

# WHAT TO DO WITH MY CREDIT? DEBT-CONSUMPTION VS. DEBT-INVESTMENT EVIDENCE FROM THE BOTTOM OF THE PYRAMID

## ¿ QUÉ HACER CON MI CRÉDITO? DEUDA DE CONSUMO Ó DEUDA DE INVERSIÓN, EVIDENCIAS DE LA BASE DE LA PIRÁMIDE.

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### Abstract

This paper analyzes the use of money from a credit by low-income individuals, the so-called base of the pyramid. In addition, differences in terms of socioeconomic profiles and their effect over their behavior when it comes to credit use is analyzed. On the first hand side, a choice can be to use the money from a credit for investment purposes that may create opportunities for producing and generating revenue. This situation is called debt-investment and it is argued that it only happens under particular conditions. Additionally, there is an alternative category proposed, called debt-consumption, where the credit can be used to purchase goods and services that do not have direct productive uses. The result of the debt-consumption category has led to the emergence of many business models that use credit to promote consumption. These arguments are tested statistically on a sample in low income areas of Guadalajara, Mexico. The results show after adding some socioeconomic variables that people is more willing to consume than to invest.

**Keywords:** Low income groups, credit usage, consumption decisions, investment decisions.

### Resumen.

Este artículo analiza el uso del dinero de un crédito por individuos de bajo ingreso, los llamados base de la pirámide. Además, diferencias en términos de perfiles socioeconómicos, y es analizado su efecto sobre el comportamiento cuando se trata del uso de un crédito. En primera instancia, una opción puede ser usar el dinero de un crédito para propósitos de inversión que puedan crear oportunidades para producir y generar ingreso. Esta situación es llamada inversión de la deuda y se argumenta que sólo pasa bajo condiciones particulares. Adicionalmente, hay una categoría alterna propuesta, llamada consumo de la deuda, donde el crédito se puede usar para adquirir bienes y servicios que no tienen usos productivos directos. El resultado de la categoría del consumo de la deuda ha llevado al surgimiento de muchos modelos empresariales que usan el crédito para promover el consumo. Estos argumentos se prueban de forma estadística en una muestra en áreas de bajo ingreso de Guadalajara, México. Los resultados muestran después de añadir algunas variables socioeconómicas, que las personas están más dispuestas a consumir que a invertir.

**Palabras clave:** Grupos de bajos ingresos, uso del crédito, decisiones de consumo, decisiones de inversión.

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## 1. INTRODUCTION

The use of credits by low income groups in particular through microcredits has been largely analyzed and discussed, above all considering that when used for productive purposes it can be seen as an alternative for poverty alleviation. It is important to differentiate and contrast the effects of microcredits targeting productive purposes from other type of credits with a more commercial orientation. Some authors [1] analyze the case of the Grameen Bank in Bangladesh and its degree of cost-effectiveness as a microlender. Additionally, there are research works that study microcredit programs in order to confirm whether they provide empowerment or not to the borrowers [2]. Interesting conclusions are derived, since it is suggested that there is no a single borrower's profile when it comes to assess microcredit programs, and that their particular conditions and the surrounding environment, affect the outcomes of the use of the resources. Others analyze five different microfinance programs and the challenges they face when they need to be for example financially sustainable with a good repayment rate. [3]

Cases as the one from Banco Compartamos in Mexico, are analyzed and show how this microlender has succeeded in making loans to low income women as their target market mainly, helping them to become entrepreneurs in very small business ventures. [4]

Most of the business projects focusing on the base of the pyramid (BOP) interestingly comes from entrepreneurs not necessarily from low income groups, this may appear as logic and it might be expected. Some analysis of business ventures that target low income groups and the impact over the stakeholders: sellers, buyers and the communities, conclude not only how important is the knowledge and understanding of these groups but also that there is not a single approach to target them. [5]

Finally, when it comes to credit use there are many variables that influence the way the resources from debt are used. There is some qualitative research that analyzes the relationship between credit use and materialism as a result of expectations regarding life transformations. [6,7] What is certain at the end of the day is that microfinance appears as an answer to those low income individuals that have not access to other financial services, providing them with both financial tools and financial power. [8]

It may be argued that this is type of credits do belong to one category, which can be called debt-investment, but there might be an alternative category with a different purpose which can be called debt-consumption, which has received less attention in the literature. It can be mentioned that the debt-investment category requires particular conditions to operate, different from those of the debt-consumption category.

The remaining of the paper consists of a literature review, and the analysis of two categories proposed, first a debt-investment category and second a debt-consumption category. In both cases, there are different assumptions and variables that can lead to the different outcomes mentioned before.

## 2. LITERATURE REVIEW

Before proposing the two categories it is important to have a more solid background to understand why the behavior of individuals that have access to the credit market and in particular those with lower incomes show different patterns under particular circumstances.

*Credit debt and the propensity to invest or consume.* As previously mentioned, this paper examines differences in attitudes toward investment and consumption by analyzing rather than the factors that motivate either one or the other, the way how the profile of the borrower influences his or her behavior towards credit usage.

Credits are loans granted by banks to individuals who want to purchase consumer durables to improve their lifestyle. [9] There are two dimensions of loans; first, a loan-focused approach that attempts to improve financial literacy by increasing consumer knowledge about loans, how and why loans work and their advantages and disadvantages. Second, a lender-focused literacy which refers to a consumer knowledge about lenders, including how and why particular lenders act as they do. [10]

It is argued that there are differences amongst consumption groups, which can be based on age, level of education, income, marital status, just to mention some. The socioeconomic level in combination with some other socioeconomic variables for example influence the capacity to pay for a range of goods and services and to achieve a particular lifestyle. [11]

Consumers purchase goods and services and perform consumption behaviors for two basic reasons: (I) consummatory affective (hedonic) gratification (from sensory attributes), and (II) instrumental, utilitarian reasons. [12] In addition, there are some factors that may motivate the ordering of consumption before investment under certain circumstances. Being the BOP not the exception, one of the main reasons for consumption is materialism, which has been defined as the centrality of possession and acquisition in consumer's lives. [7] Also, the transformation of expectations is significantly associated with materialism, and also that highly materialist costumers are more likely to think about purchases as a mean for changing who they are and other's perceptions about who they are, inducing in some cases credit overuse behaviors. [6]

Under the presence of different social natures and stages, individuals with access to credits do not necessarily see the investment as a priority over consumption making them willing to deviate from the idea that financing sources could be employed for production purposes only. For that reason, problems such as allocation, use and repayment, need to be considered together with the socioeconomic profile of credit users.

*Allocation.* It seems to be very difficult to allocate resources in an effective way, above all considering asymmetric information for both lenders and borrowers, and in addition considering the fact that as mentioned before, the order of preferences may change with time and budget conditions. Nevertheless, due to this asymmetry it is individuals who know better their own realities and can make a more objective use of the resources in what they might consider the most strategic allocations with better results. [13]

If in addition, we consider that there is a flow of resources due to progressive lending where individuals with a good repayment record keep receiving more money with the time, it provides additional incentives to make them not to deviate from this behavior. Above all, when there are options available for investment. [14]

Another allocation problem is the one that has to do with gender. In the case of microcredits, the way women use the resources because of their role, has a better, more profound and notorious impact in their communities when it comes to poverty alleviation. [15] Or the fact, that in some poor communities such as the ones in India, women entrepreneurship helps to close the gender gap leading to a certain degree of development. [16,17] Although, this is a possibility there is also some evidence that shows how women could be more likely to privilege consumption. [18,19]

*Use.* Due to the increasing availability of financial products it is necessary to better understand money management. There is some evidence by using the case of women and their dependents in the early 1980's and how after running microenterprises and creating income it affected their consumption or level of assets possession. [20]

Nevertheless, it is important to notice that different types of credits lead to different types of behaviors. Some card holders use consumption to achieve a particular lifestyle in a hedonic way while trying to keep a good and sound credit record. [21]

There are critics to microcredit by asking whether they represent poverty alleviation or poverty traps. Since there is not a good understanding of the sensitivity derived from very precarious conditions that the targeted households lived at. Concluding that one cannot expect favorable results in all cases derived from the existence of microcredit. [22] On the other hand, when it comes to poverty reduction microcredits have a low impact. All this explained by the nature of goods purchased with the credit, where 54% was invested in productive activities in contrast with 46% which was used in unproductive activities. [23]

*Repayment.* A big challenge with microcredits is the one that has to do with repayment. It is claimed that there are different mechanisms in order to assure that microlending is efficient, even when in some cases it is argued that this is not necessarily true.

It is important not to forget that a very important part of the risks involved is that the beneficiaries become highly dependant with the time on microcredits making them living in constant debt. Or even worst using loans to pay previous loans. [24]

### 3. RESEARCH DESIGN

#### 3.1 Data collection

This study started after being analyzing the BOP from different perspectives and as a way to understand its behavior. A series of interviews in low income areas of Guadalajara, Mexico were conducted. Some of the questions focused on analyzing the use the respondents will give to the resources obtained from a credit. 384 people between 18 and 61 years old were interviewed, around 52% of them were male and 48% female.

The main question was: What would you do after receiving a credit loan of US\$555: consume it or invest it? It is important to mention that another answer was to save it for business purposes so those answers were included in the investment category.

In the case of consumption in order to understand it better, there were 14 categories where people will be willing to consume or pay for, such as: electronics; home appliances; kitchen appliances; clothes; cell phone; computer, lap top or tablet; holidays; party; car or motorcycle; mortgage payment; credit payment; house maintenance; school or studies payment; and to support a relative.

#### 3.2 Method of analysis

Due to the nature of the data, it was not possible to use other analytical tools rather than descriptive statistics, which will be used first in order to understand the patterns of credit users when receiving the resources, whether they will use them for consumption or investment. And in a second approach some variables such as level of education, size of household and number of household members contributing to the household income will be added to the analysis.

### 4. RESULTS

#### 4.1 Descriptive statistics

From the sample the ages of the interviewed people start at 18, finding that around 38% have between 26-36 years, the years of education go from 0 to 16 years, where 52.5% have 7 to 9 years of education, the monthly household income is measured from MX\$0 to MX\$12999<sup>1</sup> where the majority of households around 42% have an income per month between MX\$2700 and MX\$4999.

When analyzing the responses of what would you do with a credit of US\$555. A total of 332 individuals that represent 86.46% answered that they will use it for consumption and the remaining 52 individuals which are 13.54% of the total will invest it (or save it for business purposes). As shown in [Table 1](#). It is interesting to see that the majority of the interviewed individuals from our sample prefer to use the credit for consumption. Patrick (2010) analyzed how microcredits were used for consumption, deviating from the initial use they were supposed to have from the very beginning.

In the case of those that answered that they will use the money from the credit for consumption, different options were included in the survey in order to understand the ordering of preferences of the respondents. [Table 2](#) summarizes both the number of respondents per option and their percentage to the total that prefer to use the money from the credit for consumption.

The results show that transportation (i.e. the purchase of a car or motorcycle) is the first choice of the people interviewed, followed by supporting a relative, housing or the purchase of electronics. The less important consumption options in the sample are to purchase home appliances or to pay for a party. It is important to consider that this is an ordering of preferences and that this results do not rest importance to the acquisition of other goods, on the contrary it may show a particular circumstance either personal or social that cannot be captured on the first hand side but can be at least inferred from a socioeconomic perspective.

[Table 3](#) shows some statistics from the socioeconomic profile of respondents for both, those that prefer to invest the money from the credit and those that prefer to consume it. In addition, it can be seen that when the decision is to invest, the majority (40%) have a level of education of middle school, the size of the household lies between 2.5 and 4 and that there is a minimum of one earner to a maximum of 1.5.

In the case of consumption, also the majority have a level of education of middle school (54%) followed by 30% of those that completed elementary school, the size of the household is between 2.83 and 4.1 and the mean number of earners is at as low as 1.256 and as high as 1.66.

From here it can be observed that those that prefer to consume have a household with little more members, have attended school slightly more and have also slightly more earners combining their salaries and contributing to the household income.

## 5. CONCLUSION

By analyzing a sample of low income individuals and asking them how do they prefer to use the money from a credit either for consumption or investment, it is interesting to find that 86.46% prefer to use it for consumption purposes and only 13.54% to invest it. It is proposed in this research that some people prefer to go into debt and use the resources for consumption, this situation is called debt-consumption, in contrast some other people prefer to use the resources and invest them with productive purposes, this situation is called debt-investment. This work is a first approach to analyze under what circumstances people prefer the debt-consumption category over the debt-investment understanding that there are certain social and personal conditions that may put some pressure over the decision. The analysis in this work is statistical due to the nature of the data, so in the case of our sample there is evidence that people has preference to purchase or pay for those goods that they consider cover more primary needs such as paying for a car or motorcycle, support a relative or housing, with the only exception of electronics which is not necessarily primary, it is interesting to notice that the needs of the family in the household matters. Additionally, the answers show that people that prefer to invest the money from the credit rather than to consume it live in households with slightly less members and lower income which could be as expected, in terms of education in both cases the majority of those that prefer to invest and to consume have a level of education of middle school.

More observations and additional tools could be used in this analysis, but it is interesting to see how people make short vs. long-run decisions being the first more oriented towards consumption. Of course it is important not to forget that purchasing motivators have a different nature, that is why the analysis tried to capture some of them by analyzing the effects of some socioeconomic variables. At the end of the day what is true is that needs and perceived needs do vary with time, levels of income, marital status, amongst others.

## 6. LIMITATIONS AND FUTURE RESEARCH

This research uses a particular method of analysis, that could be complemented by having more data and different types of answers with econometric analysis, also some other socioeconomic variables can be added together with different stages of the situation of the individuals interviewed and by expanding the sample to other place and comparing them. This work aims to be an initial research to understand how we can relate a particular profile of borrowers with their consumption or investment preference ordering under particular conditions.

**Table 1.** Descriptive statistics. What to do with my credit?

What to do with the money from a credit of US\$555?				
	Consumption		Investment	
	Respondant	Percentage	Respondant	Percentage
<b>Total</b>	332	86.46%	52	13.54%

**Table 2.** Descriptive statistics. Consumption categories and their percentages.

What would it be purchased if the choice is consumption, with a credit of US\$555?		
Consumption per category:	Respondent n=	Percentage
Car or motorcyle	47	14.16%
Support a relative	44	13.25%
Electronics	38	11.45%
Housing payment	38	11.45%
Clothes	31	9.34%
Holidays	31	9.34%
House maintenance	26	7.83%
Computer, lap top or tablet	23	6.93%
School or studies payment	19	5.72%
Credit payment	17	5.12%
Kitchen appliances	9	2.71%
Cell phones	5	1.51%
Party	3	0.90%
Home appliances	1	0.30%

**Table 3.** Socioeconomic profile for consumers and investors.

Investment				
Level of education	Number of respondents	Percentage of total	Mean size of household	Mean number of earners
Unschool ed	5	10%	4	1.4
Elementary School	10	19%	3.4	1.1
Middle School	21	40%	3.8	1.33
High School	8	15%	3.125	1.125
Undergraduate School (incomplete)	2	4%	3.5	1
Undergraduate School	2	4%	2.5	1.5
Junior college	4	8%	3.25	1.5
	52			
Consumption				
Level of education	Number of respondents	Percentage of total	Mean size of household	Mean number of earners
Unschool ed	11	3%	4.1	1.545
Elementary School	28	9%	3.643	1.285
Middle School	179	54%	2.475	1.256
High School	98	30%	2.95	1.316
Undergraduate School (incomplete)	2	1%	3.5	1.5
Undergraduate School	6	2%	2.83	1.66
Junior college	5	2%	3.2	1.6
	329*			

\*Three observations were excluded due to the lack of information.



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