

# Chapter 7

## Mental Accounting: Shaping Financial Choices and Behaviors

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### **ABSTRACT**

*This chapter explores the concept of “mental accounting,” first introduced by Richard Thaler, and its influence on financial behaviors. It aims to understand how mental categorization of finances affects decisions related to spending, saving, and debt management. Through both theoretical insights and empirical data, the chapter reveals how biases arising from mental accounting often lead to irrational financial decisions, such as overspending on windfalls and inefficient debt management. Using primary and secondary data, the chapter highlights potential implications for long-term financial well-being and recommends strategies for individuals and institutions to mitigate these biases and promote better financial outcomes.*

### **1. INTRODUCTION**

The idea of “mental accounting,” first proposed by behavioral economist Richard Thaler, highlights how people mentally organize, assess, and manage their financial resources, posing a major challenge to conventional economic theory (Silva et al., 2013; Thaler, 2016). In contrast to the conventional economic paradigm, which views money as fungible that is, as being equal to any other dollar, mental accounting shows that people mentally assign varying values to money depending on arbitrary elements like its source, timing, or intended use. These mental models frequently

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cause people to make financial decisions that are not in line with reason, which leads to inefficiencies and worse than ideal financial results (Becker et al., 2020).

The theory of mental accounting offers a framework for comprehending why people could perceive lottery winnings or tax refunds as “extra” money, which encourages more extravagant spending, while treating regular paychecks with more caution (Garduno, 2022). In a similar vein, even though the interest rates and financial gains imply otherwise, people may classify funds set aside for savings and expenses in separate categories. For instance, a person may continue to make high-interest credit card debt while retaining savings in a low-yield bank account. This division of labor is not always advantageous and might make money problems worse (Mitchell & Lusardi, 2020).

Mental accounting is useful in institutional contexts in addition to personal money. When designing products or treatments meant to enhance financial decision-making, financial institutions and legislators need to take mental accounting into account (Gajewski et al., 2024). Modern financial methods are greatly influenced by behavioral economics, which includes mental accounting. This includes how people save for retirement and react to marketing campaigns that present financing or discount choices (Bogunjoko, 2021). Organizations may be able to develop financial solutions that better suit consumer behavior by taking these cognitive biases into account. This might lead to increased financial well-being for both individuals and society as a whole.

Though mental accounting plays a crucial role in behavioral economics, its practical ramifications are still largely unexplored, especially when it comes to long-term financial well-being, demographic variations, and ways to reduce the biases that result from this cognitive phenomenon (Hon et al., 2021). Moreover, much of the available material tends to focus on Western contexts, with relatively less emphasis paid to how these biases operate across other cultural and socioeconomic settings. Furthermore, there is a dearth of studies directly connecting mental accounting to its possible effects on long-term financial stability. Therefore, it's still crucial to comprehend the particular situations in which mental accounting can support or undermine sound financial judgment (Hans et al., 2024).

The influence of mental accounting on debt management is one of the primary challenges it raises. Because people have a propensity to psychologically separate their finances, they may find themselves with savings in one account and high-interest debt in another (Silva et al., 2023). Mental accounting biases that put the satisfaction of saves ahead of the sensible choice to pay off expensive debt are directly responsible for this behavior (Sattar et al., 2020). This chapter attempts to show how these cognitive biases are not only present but also perpetuated by societal conventions and standard financial procedures, underscoring the importance of devising counter strategies.

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