

IAREP/SABE/ICABEEP Summer School 2010, Moscow, Russia
"Behavioral Economics and Economic Psychology"

The puzzle of simultaneous savings and debts



RATIONALE

- *"Neither a borrower nor a lender be,"*
Shakespeare, Hamlet
BUT what about a person being a borrower and a saver in the same time?
- *A basic rule of rational economic decision making is: do something only if the marginal utility you get from it exceeds the marginal cost of doing it.*
BUT isn't usually the interest rate for loans higher than the interest rate of savings?



*Saving and borrowing do not describe mutually exclusive strategies of financial management. Many people retain savings or carry on **saving at the same time as having debts.***



(Livingstone & Lunt, 1993)

...some more questions

- Does acquiring new debts while maintaining savings generate an individual feeling of security and/or a collective vicious circle of indebtedness?
- Should I use my savings to pay my debts?
- What role does play the nature/category of the good which is the object of savings or debts in making the financial decision?

What's missing?

**“We (economists) think of wealth as fungible; We think a dollar is a dollar. Why don't they (the others) do so?”
(Solow, 1987)**



1 \$ = 1\$?



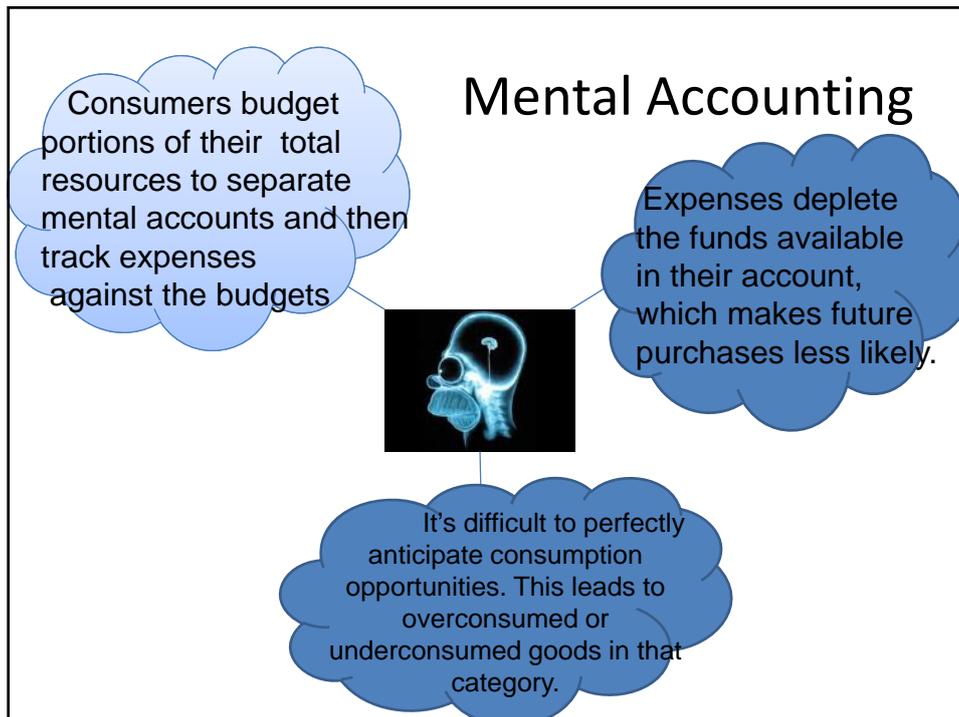
- Imagine that you have decided to see a play where admission is \$10 per ticket. As you enter the theater you discover that you have lost a \$10 bill. Would you still pay \$10 for a ticket for the play?

(Yes 88%)

- Imagine that you have decided to see a play and 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?

(Yes 46%)

(Tversky, Kahneman 1981)



Consumers may label mental accounts/budgets in different ways:

SIMILAR GOALS

REASONS

EXPLICIT PURPOSES

SIMILAR PURCHASE FEATURE

People create mental accounts not only for spending. There is evidence they do so also for time - people attempt to balance their time across work and non-work activities.

Why do people divide spendings in categories?

To facilitate making rational trade-offs between competing uses of funds



Self-control device



- ✓ *Some studies suggest that the processes underlying mental accounting are the same as the processes described in categorization, schema, and script theories*



Our question



If mental accounting prevents people from spending money from one „mental account” on goods belonging to another one...

...will people - after using all their money from a given account – be **willing to go into debt** to buy goods belonging to this account in a situation when **they still have money in other accounts?**

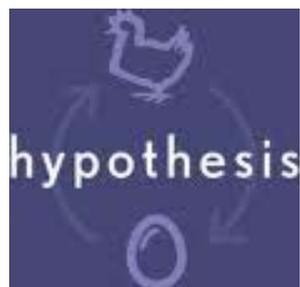


- ***Main purpose of the research:***

We want to show how the mental accounting theory can explain savings inclination versus debt inclination

- ***Implications:***

It can bring some new perspective on why we irrationally go simultaneously into debt and overconsume in some areas



The subject will be more likely to decide to get a loan in a situation when goods belong to different categories, than when both goods belong to the same category

Subjects



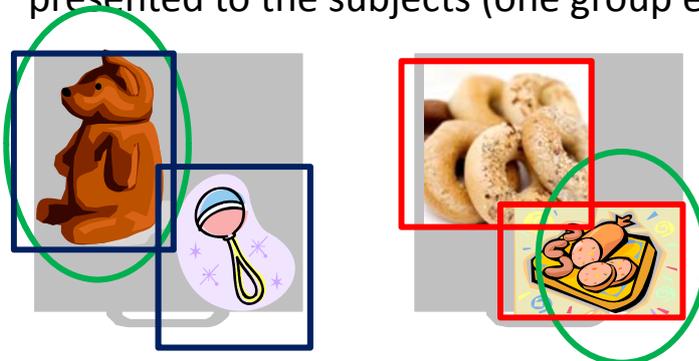
3 groups of 32 subjects each, from a widespread range of nationalities

No payment for participation in the experiment.

The survey took approximately 2 minutes to complete

Design

- There were three different situations presented to the subjects (one group each):



Pilot study - Categorization

- AIM: to identify two pairs of objects. Both of them should consist of objects which are the most frequently put in the same category, but items from each pairs shouldn't be put together in one category



- Subjects (20 of the ICABEEP summer school participants) were presented with 32 items representing different goods or services of approximately the same value.
- Their task was to arrange the items in as many categories as they found appropriate and to give a name to each category.

Results of the pilot study

- The most frequently used categories:
necessities, leisure & hobbies, luxurious items, home & maintenance, transport
- The most frequent goods from the winning categories:

Used car	Equipment for extreme sports
Bathroom renovation	An exotic trip for the family
Kitchen furniture set	A professional home cinema system
Roof repair	

PROCEDURE: 3 mini-surveys conducted through the online soft Kwik Surveys

Group 1 (control group for 2 goods from the category “necessities”)

You have been saving for a long time in order to replace your old car. Recently you have had some serious plumbing problems and you really need to renovate your bathroom.

Group 3 (control group for 2 goods from the category “leisure”)

You have been saving for a long time for going on a perfect vacation. Recently you have found out that there is a special offer on a high quality sport equipment that you also dream about.

*I would definitely use my savings , I would probably use my savings
Neutral*

I would probably get a loan, I would definitely get a loan

Please explain your choice (open question)

Demographics: Age, Gender, Nationality

**Group 2
(experimental group)**

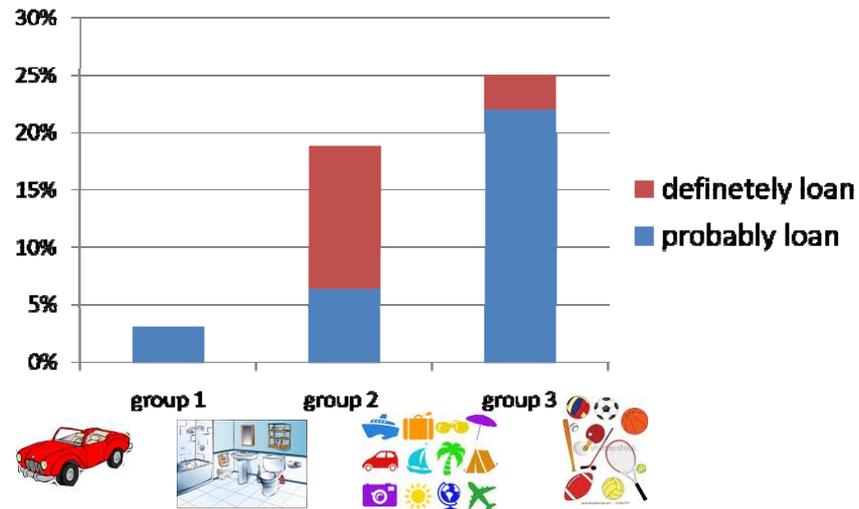
You have been saving for a long time for going on the best vacation of your life around the world. Recently you have had some serious plumbing problems and you really need to renovate your bathroom.

Would you use your savings to solve the problem or would you rather get a loan ?

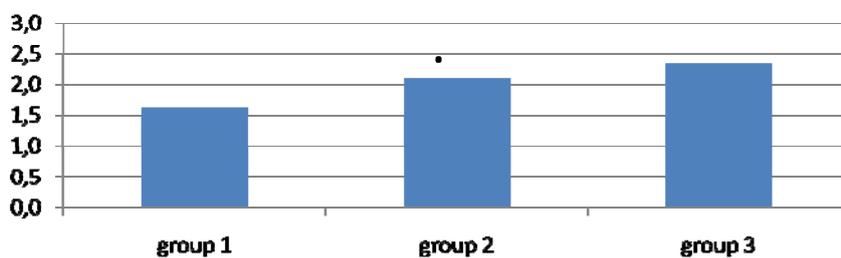


SURVEY RESULTS

willingness to go into debt



- One interesting interference from here was that young people (average 25-26) are more likely to go into debt for goods from the category of leisure than for necessities.
- In the open question and as feedback for the survey, we had some people “confessing” that this was a quite difficult decision to make, which according to the economic theory shouldn’t have been
- Also, a remarked found in the literature review was that when people want to go for an experience they would try to avoid additional burdens so they would try not to take a loan for a vacation



A one-way between subjects ANOVA was conducted to compare the effect of the pair of goods on the willingness to take loans

$$F(2,93) = 3,109, p=0,049$$

Post-hoc comparisons using the Tukey HSD test indicated, that the mean score for the first situation is significantly different than the third condition. However, the second situation did not significantly differ from the other conditions.

Discussion (1)

- Our hypothesis wasn't confirmed BUT we believe this happened not because of its strength but just because a **series of factors that we didn't managed to incorporate in our design**
 - The sample has a very low average age that positions us in a life cycle stage when savings are not a priority and spending them seems the best solution
 - In the same time independence seems to be important and may lower the willingness to go into debts
 - The current financial crisis exerts a strong framing effect especially for young people which makes them more risk adverse to loans

Discussion (2)

- The particular situation of some countries (Armenia – current high level of debts, Moldova – very low wages) that makes loans not easily accessible or increased the duration of receiving one
- Urgency of needs and determining the same level of importance for the pair of good was difficult and subjective. A possible solution would be to apply the categorization process and the surveys to the same sample.

Limitations of the research

1) Methodology:

- Imaging that... (real actions can differ from imagined)
- NO empirical generalizations to a larger population
- Experimental and control groups generally are not randomly selected from a population
- The small size of experimental and control groups also limits generalizing from the experimental results

2) Project:

- Time limitations
- Cluster analysis and categorization
- Sample: age limitation,
English speaking = educated



Further research

1) Project fulfillment:

- Cluster analysis: categorization and typicality of the goods
- Addressing to different age segments (life cycles of the households)

2) Project development:

- Cross-country differences – 4 countries sample and comparison
- Under what conditions people will be more flexible in their decision-making (for example, shifting from one category to another while spending)?
- More hypothesis: there are some categories of products people tend to save for and products for taking loans
- Household structures and wealth



Spasibo!

Selective references

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