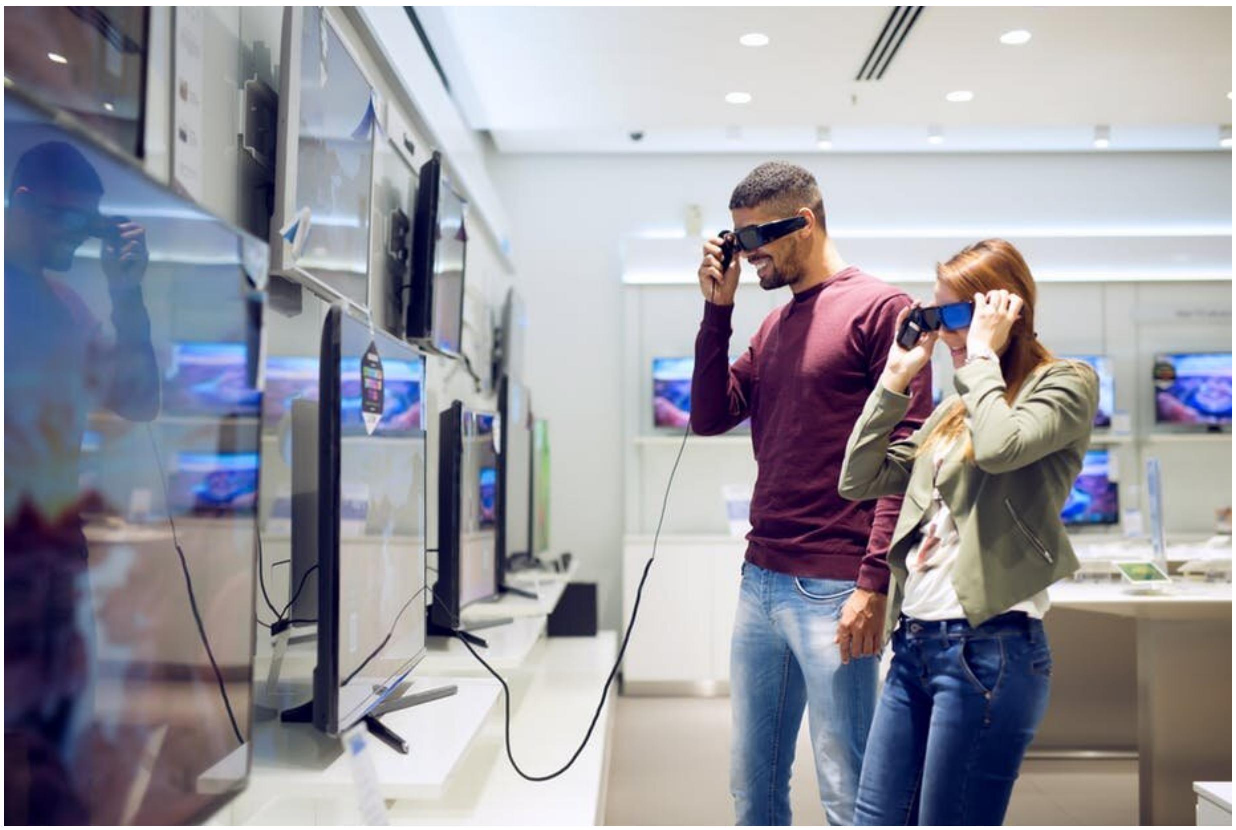
Why you should think twice before buying that new TV set

December 16 2019, by Alberto Cardaci



Can you really afford a 3D TV set? Credit: Dusan Petkovic

Planning to buy a new TV set as a Christmas family gift? Your decision would probably be based on a series of technical characteristics, such as size or screen resolution. Yet at some point you might ask yourself: can I really afford this?

You would probably answer this question by taking into account not only the price of the TV, but also how much money you have and, more generally, how wealthy you are. But do you actually have the correct perception of your wealth?

Distorted perceptions of personal wealth

This question might sound trivial. In fact, right now you are probably thinking, "Sure, I might not know exactly how much is in my checking account or the exact value of my stocks, but I definitively have an approximate idea of how much I am worth in terms of wealth". Right?

Wrong. A growing number of theories and findings in economics and psychology suggest that people often have a distorted perception of how wealthy they are. For example, people often overestimate (or underestimate) how rich they are compared to their peers, or the people living in the same area.

Another reason explaining the misperception of wealth may be related to your expectations about the possible materialization of future earnings.

Let's imagine that you decide to bet 100 euros on your football team winning the Champions League final. It is possible that you are so confident that the bet will pay off, that you will perceive yourself as being richer even before your team plays the game.

Another reason for wealth misperception is the so-called money illusion problem. As research has shown, people often tend to ignore the change in prices and focus only on the relative change of their wealth (or income). For example, imagine your wealth has increased from last year. If you ignore the increase in prices in the same period, you will perceive your wealth to be much higher than last year, but in fact it is only slightly higher (or maybe even lower).

A lab experiment

In a research supported by the Axa Research Fund and described in a November 2019 working paper, I conducted a laboratory experiment with economists Tiziana Assenza and Domenico Delli Gatti, to dig deeper into the issue of wealth misperception.

In the study, we built a controlled environment where wealth misperception should not emerge and tested whether we observed it nonetheless. In the experiment, each subject was shown some pairs of financial portfolios and was asked to report if they perceived any portfolio in each pair as financially better off than the other.

The key feature was that the paired portfolios were financially equivalent. So, a study participant who is both rational and has at least a basic knowledge of key financial concepts should have perceived no portfolio as being better off. This would indicate a correct perception of wealth.

This is not what we observed, however. Approximately 80% of the subjects perceived one of the equivalent portfolios as better off. In other words, most of the subjects associated a given level of net wealth with different levels of perceived wealth.

This result is surprising, not only because it goes against standard consumer theory—whose idea of the fungibility of money predicts the absence of such a phenomenon—but also because it is hard to reconcile with any rational criterion.

Moreover, even financially educated subjects exhibit the same pattern of answers. That is, financial education does not prevent the formation of wealth misperception (at least in our experiment). So, how to explain it?

Are you a fast or a slow thinker?

Our results suggest that this is related to differences in the way we think and the amount of attention we use.

In general, we all have two types of thoughts: some thoughts are faster, more intuitive and require a lower amount of attention; others, instead, are slower, more sophisticated but make use of a great deal of attention.

These two systems of thought are often referred to as System 1 and System 2, a terminology that dates back to what psychologists and behavioral economists call dual-process theory.

Our results—obtained through the inclusion of the Cognitive Reflection Test in our experiment—indicate that subjects with distorted perceptions of wealth have a greater tendency to rely on their System 1. In other words, these people are faster but more inattentive thinkers, who process the available information in a more intuitive, yet wrong, way.

On the contrary, the minority of subjects, who make no mistake in the perception of wealth in our experiment, seem to be more sophisticated thinkers, who make a greater use of their attention.

Why does such wealth misperception matter?

In our experiment we also ask subjects to make a series of hypothetical consumption and borrowing decisions. We observe that subjects with wealth misperception are more impatient, greater spenders and less averse to the idea of borrowing, compared to subjects who make no mistake in the perception of wealth. In other words, less cognitively sophisticated people are more likely to have distorted perceptions of wealth and this, in turn, seems to affect the way they make decisions to spend and borrow.

In fact, the misperception of wealth is also associated with a greater tendency to rely on debt to finance consumption and deal with financial emergencies (like paying overdue bills), even if other options—such as using savings, or cutting on other expenses—are available. It seems that having a wrong perception of wealth corresponds to financial decisions that may jeopardize your financial health.

So, next time you have to decide whether to buy that expensive TV, think twice about it and consider carefully how much money you actually have.

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