

“The Curse of Mental Accounting”

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I'm writing this blog post because I just paid \$16.95 for hotel internet access. Normally, I get around the hotel internet conundrum by walking to the nearest Starbucks and drinking a cup of coffee while sending my email. Alas, I seem to be in the last zipcode in America without a Starbucks. And that's why I ended up paying a ridiculous amount of money to get online.

And it's not just the internet. If I decided to eat breakfast in my hotel room, I'd pay \$8 for a pot of tea. Eggs with bacon and toast would set me back \$22. Smoked salmon hash? \$28. A bowl of Cheerios? \$12, plus tax, tip, and a \$4 room delivery charge.

Why can hotels get away with such exorbitant fees? Part of the explanation is convenience – I imagine it's pretty fun to eat breakfast in a hotel bed. A second explanation is expense accounts, as most business travelers have little incentive to shop around for a better breakfast value or cheaper internet options. The charge will end up on someone else's credit card.

And yet, I don't think these rational economic explanations can fully account for the absurdity of \$20 bowl of cereal. And that's why I'd like to tell you about a recent experiment involving M&M's. In 2006, psychologists at the University of Pennsylvania decided to conduct an experiment in an upscale apartment building. One day, they left out a bowl of the chocolate candies with a small scoop. The next day they refilled the bowl with M&M's but placed a much larger scoop beside it. The result would not surprise anyone who has ever finished a Big Gulp soda or a supersized serving of McDonald's fries: when the scoop size was increased, people took 66 percent more M&M's. Of course, they could have taken just as many candies on the first day; they simply would have had to take a few more scoops. But just as larger serving sizes cause us to eat more, the larger scoop made the residents more gluttonous.

Economists call this sleight of mind “mental accounting,” since people tend to think about the world in terms of specific accounts, such as scoops of candy. While these accounts help us think a little faster – it's easier to count scoops than tiny little M&M's – they also distort our decisions. Richard Thaler, a behavioral economist at the University of Chicago, was the first economist to fully explore the consequences of this irrational behavior. He came up with a simple set of questions that demonstrate mental accounting at work:

Imagine that you have decided to see a movie and have paid the admission price of \$10 per ticket. As you enter the theater, you discover that you have lost the ticket. The seat was not marked, and the ticket cannot be recovered. Would you pay \$10 for another ticket?

When Thaler conducted this survey, he found that only 46 percent of people would buy another movie ticket. However, when he asked a closely related question he got a completely different response.

Imagine that you have decided to see a movie where admission is \$10 per ticket. As you enter the theater, you discover that you have lost a \$10 bill. Would you still pay \$10 for a ticket to the movie?

Although the value of the loss in both scenarios is the same – people were still losing ten dollars – 88 percent of people said they would now buy a movie ticket. Why the drastic shift? According to Thaler, going to a movie is normally viewed as a transaction in which the cost of a ticket is exchanged for the experience of seeing a movie. Buying a second ticket makes the movie seem too expensive, since a single ticket now “costs” \$20. In contrast, the loss of the cash is not posted to the mental account of the movie, so we don’t mind forking over another \$10.

Of course, this is woefully inconsistent behavior. After losing a ticket, most of us become tightwads; when we only lose cash, we remain spendthrifts. These contradictory decisions violate an important principle of classical economics, which assumes that a dollar is always a dollar. (Money is supposed to be perfectly fungible). But because the brain engages in mental accounting, we end up treating our dollars very differently. For example, when Thaler asked people whether they would drive 20 minutes out of their way to save \$5 on a \$15 calculator, 68 percent of respondents said yes. However, when he asked people whether they would drive 20 minutes out of their way to save \$5 on a \$125 leather jacket, only 29 percent said they would. Their driving decision depended less on the absolute amount of money involved (\$5) than on the particular mental account in which the decision was placed. If the savings activated a mental account with a miniscule amount of money – like buying a cheap calculator – then they were compelled to drive across town. But that same \$5 seems irrelevant when part of a much larger purchase. This principle also explains why car dealers are able to tack on unwanted extras and why we’re often suckered into paying for unnecessary warranties on big electronic purchases. Needless to say, mental accounting also explains my expensive internet connection. In the end, expensive hotels are able to charge insane amounts of money for Cheerios and wifi because these exorbitant charges get posted to the mental account of the hotel bill, which will be hundreds of dollars anyways. As a result, the charges don’t seem quite so crazy. (This also helps explain why cheap hotels are so much more likely to offer free internet and breakfast buffets. Sometimes, we get more when we pay less.)

I agree with those behavioral economists who believe the field is often over-hyped, used to solve phenomena that can best be understood with traditional economic models. Nevertheless, there are certain aspects of economic life, such as this damned expensive internet connection, which can only be explained when we grapple with the bounded nature of our brain. Since the conscious mind can only handle a few thoughts at any given time, it’s constantly trying to “chunk” stuff together, to make the complexity of life a little more manageable. Instead of thinking about each M&M, we think about the scoops. Instead of counting every dollar we spend, we parcel our dollars into particular purchases, like paying for a hotel room. We rely on misleading shortcuts because we lack the computational power to think any other way.