THE GLOBE AND MAIL

Why people can't resist blowing their tax refund

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SPECIAL TO THE GLOBE AND MAIL
PUBLISHED APRIL 5, 2018UPDATED APRIL 5, 2018

Let me ask you something: What did you do with your tax refund last year?

According to the Canada Revenue Agency, the average refund was $1,765, enough to buy 135 slices of avocado toast, a new iPhone X with extra storage, or round-trip airfare from Toronto to Japan.

It's also enough to help pay down your credit card or get a head start on next year's RRSP contribution, which is what most financial experts would say is the smart thing to do with your refund. It may sound boring, but your tax refund is an excellent way to invest in your future.

But if Canadians are anything like our American neighbours, most of us (62 per cent) would choose to spend that money on a vacation, a major purchase or everyday items.

And we have some very good – albeit irrational – reasons for behaving this way.

A lot of us think of our tax refund as "free money" from the government. The more accurate and less satisfying reality is that this money is the chunk of our annual earnings that we hand over to the government. It's simply returning the portion we overpaid.

When you think about it this way, would you rather pay extra tax throughout the year to receive a big refund in April? Or would you rather pay exactly what you owe and receive nothing back at tax time?

According to a 2007 study published in the Journal of the American Taxation Association, taxpayers actually prefer to overpay taxes. In spite of the obvious cost (our tax dollars are essentially an interest-free loan to the government), people prefer the satisfaction of getting a refund and enjoy making plans about how they will use the money. It is, in a way, a form of forced savings.

However, the reason we feel entitled to spend this money freely is because it isn't earmarked for anything specific. If you haven't precommitted to a good-for-you goal such as building up your emergency fund, retirement, or paying down debt, you're more likely to spend it on something that gives you immediate gratification.

From a psychological perspective, the unexpected nature of the savings from our tax refund is known as "windfall gains." Research has shown that we are more likely to spend this money than save or invest it. In one study involving gambling, participants who had been told ahead of time they would be paid for their participation were less likely to spend the money than those who found out about the payment after they arrived. Those who received the money unexpectedly bet significantly more than those who knew it was coming. In the same way, we are much more likely to treat our tax refund as "fun money" because it feels unexpected and unassigned.

Economists refer to this idea that we categorize money differently depending on where it comes from and where it's going as mental accounting. Here's an example of how it works: Say you paid $10 for movie ticket, but when you got to the theatre you realized you lost the ticket. Would you pay for another one? Now imagine a scenario in which you planned to buy your ticket at the box office, but when you got to the counter you noticed $10 had gone missing from your wallet. Would you still buy a ticket?

Nobel Prize-winning economist Daniel Kahneman and his partner Amos Tversky performed this exact study back in the early 1980s. They found that fewer than half of us (46 per cent) would buy a new ticket after misplacing our first ticket, but the majority of us (88 per cent) would still pay for a ticket if we misplaced some cash, even though we lose the same amount of money in both scenarios.

In the first case, the perceived cost of the purchase is $20 because both tickets came from the "movie mental account." But in the second case, the perceived cost is just $10, because the lost cash came from our "general wallet" and was not assigned to any particular category. In the same way, the "windfall" we get from our tax refund isn't assigned to any one mental account.

Until you assign it to one, that is.

One guaranteed way to make sure you do something productive with your tax refund is to come up with a set plan. Consider having your refund automatically deposited into a savings account, or transfer the money in advance toward your RRSP, credit card debt or savings. Using your tax refund wisely doesn't have to be a choice – if you make it automatic.

In the end, the most important thing you can do to avoid blowing your refund is to re-frame how you think about the money. Consider your tax return as a form of savings – money the government is holding on your behalf to prevent you from spending it. Even though it feels like a windfall, remember you worked hard for that cash. You don't have to spend it wisely. But by making a plan for it, you can at least spend it intentionally.

Stephanie Bank is a behavioural economist at Evree, a Toronto-based startup that builds an app that makes saving as easy as spending. If you have a question you'd like answered, send it our way.