to increased credit card lending do not account for why consumers took advantage of available credit cards and began steadily accumulating revolving credit card debt at exorbitant interest rates. The reasons are likely multi-fold, but two major influences follow. First, credit card companies influenced merchants to start accepting credit cards by convincing them that people spend more money using credit cards than any other form of payment (Evans and Schmalensee 2005). Second, the increases in inequality of income and wealth in the United States in the past twenty five years has helped promote credit card borrowing. Many people's incomes are insufficient to cover basic necessities, so people will many times rely on their credit cards to help them get through a difficult financial period. However, once credit card debt is established, a combination of high interest rates, fees, and insufficient income usually keeps people from paying off their debt (Peterson 2001, 174-5). This has also contributed to America's recently reported negative savings rate (-0.5 percent) – something that has not occurred since the Great Depression (Rankin and Armah 2006). Veblen captures this idea perfectly by claiming that “any retrogression from the standard of living which we are accustomed to regard as worthy . . . is felt to be a grievous violation of our human dignity” (Veblen [1899] 1994, 156). Therefore, people today will typically go into debt before they reduce their levels of consumption.

The theoretical foundation of neoclassical consumption theory is the permanent income/life cycle consumption hypothesis developed independently by Milton Friedman (1957) and Franco Modigliani, respectively (Modigliani and Brumberg 1954).¹ These theories were developed in the 1950s, which was a time of

negligible consumer debt. They used popular techniques of the time (discounted utility theory) to solve the consumer problem with linear optimization. In order to model their theory mathematically, they had to make broad assumptions, such as: (a) individuals are rational; (b) they have access to complete markets (perfect information and foresight); and (c) they have stable, well defined preferences. Consequently, they assume away any responsibility of the markets to attribute to consumer spending (or borrowing) problems. More contemporary research (Courant, Gramlich, and Laitner 1984; Mokhtari 1990; Thaler 1990) provides evidence that the permanent income/life cycle hypothesis has not held up under empirical scrutiny. Their research asserts that contrary to the neoclassical view, people actually under-consume early and late in life and over-consume during high-income earning years; furthermore, consumers' utility functions are dynamic, not static as neoclassicals assume. More importantly, they found that consumer spending is influenced more heavily by social influences than income optimization, which was an idea Veblen formalized in his classic article *Why is Economics not an Evolutionary Science?* (Veblen [1898] 1998; Hodgson 1998).

Neoclassical models fail to account for the role institutions play in consumer spending/borrowing decisions (Cosgel 1997, 1534). Thus, neoclassicals believe individuals are solely responsible for their credit card debt; so, any attempt to reduce credit card indebtedness must come from individuals and no where else. John Kenneth Galbraith called this perception the accepted sequence, which makes the consumer ultimately responsible for all market activities because information is transmitted from "consumer to market to producer" (Galbraith 1967, 211). He further states that the accepted sequence is not "a description of reality" and that it is actually the producer that reaches out "to control its markets and on beyond to manage the market behavior and shape the social attitudes of those, ostensibly, that it serves" (212). He calls this the revised sequence. It makes producers responsible for generating market demand that allows them to gain profit (212-5). This concept supports Veblen's ([1899] 1994) institutional theory of consumption and dismisses the neoclassical view that the atomistic borrowing agent is the sole party responsible for increases in credit card debt.

Neoclassicals also fail to see that many credit card debtors rely on their credit cards to pay for household necessities because they lack sufficient income to pay for their basic needs. Unpredictable expenses can lead people into credit card debt. And once people take on debt, the credit card companies react by doing at least one of the following: (1) increase interest rates; (2) charge fees/penalties; and (3) increase credit limits; all of these actions help to raise the likelihood a debtor will not pay off their debt quickly. Therefore, trying to change people's attitudes toward over-consumption will not solve this problem, because buying basic necessities is not over-consumption but merely maintaining existence. In other words, for many credit card debtors, over-borrowing is due to a lack of sufficient income. Neoclassical economists have recently promoted increasing poor people's real-assets in order to bring them out of poverty; but this does not necessarily lead to an increase in income; in fact, this kind of policy may hinder poor households by encouraging them to over invest in relatively illiquid housing that is subject to price volatility (Bahchieva, Wachter, and Warren 2005; Manning 2000).

Veblen's Cultural Theory of Consumption²

Metin Cosgel (1997) credits Veblen as an innovator in the analysis of consumption processes and a pioneer of institutional consumption. Veblen ([1899] 1994) stated that consumers are culturally programmed to spend money, and that “propensity for emulation is a pervading trait of human nature” (109). Furthermore, when people are given easy access to credit many of them will use it out of necessity, want, or both. According to Veblen, it is not standard expenditures that guide our consumption efforts, but rather those items just beyond our financial reach ([1899] 1994, 103). So, there is a large portion of credit card debtors who over spend using credit cards simply because they are given credit too easily without consideration to whether they can really handle the amount of credit issued. Veblen ([1899] 1994) asserts that most people want to be recognized as living one class-stratum above where they presently live. But until recently, households were trapped in their class-stratum with few means to reach that next higher level. Credit cards allow many people the ability to reach what, in their minds, equates to living in the next higher class level. Today, more than at any other period in history, the prevalence of conspicuous consumption is highest because of the vast number and variety of goods and services available in the economy. Credit cards give people access to these items: expensive clothes, elaborate vacations, and expensive restaurants – whatever someone equates to higher-class living is often achievable now because of credit cards.

An increase in income and wealth inequality will cause a rise in credit card debt. James Duesenberry (1952), following Veblen's ([1899] 1994) logic, developed the idea that people are quick to increase their consumption with an increase in income, but are terribly resistant to decrease consumption when incomes fall. Thus, any rise in income inequality will only increase the lower class's demand for credit; consequently increasing credit card companies' profits perpetuating the inequality cycle and likely making it worse. And because inequality provides the upper class with additional income and wealth, their level of conspicuous consumption will rise as well.

Today, Veblen's conspicuous consumption is linked with what we may call conspicuous borrowing (Seckler 1975, 45). We can further posit that conspicuous borrowing leads to more ceremonial/wasteful consumption. So, not only are credit card companies gaining profits from interest rates and fees, but they in turn issue more credit, which promotes additional ceremonial consumption. Thus, credit card companies survive off of ceremonial profit, which in Veblen's analysis, generally has a detrimental effect on the economy.

Within Veblen's theory we see that many sources are responsible for social institutional failures that occur. For our purposes, we can assume three groups are responsible for the credit card debt problem: credit card companies (producers), consumers, and the government.

A distinguishing insight provided by Veblen is that he sees companies that are interested in producing nothing of substance, such as credit card companies, as blackmailers because they are trying to get something for nothing (Veblen [1919]

1964, 76). In other words, credit card companies produce nothing of tangible value for the economy or society. Instead, credit card companies extend credit to people arbitrarily, and when people fail to pay their credit card balance in full even once, they raise defaulters' interest rates to often absurdly high levels. The credit card companies often compound this problem by charging penalties and fees and increasing debtors' credit limits. Using one of Veblen's metaphors: credit card debt accumulation starts a parasite/host relationship between credit card companies and their indebted borrowers. Once this relationship is established, the parasites (credit card companies) drain their hosts (borrowers) of money by charging numerous fees and penalties, which account for over \$90 billion in revenue for credit card companies each year. And this relationship is dissolved only when the borrowers (hosts) free themselves of their parasites (credit card companies) (Edgell 1975; Ritzer 2001, 206; Veblen [1904] 1932, 64).

For credit card companies, propagating consumer debt is profitable business. While credit card borrowing is debt for consumers it equates to surplus profits for businesses, and businesses get this additional profit without increasing incomes (Watkins 2000). These companies do not make money on people that pay off their balances in full each month (they are known in the industry as *deadbeats*). Deadbeats are expensive for credit card companies. Profits are made off people who accumulate considerable debt. Over 30 percent of credit card companies' profits (more than \$15 billion) are generated from penalty fees; this number has more than doubled in ten years. Therefore, it is sensible for companies to maximize borrowers' financial indiscretion in any manner possible. Under the direction of credit card industry consultant Andrew Kahr, credit card companies lowered their minimum payment on credit card balances from five percent to only two percent. They knew this would increase borrowing, thus, indebtedness. Due to the small required minimum payments people no longer felt constrained in their spending by having to pay their bill in full every month. Now people only had to pay a fairly small minimum balance to keep from defaulting (Nocera 1995, 320-1).

Policy Options

Due to social influences on consumers to spend, and the additional support of institutions to feed people's desire to spend money it is unlikely they will escape persuasion easily. Furthermore, rising inequality is creating a class of citizens that rely on credit for subsistence; and credit subsidizes their insufficient incomes. Therefore, without an active drive by the government to decrease income inequality (more progressive tax structure, increase minimum wages, wealth tax) people's desire to use credit will grow in direct relation to their needs not met by current income.

There exist too few underwriting standards for issuing credit card loans. Billions of unsolicited pre-approved credit card offers are sent to households each year, and many of these households are ill-equipped to handle the level of credit that credit card companies eagerly provide them. The solution to this problem must come from the Office of the Comptroller of the Currency (OCC) (a division of the Treasury

Department). The OCC is responsible for regulating credit card lending operations. The OCC should enforce the following: (1) stricter industry-wide credit card lending standards so that criteria such as income and credit history play a role in companies lending decisions; (2) credit card companies should raise required minimum payments – the old rule of 5 percent seems reasonable, but could probably be higher; (3) interest rates, fees, and account maintenance charges should be transparent to customers; (4) credit limit increases must be approved by customers; and (5) a maximum limit should be put on credit card interest rates, fees, and penalty charges. These policies ideally will not eliminate access to credit, but rather ensure borrowers are given an amount of credit they can reasonably handle.

The government must guarantee that consumers are protected from overt exploitation by credit card companies. Besides regulations initiated by the OCC, the government itself must pass laws that better serve its citizens. First, carpet bombing by credit card companies has gone too far. Credit card solicitations make up almost 9 percent of all mail volume in the United States, and have increased at an annual rate of 12 percent since the late 1980s. Second, recent changes to the bankruptcy code (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)) have made eliminating consumer credit card debt much more difficult. Therefore, it is reasonable for the government to consider either allowing credit card debt to be discharged without repayment under Chapter 13 bankruptcy – this is the easiest solution; or, by making Chapter 7 bankruptcy easier for credit card debtors to file (such was the case before the BAPCPA) (Waller 2001).

Increasing financial literacy in the United States will also help reduce credit card over-borrowing problems, but this is a more long-run solution. People's math and finance skills are becoming increasingly sclerotic. Among educated people, credit card over-borrowing is much less common; therefore, educating people early about financial management will help enforce better financial decisions. American high schools must start to include in their national standards training in personal finance, dealing with topics such as debt, savings, and investing. Schools could incorporate these lessons easily into social studies courses.

Conclusion

Veblen's social theory of consumer behavior has remained unmatched for over one hundred years. The recent surge in credit card lending is an important new development in the modern economy, yet Veblen's theories remain as a useful guide to explain why credit card over-borrowing has developed and what solutions are realistic to reduce superfluous credit card debt.

Notes

1. Other economists responsible for influencing the development of these theories were Irving Fisher ([1956] 1930) and Roy Harrod (1948).
2. Heading title inspired by Wesley C. Mitchell's introduction entitled *Thorstein Veblen* in his edited volume *What Veblen Taught: Selected Writings of Thorstein Veblen* (1964).

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