The Psychology of Money

Goals for today's class

Recognize why and in it what way thinking about money may be difficult for people

Realize what mental accounting is and learn about its benefits and negative consequences

Learn about the pain of paying illusion

People who are my inspiration when it comes to thinking about money

Dan Ariely

Richard Thaler

Tomasz Zaleśkiewicz

Tadeusz Tyszka

Discussion questions

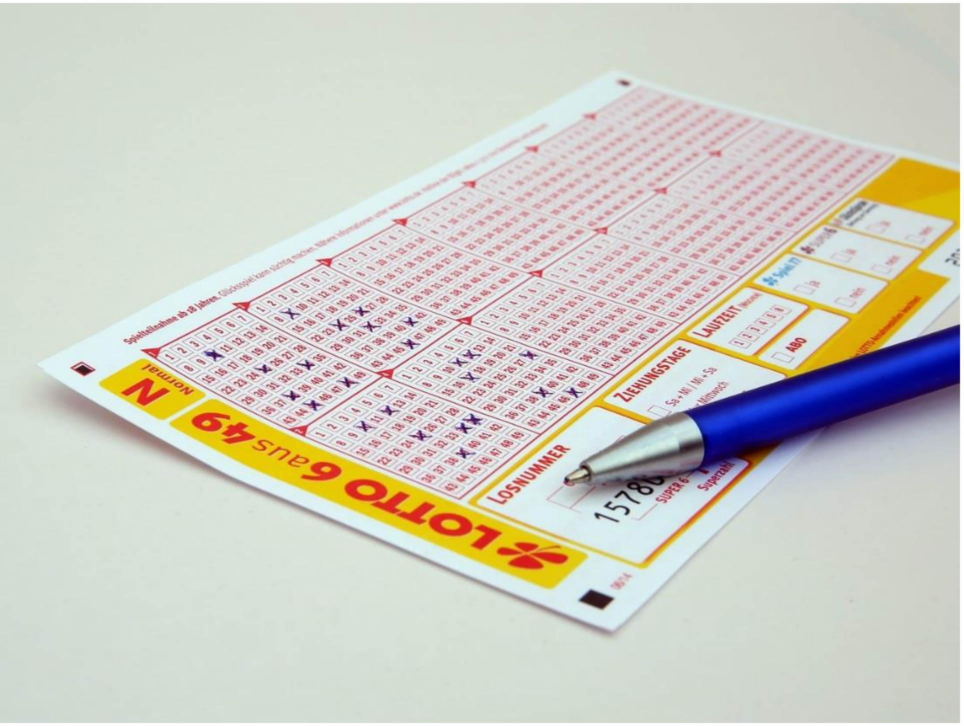
1. How is it possible that professional athletes who earn fortunes sometimes go bankrupt or are under financial stress after ending their careers?

Discussion questions

2. How is it possible that people at the same time have loans in banks and keep their savings on bank deposits (loan’s annual percentage rates are much higher than deposit rates for saving accounts)?

Discussion questions

3. How is it possible that people spend their money on national lotteries when chances of winning are extremally small?



The idea of mental accounting

Mental accounting is the set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities.

„(…) Mental accounting violates the economic notion of fungibility. Money in one mental account is not a perfect substitute for money in another account.”

(Thaler, 1999, p. 183).

Mental accounting abroad

Imagine two people: A and B who go together for a trip abroad.

A decided to exchange currency and took the equivalent of 200 Euros in local currency

B decided to pay with credit card and thought that he may spend 200 Euros.

It turned out that the person they were visiting prepared the entire trip and paid for everything. Now it is their final night. Who would be more likely to spend a lot?

Three important components of mental accounting (Thaler, 1999)

1. The perception of costs and benefits – the evaluation of the outcome of financial activities
2. The assignment of activities and financial resources to different accounts
3. The frequency of accounts evaluation

Mental Accounting

Imagine two different students. They both have a rather fixed amount of money that they plan to spend on food each month (500 pln). In order to track spending one of them thinks about the food money in terms of one day (tries not to spend more than app. 16.5 pln each day) and another one in terms of one week (tries not to spend more than app. 115 pln each week).

How would you expect their behavior and habits to differ?

Would you consider one of them to be more rational?

The pain of paying

Interesting article:

Mazar, N., Plassmann, H., Robitaille, N., & Lindner, A. (2016). Pain of paying?—A metaphor gone literal: Evidence from neural and behavioral science.

This paper is the first to present direct empirical evidence that the metaphor is more than a theoretical concept; it stands for a literal pain experience. In addition, the authors characterize its quality as an affective pain experience in three incentive-compatible experiments.

The pain of paying

Standard economic approach:

- price of a product or a service is considered in terms of opportunity cost (the value of the best alternative product that could have been purchased with the money instead) - Buchanan (1999).

The pain of paying:

- There is an additional emotional element - the experience of a “direct and immediate displeasure” (Zellermayer, 1996)

The pain of paying

What is a perfect gift?

http://danariely.com/2010/11/26/an-irrational-guide-to-gifts/

How to increase and decrease the pain of paying (Dan Ariely)

TO INCREASE POP

Use a method of payment that is most closely related to experiencing money being spent (i.e. cash)

Increase the mental availability of the fact that money is spent (e.g. notifications)

Increase salience (e.g. install meters that indicate how much money is spent)

TO DECREASE POP

Use a method of payment that is least closely related to experiencing money being spent (e.g. credit card, coupons, casino chips)

Keep payments hidden (e.g. no notifications, information of the amount of money spent not easily available)

Introduce prepayment (separate the moment of spending the money and consumption)

The money illusion as a cognitive psychological mechanism responsible for the perception of money

The money illusion – term coined by Irving Fisher, an American economist who observed that people do not take inflation into account when they analyze gains and losses.

They look at nominal and not real values.

James Tobin (1972) wrote: „(...) An economic theorist can, of course, commit no greater crime than to assume money illusion”

The money illusion

people have difficulties with realizing the difference between the nominal and real value of currency.

Implication of money illusion – What would most people choose:

1. Have a 2% salary increase when inflation rate is at 4%?
2. Have a 1% salary decrease when there is no inflation?

The money illusion - continued

The Euro illusion as an example

Does introducing Euro as a currency change anything in the perception of money?

People tend to believe that prices will be higher

On the other hand they may be perceived as lower due to the money illusion (in countries where nominal prices are lower than before)

Sources and recommended readings

- Mazar, N., Plassmann, H., Robataille, N., & Lindner, A. (2014). *Pain of Paying—A Metaphor Gone Literal: Evidence from Neurobiology and Behavioral Decision Making*. INSEAD working paper.
- Rick, S. (2018). Tightwads and spendthrifts: An interdisciplinary review. *Financial Planning Review*, *1*(1-2), e1010.
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