How people trick themselves into overspending

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It's tax-time. For many people that means handing some hard-earned money over to Uncle Sam, but for many others tax time is refund time. Theoretically, that refund is money you've earned as a part of your salary, and should be accounted for and spent like regular income. However, most people view it as "found money" and generally find a way to justify spending it on something they didn't necessarily need.

"They often think of the refund as if it were 'free money'," says Amar Cheema, assistant professor of Marketing in the Olin School of Business at Washington University in St. Louis. "People mentally credit it to specific budgetary accounts so as to justify spending it on desirable luxuries such as a vacation or a nice dinner on the town."

Keeping mental accounts of one's money is a common method of controlling spending, Cheema says, even though in some cases it makes it easier to over-spend. Cheema and co-author, University of Toronto professor Dilip Soman, explain how people justify spending through mental accounting in their paper, "Malleable Mental Accounting: How Individuals Manipulate Mental Accounts to Justify Attractive Consumption and Spending Decisions." Cheema defines mental accounting as a process where consumers use mental accounts - intuitive bookkeeping mechanisms - to track and control spending.

Everyone has indulged in creative mental accounting at some point, Cheema and Soman say. The best example is when someone overspends during the holidays. That person compensates for the behavior by invoking an "un-incurred" cost—for instance, not signing up for a cable TV service that would have cost $400 a year. When given a chance, individuals selectively interpret and manipulate evidence in order to justify a preferred choice or judgment.

"Consumers are motivated to define expenses and shape mental accounts in a way that allows them to do what they want to do rather than what they should do," Cheema says.

"Our research identifies loopholes that people exploit so they can do what they should not do—overspend, incur debt… in sum, make poor decisions."

These loopholes exist in the two different kinds of mental-accounts that most people create. First, people control spending by allocating certain expenditures to various "budgetary accounts," or spending categories: food, housing, entertainment. Then there are what the researchers call "transaction-specific" accounts. This is when consumers buy something, debit the transaction account by the amount paid for the item, and later credit the account by the benefit they get from using the item.

"Maybe someone needs to buy a refrigerator. They pay for it with money taken out of a mental account and then credit this 'refrigerator account' to the benefits they get over the years they use it," Cheema says. "Or if someone buys a $50 symphony ticket, they debit the 'symphony account' by the $50 paid for the ticket, and credit it to the pleasure that the experience brings. In other words, people explain the tradeoff between spending money and getting their money's worth."

That kind of accounting can get sticky, but the real trouble is caused by when people don't know how to categorize their purchases. And it's here where people find the loopholes that get them into trouble.

The researchers' study of mental accounting helps to explain why people's attempts to control spending may or may not work. Cheema says it's easy for consumers to break their boundaries with "malleable" mental accounting. Take a tax refund.

"Let's say I have wanted to go on a vacation to Miami for a while, and I may apply this refund money to my "vacation" budgetary account to justify taking that vacation, which is what I want to do, rather than paying off some of my mortgage, as I should do," Cheema says. "In doing so I exploit the ambiguity associated with the purpose of the account, and find a way to spend on luxuries that I was trying to otherwise control."

If you're really motivated to buy something and there is some ambiguity in categorizing the expense, you'll usually find a way to dupe yourself and spend the money with a little mental accounting, Cheema says.

"Another example is if you really want to go out to a dinner with friends, but have already spent a lot this month on food. You could always say 'this isn't a food expense, its an entertainment/social expense!' and incur it," Cheema says. "But if you have already spent a lot on entertainment, but not on food, you may classify it as food instead. This is another way that you could use the ambiguity to justify spending."

Such flexible accounting to justify spending is less likely to happen if consumers have to be accountable for money to someone else, Cheema says, such as a spouse. External sources may eliminate the tendency to find the loopholes that lead people to overspend. Such justification is also harder in the absence of ambiguity.

The lesson, Cheema says, is that if people draw clearer boundaries and create clearer definitions of their spending categories, then it should be easier to control spending.

Source: Washington University in St. Louis