THE GLOBE AND MAIL

Will you blow your tax refund on something fun? Blame it on mental accounting

PREET BANERJEE
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED APRIL 26, 2019UPDATED APRIL 26, 2019
4 COMMENTS

When Dilip Soman worked in sales, his income came in two forms: salary plus commissions. How much he spent on shelter costs was dictated by the salary component. But how much he spent painting the town red was dictated by the commissions.

This is a perfect example of a concept known as mental accounting. While money is fungible, meaning one dollar of salary has the same value as one dollar of commission, we treat money differently depending on various factors, such as the source of the money and how we plan to spend it.

The topic is especially timely given it's tax time and many Canadians will have recently, or are about to, receive an income tax refund. Do we allocate those refunds wisely? Or do we blow them indulgently?

"I made my career studying mental accounting," says Dr. Soman, director of Behavioural Economics in Action at Rotman (BEAR) at the University of Toronto.

"The cognitive equivalent of accounting is this notion of labelling. You call something 'fun money' and it gets spent for fun. You call something 'serious' money and it gets spent on serious things."

But there is more to mental accounting than just labelling money. We employ a mental ledger that reconciles consumption and payment. Dr. Soman, an avid cricket fan, gives the example of spending $50 on purchasing a ticket to watch a cricket match as the opening of a mental account and the consumption of actually attending the event as the closing off of that account.

When there is a mismatch between payment and consumption, we can book mental gains or losses. If we missed attending the cricket match, there would be red in our mental ledger.

Tax refunds fall outside of our regular budgeting, a gain we book on our mental ledger that feels unexpected. “If it’s a windfall gain, people will spend it on things they would never spend their salary on," Dr. Soman says.

Every year around this time, someone chastises the masses over being happy about getting an income tax refund when, in effect, they’ve given the government an interest-free loan for the year. Why don’t more people file paperwork with their employer to reduce the amount of tax withheld on one’s paycheque in the hopes of a perfectly reconciled tax return the following year, with no money owed and no money owing?

Well, a third principle of mental accounting relates to Prospect Theory, which is a behavioural model that says we think about gains very differently than losses. On an absolute magnitude basis, the pain of owing $5 in tax upon filing is larger than the pleasure of receiving a $5 refund.

“You could actually plot happiness as a function of ‘whether or not’ you get [a refund], and then ‘how much.' And the ‘whether or not’ contributes a heck of a lot. Just going from tax owing of $5 to a refund of $5 is a big boost in mental happiness from a mental accounting perspective,” Dr. Soman says.

He suggests one makes a commitment to move a portion of an anticipated tax refund into a separate account. The decision to save part of a future windfall feels a lot easier than starting a savings plan today. If you decide that half of your refund will be put into a tax-free savings account earmarked for retirement, then when your refund arrives, no matter the exact amount, you’ll have a plan in place. Essentially, you will have opened a mental account that you’ll likely feel the need to close by making that contribution into that TFSA.

Preet Banerjee is a management consultant to the financial services and founder ofMoneyGaps.com.