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EXPLAINING FINANCIAL SUSTAINABILITY BY RATIONALISING THE LIFE CYCLE THEORY AND PERMANENT INCOME THEORY

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ABSTRACT

This article emphasizes the dynamics interaction of household financial literacy with fundamental economic consumption theories and household context of financial sustainability. The underlying concept is to explore the complexity between household financial management knowledge in the form of money attitude, behaviours and household debt motivations. By synthesizing the fundamental two household economic consumption theories, namely Life Cycle Theory and Permanent Income Theory, this article proposes an initial framework for analyzing household debt within the context of long-term personal finance sustainability body of knowledge. The integration of these two theoretical foundations allows us to nuanced examination on the multifaced factors influencing sustainable financial practices. The crucial elements in understanding household consumption patterns, debt management and repayment sustainability, money matters attitudes, investment choices that offer reasoning mental issues in managed personal finance. Finally, this article aims to provide a more comprehensive understanding on how households navigate the complexities of financial decision-making across different household lifecycles in pursuit of financial stability.

JEL classification*: D11, D14, D15*
Keywords*: Life Cycle Theory; Permanent Income Theory; Household Debt; Personal Finance Sustainability.*

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1. INTRODUCTION

The awareness on personal finance sustainability is undeniably a crucial determinant of individual and household financial stability, which indirectly affects nations quality of life. Financial sustainability in this context, refers to the ability of individuals, represent by household to manage its finance in a way that does not compromise the needs or resources of its future generations. By incorporating sustainable practices in their household finances, individuals can simultaneously contribute to a more sustainable

future and enhance their personal financial stability and quality of life. Thus, two consumption theories, the Life Cycle Theory (LCT) and Permanent Income Theory (PIT), denote significant foundations in understanding how households save and spend money throughout their lifetimes (Browning & Crossley, 2001; Ganic & Mamuti, 2020; Isaac & Graham, 2002; Lim & Yoon, 2011; Modigliani & Cao, 2004). These theories contribute valuable insights into consumption decisions based on long-term income expectations, allowing individuals to plan for future expenses and avoid excessive debt or overspending. This article will explore the grounded foundations of the LCT and PIT contribution to practices and strategies on how individuals or household used to manage its debts effectively by appraising the elements of household's financial literacy, it aims to highlight the importance of making informed economic decisions in managing household debt and ensuring long-term financial sustainability.

This study's motivation is to make a significant contribution to existing knowledge by addressing the key issues at the intersection of personal finance sustainability, household debts, and the rising cost of living. This research aims to highlight how these factors can lead to social distress. By examining the relationship between living costs and personal income taxes, this study will help for a better understand how the combination of increasing expenses and higher debt levels can put immense pressure on personal finances. This, in turn, negatively impacts household financial sustainability and affects overall quality of life. The findings from this study will shed light on these important connections and implications.

The remainder of the paper is organised as follows. The next section provides an overview of the concept of financial sustainability through a revitalized lens, re-examining the classic economic principles of LCT and PIT. It begins with a brief introduction into the topic, by establishing the inherent objectivity and limitations of these theories in addressing long-term household debts financial decisions impacts on quality of life. Then, the paper then explores the motivations and benefits of integrating these theories with the principles of personal representation by household finance sustainability, emphasizing the shift towards a long-term perspective and responsible consumption. Hence, the proposed framework linking consumption to household sustainable finance is presented. findings and additional analysis. Last, the paper presents conclusions by presenting the practical applications of this integrated approach are illustrated through examples in borrowing, spending, saving, and investing, advocating for a holistic approach to financial well-being that encompasses individual, societal, and environmental health.

2. THE LINK BETWEEN CONSUMPTION THEORIES AND HOUSEHOLD DEBTS

Consumption theories in economics provide explanations for the behaviour of household debt management. The most widely used theory to study household debt is based on the Life Cycle Model (LCM), which posits that customers (households) are rational and forward-thinking, and that debt is the result of utility maximisation. Hence, mainstream consumption theories consist of the Life Cycle Model (LCM) developed by Modigliani and Brumberg (1954) and Friedman's (1957) Permanent Income Hypothesis (PIH), which assume that households are rational and will smooth out their consumption over time based on their expected lifetime earnings (Drakopoulos, 2021; Fanta & Makina,

2019; Olsson, 2013; Zakaria et al., 2017). The initial research by Murphy (1997) on household debts and spending consumption provided a comprehensive explanation of the inverse correlation between an increasing debt-service ratio and the deceleration of spending growth. The study also examined the impact of uncertainty regarding future income on current spending growth.

The Life Cycle Hypothesis (LCH) shows that households in early life may consume more than their present income and finance the difference through borrowing (Ganic & Mamuti, 2020; Modigliani & Cao, 2004). The LCH was established by Franco Modigliani to propose that individuals plan their spending and saving behaviour throughout the course of their lifetimes, taking their predicted income and wealth into account (Modigliani & Cao, 2004). In depth, the LCH posits that individuals seek to smooth their consumption across their lifetime by borrowing when they are young and have low income and repaying the debt when they are older and have higher income (Ganic & Mamuti, 2020; Modigliani & Cao, 2004). On the other hand, Wang (2006) proposed an optimal consumption model with a lower trade-off between the raise in pay that households spend on the consumption of goods and services to consume out of human wealth rather than out of financial wealth. The model suggested that additional precautionary savings increase with the household's current income, which is altered by Friedman's LCH. Meanwhile, LCH has also been utilised to explain the high saving rates in China, where income growth has been the primary cause driving the substantial increase in the saving rate, as expected by the LCH (Nkomo & Adanlawo, 2023; Wen, 2009).

Thus, LCH is supported by empirical evidence from numerous studies (Ganic & Mamuti, 2020; Modigliani & Cao, 2004; Nkomo & Adanlawo, 2023; Stephens Jr., 2008). However, some studies have questioned the validity of the LCH, particularly considering the financial crisis of 2008. These studies suggest that the Keynesian relative income hypothesis, which claims that current consumption is influenced by factors such as current income, its distribution, household borrowing, and household indebtedness, may offer a more comprehensive account of household consumption behaviour.

Numerous articles re-evaluate Friedman's Permanent Income Hypothesis as another version of consumption theory (Murphy, 1997; Tolar, 1997; Wang, 2006). The classic PIH assumption is that consumers make consumption decisions based on their long-term average income rather than their short-term revenue volatility. Friedman supported the idea that individuals have a target level of consumption that they want to sustain throughout their lives, which he referred to as their permanent income. Most articles direct PIH arguments based on a theoretical framework (Musgrove, 1979; Palley, 2010; Aisbett et al., 2024; Yun et al., 2024); however, Tolar's (1997) argument on PIH has been adopted based on the context of nondurable consumer expenditure decision-making. His study employed both primary data via telephone interviews and secondary data such as nondurable consumption expenditure, disposable household incomes, and total credit available in testing PIH within the context of the behavioural consumption function. Temporary income adjustments, such as receiving a bonus or a wage increase, do not have a significant impact on their consumption behaviour. Lim and Yoon (2011), on the other hand, suggest that in a PIH setting, households may borrow for consumption to

smooth their consumption patterns over time. When individuals have low current income but expect higher income in the future, they may choose to borrow to support their desired level of consumption in the present.

The PIH has been studied in various contexts, including the analysis of credit card usage and the spending behaviour of low-income households (Murphy, 1997; Wang, 2006). For example, research has shown that the PIH has noteworthy results for low-income households in terms of food consumption, showing that they may borrow to meet their basic needs (Lim & Yoon, 2011). Similarly, a study conducted among food stamp recipients found that low-income households on welfare can smooth their consumption, even though borrowing and saving may be challenging for them (Lim & Yoon, 2011). Ziliak's (1998) study revealed a common scenario in more developed nations where individuals often experience a temporary negative shock to income, leading to the need for food stamps to stabilise their food consumption. In general, the aftermath of the income elasticity of food demand is smaller compared to other less significant components of consumption. Overall, the PIH provides a framework for understanding why households may choose to borrow for consumption, particularly when their current income is limited. By considering their expected future income, individuals can make decisions to support their desired level of consumption in the present.

3. THE CONNECTION BETWEEN CONSUMPTION THEORIES AND HOUSEHOLD FINANCIAL SUSTAINABILITY

Financial sustainability research is becoming increasingly popular in financial literacy. As a result, the financial sustainability of the household has been designated as an indicator of its financial security and stability (Yergasheva et al., 2020). The household sector is reflected in the national accounts and represents a huge composition of buyers, both in the economy and in financial markets. The sector has an effect on the overall demand for goods and services, which promotes economic maturation and growth that lead to the economy's financial sustainability. Despite its contribution to the national accounts segment, this sector shapes the aggregation of responsible savings and spending habits and includes a part of business revenues due to their insatiable consumption appetites, which benefits not only individuals but also contributes to overall economic stability (Bunn et al., 2016; Organisation for Economic Co-operation and Development (OECD), 2021a, 2021b; Stenning et al., 2010). Additionally, the household sector encompasses the labour market participation influenced by propelling employment rates and income levels skyward, aside from the role of property market participation for own residence, wealth accumulation, and investment opportunities in an economy. Overall, the actions and behaviours of the household sector have a direct impact on financial sustainability at both the individual and macroeconomic levels. Understanding these nuanced dynamics is critical when considering policies aimed at promoting financial equilibrium within an economy.

A multitude of studies have been conducted to analyse the factor of sustainability, including Boj del Val et al. (2022), Munisamy et al. (2022), Shah et al. (2020), and Yergasheva et al. (2020), with mixed results. Munisamy et al. (2022) investigated the socioeconomic sustainability of low-income households in Malaysia and discovered that financial literacy (knowledge, attitudes, and behaviours) has a favourable impact on the socioeconomics of such households. These findings imply that financial literacy can help

low-income households improve their economic potential and support their social status in highly competitive markets. Another study conducted by Shah et al. (2020) investigated the impact of financial attitudes, financial behaviour, and financial self-efficacy on financial sustainability, utilising 284 Malaysian employees from the manufacturing sector. The study discovered that psychological elements such as financial attitudes, financial behaviour, and financial self-efficacy have a substantial impact on the financial sustainability of manufacturing sector employees in Malaysia.

There is a scarcity of studies on financial sustainability (Shah et al., 2020; Munisamy et al., 2022), particularly on East Malaysian households and their impact on socioeconomic status. Accordingly, the objective of this study is to enhance households' financial literacy to enable informed financial decision-making and achieve financial well-being, thus improving their socioeconomic standing. It is plausible to believe that household financial literacy, economic conditions, and external variables all play a role in financial sustainability.

The important role of households in the social financial system and the financial stability of a household can be defined as the ability of the family to uphold a basic standard of living in varying circumstances (Bimendiyeva et al., 2019). By understanding LCT and PIH, households can more effectively prepare for upcoming costs and steer clear of significant debt or overspending. As stated by Schooley and Worden (2008), a fundamental theory is the life-cycle hypothesis, suggesting that people generally spend more during youth and save increasingly as they get older. It further clarifies that their income and consumption habits change over their lifespan, reaching a high in expenditures during middle age. This data is essential for families since it enables them to anticipate future costs according to their current life phase. Furthermore, it emphasizes the significance of preparing for retirement and other long-term objectives instead of depending only on credit or loans. By understanding these theories, people can make improved financial choices that align with their long-term objectives and steer clear of financial pitfalls like excessive debt or overspending. This information is particularly important for college students who are starting to handle their own finances and require advice on effective budgeting. Sustainable consumption behavior regarding financial literacy and financial knowledge, by lateral definition, pertains to consumption actions related to selecting products or services that are eco-friendly, socially advantageous, and maintain personal well-being (Betti et al., 2007; Sheoran & Kumar, 2022).

Today, financial education and literacy have expanded to include sustainable consumption behaviour for the purpose of educating individuals to make informed economic decisions that lead to sustainable living. As del Castillo Negrete (2022) states, changes in wealth, both physical and financial assets, can affect one's financial well-being. Therefore, having a solid understanding of sustainable personal finance is essential for individuals to navigate the complex world of economics. This includes knowing how to manage money effectively, budgeting wisely, and investing intelligently. Without proper financial knowledge and skills, individuals may fall prey to predatory lending practices or make uninformed investment decisions that could have profound consequences for their financial future. By promoting financial education at the college level, students can gain a deeper understanding of economic principles and learn practical

strategies for managing their finances. This will not only benefit them personally but also contribute to the overall economic stability of a broader society.

Personal finance literature often overlooks individuality in sustainable finance; most literature includes the macroeconomic point of view when discussing financial sustainability. Thus, it is critical for personal finance to explore the concept of sustainable consumption at the individual household level as part of the scope of financial literacy. The most common topic in the household sector's link to financial literacy, specifically sustainability and well-being, is the household debt market segment (Zhang & Chatterjee, 2023). The review by Kaiser et al. (2022) found that financial education programmes have positive causal treatment effects on financial knowledge and downstream financial behaviours, which shows the impact that proper education can have on one's financial decision-making abilities. This underscores the significance of comprehending personal finance to guarantee a stable financial future. Individuals can develop a solid foundation for making sound financial decisions in the future by learning about topics such as budgeting, saving, and investing in college. Furthermore, having a higher level of financial literacy can lead to greater financial sustainability. Individuals are better equipped to navigate complex economic systems and make informed financial decisions with increased knowledge and understanding. Thus, improving one's financial literacy benefits not only the individual but also contributes to overall societal stability and growth.

The suggested framework clarifies the relationship between the two consumption theories and the household's sustainable finances, or overall quality of life. In this proposed model, the moderator identified as financial literacy, which in the context of this article, pertains to managing household debt.

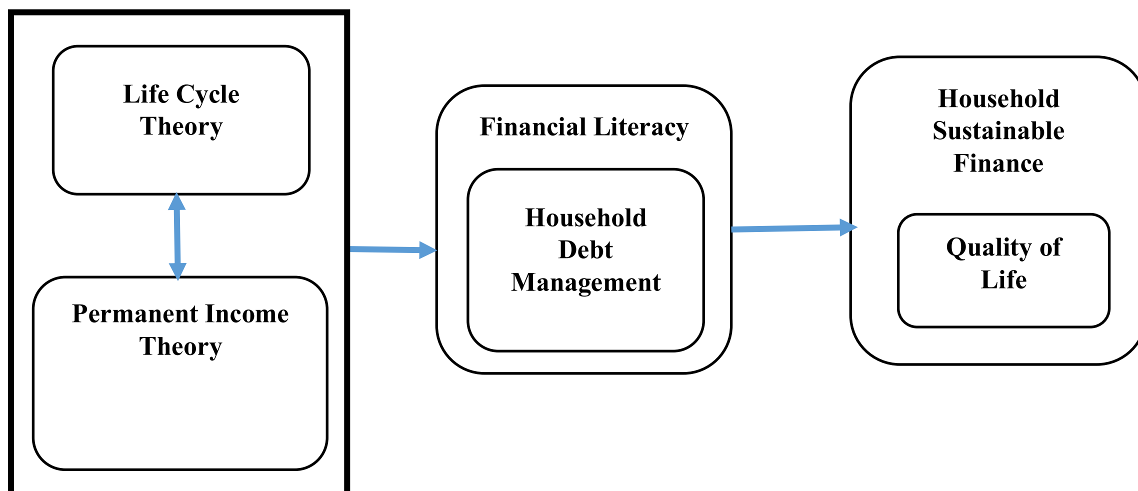

Figure 1: Propose Framework Linking Consumption Theory to Household Sustainable Finance

In the household segment, financial sustainability is defined as the ability of the individual to maintain a stable and secure financial position over time, which necessitates

personal finance knowledge and literacy. It entails the ability to effectively manage money, make informed decisions, and plan, including topics such as budgeting, saving, investing, and managing debts. Individuals with inadequate knowledge and literacy in these areas may find it difficult to maintain their financial stability over time.

Both LCT and PIT provide an understanding of how individuals spend their money and save income over their lifetimes. Despite criticism, these consumption theories provide sound justifications for making saving and spending choices that affect the larger economy. Grasping these theories can help policymakers create successful strategies to enhance financial sustainability and stimulate economic growth. The LCT suggests that people adjust their saving and spending habits to maintain an adequate quality of life throughout their lives. The PIT proposes that people make spending choices based on the perceived "sustainability" of their income, meaning the average expected earnings over a period, rather than the cash they have at the moment. When people participate in random economic activities, researchers like Hall (1978) describe how these two consumption theories influence how households react to unforeseen events, such as income shifts, unexpected expenses, or economic unpredictability regarding real-world actions and results. Therefore, this research suggests incorporating sustainable personal finance courses to improve the financial literacy of young adults. Praveena and Rachel (2018) assert that early financial literacy helps young individuals grasp the essentials needed to attain a financially stable, sustainable, ethical, and responsible way of living, particularly in managing household debts for future economic security. People with a strong understanding of financial literacy are able to make improved decisions about their finances and strive for long-term financial security. Moreover, as technology and digital banking progress, it is essential for people to possess the required understanding to maneuver through this evolving environment. In general, enhancing financial literacy can result in improved economic results for both individuals and communities.

4. CONCLUSION

The Life Cycle Theory explains how households manage and utilise debt over the course of their lives, which explains household debt by considering the distinct phases of an individual's life and their corresponding income, consumption, and saving patterns. On the other hand, the Permanent Income Theory primarily focuses on consumption behaviour and how individuals make consumption decisions over time based on their perceived long-term or "permanent" income. While the theory itself does not explicitly address household debt, it indirectly explains household debt via consumption behaviour by shedding light on how individuals manage their finances and make borrowing decisions.

The Life Cycle Theory and the Permanent Income Theory are two economic theories that explain how individuals make financial decisions. According to the Life Cycle Theory, saving and spending habits among individuals change as they progress through various stages of their lives. For example, young adults may save money for major life events (e.g., buying a house), while middle-aged individuals may focus on retirement plans. In contrast, the Permanent Income Theory suggests that consumption decisions are based on long-term income expectations rather than current income levels. Consequently, individuals may refrain from increasing their expenditures despite receiving a substantial

amount of money within a specified year, as they expect that it will not be a consistent source of income. Behavioural household finance is an emerging field that looks at how individuals make financial decisions in real-world situations rather than assuming rational behaviour as traditional economic models do. According to Beshears et al. (2018), this approach considers observed patterns that challenge classical economic assumptions and offers explanations grounded in behavioural economics. By incorporating psychological factors such as emotions and biases into the study of economics, behavioural household finance provides valuable insights into the reasons individuals save and spend money in certain ways. This theory reinforces the idea that human behaviour is complex and cannot always be explained by simple economic models.

In summary, this preliminary evaluation of the two economics theories justified essential function of the LCT and PIH in clarifying the complexities of household financial sustainability. By recognizing the relationship between household's lifecycle phases, spending habits, debt management and income distribution via monthly economic activities, and money matters expectations, household can make educated financial choices that encourage long-term stability and sustainable financial freedom. These theoretical models highlight the significance of synchronizing spending and saving actions with expected future conscious reasoning, reducing the deeper in financial debt traps and unreasonable overspending. Additionally, emphasize the essential importance of financial literacy and education in enabling households to make wise economic decisions. Modigaliani (1986) insightfully noted, grasping the basic understanding of LCT together with PIH in household personal economic choices parallelly influencing overall financial well-being. Incorporating these theoretical understanding into personal finance methods can greatly improve the likelihood of attaining and sustaining stable household finances.

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