Consumption Smoothing is Stupid

Consumption smoothing is the idea that your spending or consumption should be relatively similar throughout your life. That means when you are earning lots of money, you only spend a small part of it and when you aren't earning much, you borrow or use your savings to fund consumption. It seems wise at first glance- you always get to spend the same amount of money, but in practice it is a really bad idea. I'm not the only one who thinks so and my recent review (actually written months after this post was) of Jonathan Clement's book How to Think About Money (with a foreword by Bill Bernstein) showed me that at least two other smart people agree with me. Here's what Dr. Bernstein had to say about it:

> *Academics tout the tide of so-called consumption smoothing: borrowing heavily when you're young, then paying off those debts when you're old, so as to maintain a constant standard of living throughout your life. This is a really, really dumb idea, since it ignores habituation: Get used to the Beemer and business class when you're young, and by the time you're middle-aged you'll need a Bentley and private jet. My medical colleague and fellow financial author Jim Dahle advises newly established doctors to continue "living like a resident" for*

> *several more years after starting practice. That's good advice for just about everyone else too: Get used to Motel 6 when you're young, and when you're older and richer you'll pinch yourself every time you check into the Radisson.*

Later in the book, Clements says this on the subject:

> *At issue here is the so-called hedonic treadmill or hedonic adaptation. The notion: We aspire to get that next promotion and, initially, we are thrilled when the promotion comes through. But all too quickly, we adapt to our improved circumstances, we take the new job for granted and soon we're hankering after something else….The process of striving for material improvements, and then quickly adapting to those improvements, makes it difficult to achieve permanent increases in our level of happiness.*

If you look around, you will see examples of consumption smoothing all over the place. It manifests itself with medical students going on vacations paid for by student loans, residents driving cars they can't afford until they're ten years out of residency, and with new attendings buying a house with zero down despite having a net worth of -$400,000. There are obviously some valid uses of debt (consider how student loans may increase your career earnings by five times what they would be if you never went to medical school). In addition, savings are extremely useful in times of job loss, financial stress, and certainly during retirement. Despite these facts, consumption smoothing is a terrible idea for three reasons.

1 Consumption Smoothing Messes Up Your Mindset

There is a certain mindset required to become rich/wealthy/comfortable etc. Just about every self-made millionaire shares the same traits and mindset. They work hard, they save money, and they practice frugality, especially when young. Consumption smoothing encourages you to never really develop this mindset. Like the little red devil on your left shoulder, it tells you to "Go ahead and buy that Mercedes, you're a doctor and you'll make plenty of money eventually. You deserve it." Someone with a consumption-smoothing mindset instead of a wealth-building mindset is unlikely to ever build the wealth that would actually allow for consumption smoothing.

2 Spending Is Like Narcotics

More importantly, as mentioned by Bernstein and Clements above, the main problem with consumption smoothing is hedonic adaptation. If you are living like an attending as a resident (you know, staying at the Radisson), there will be no reward later for all your hard work. Spending and consumption are like narcotics. Not only can you become addicted to them, but you gradually become tolerant, such that the same amount of spending no longer brings the same level of happiness. So if you spend the same amount throughout your life, your happiness, at least as far as it can be purchased with money, will actually decrease due to this increasing tolerance. Want to have "happiness-smoothing" throughout your whole life? Then set up your finances so you can spend a little more each year.

That means you had better start out spending very little early on, which is the exact opposite of consumption smoothing.

3 Consumption Smoothing Encourages You To Borrow Too Much

Another big issue with consumption smoothing is that it requires a great deal of borrowing, at least in the beginning, and then you spend the rest of your life paying back that debt from your youth. Some people are huge fans of debt and barely even make a distinction between good debt and bad debt. Others are rabidly anti-debt, since “the borrower is slave to the lender.” I’m more of a “debt is a necessary evil” where I can justify a few debts but they should be few and far between, at the best possible terms, and paid off relatively quickly unless there is some obviously better use for the money (like getting the match in a 401(k) or perhaps maxing out retirement accounts.) The problem with debt is it locks you into a pathway. When you borrow $450K to go to medical school, well, guess what you’re going to be doing for the next 20 years whether you want to or not? That’s fine if it is what you want, but too often, it isn’t. In reality, when you borrow you aren’t borrowing from the bank or the federal government. You’re borrowing from “Future You.” And Future You may not appreciate the amount you borrowed or the terms you agreed to. You would do well to assume that Future You would like to take even nicer vacations than you like, drive an even nicer car than you drive, and have fewer financial worries than you have. Besides, life changes. Maybe you want to change careers. Perhaps you become disabled, or divorced, or widowed. Maybe you have a special needs child. Maybe your expected income gets halved. In all these situations, the goal level of spending you are “consumption-smoothing” to will be too high. Now what? You’re hosed, that’s what.

Thanks to adaptation, we can easily adjust our lifestyles to lower levels and still be happy in the event of economic downturn. But if you have big debts and high levels of other fixed expenses, that adjustment is difficult, if not impossible.

Consumption smoothing is a bad idea. People are not automatons and life changes. Start your adult life with very frugal habits and you will always feel wealthy.

What do you think? Do you believe in consumption smoothing? Why or why not? Why do doctors and other high income professionals get suckered into this? Comment below!