

# Mental Accounting Matters

Research Article

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## ❖ ABSTRACT :

Mental accounting is the set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities. We wish to understand the decision-making process of an individual or a household interacting in an economic environment. How does a person make economic decisions, such as what to buy, how much to save, and whether to buy or lease an item ? And how are the outcomes of these financial transactions evaluated and experienced ?

## ❖ DATA :

- Value function of Kahneman and Tversky's (1979) prospect theory.

## ❖ EXPERIENCES :

### THE FRAMING OF GAINS AND LOSSES

- You are about to purchase a jacket for (125\$) [15\$] and a calculator for (15\$) [125\$]. The calculator is on sale for (10\$) [120\$] at the other branch of the store, 20 minutes drive away. Would you make the trip to the other store ?

**Results :** People are more willing to drive across town to save money on a small purchase. (context of choice and utility)

- For two outcomes  $x$  and  $y$ , when will  $v(x+y)$  be greater than  $v(x) + v(y)$  ? (Example : Lottery)

### MENTAL ACCOUNTING DECISION MAKING

- Consider a thirsty consumer who would rather have a can of soda than one dollar and is standing in front of a vending machine that sells soda for 75 cents. Clearly the purchase makes her better off, but it might be rejected if the payment were cognitively multiplied by 2.25.
- Consider the example of someone who buys 100 shares of stock at \$10 a share. This investment is initially worth \$1000, but the value will go up or down with the price of the stock.

**Results :** Realized loss is more painful than a paper loss.

### BUDGETING

- Another component of mental accounting is categorization or labeling. Money is commonly labeled at three levels: expenditures are grouped into budgets (e.g. food, housing, etc.); wealth is allocated into accounts (e.g. checking, pension, 'rainy day'); and income is divided

into categories (e.g., regular or windfall). Such accounts would be inconsequential if they were perfectly fungible (i.e. substitutable) as assumed in economics. But, they are not fungible, and so they 'matter'.

#### CHOICE BRACKETING AND DYNAMIC MENTAL ACCOUNTING

- The location of the parentheses matters in mental accounting -a loss hurts less if it can be combined with a larger gain; a purchase is more likely to be made if it can be assigned to an account that is not already in the red; and a prior (sunk) cost is attended to if the current decision is in the same account.

#### ❖ CONCLUSION :

Mental accounting often leads people to make irrational investment decisions and behave in financially counterproductive or detrimental ways, such as funding a low-interest savings account while carrying large credit card balances.