THE PUZZLE OF SIMULTANEOUS SAVINGS AND DEBTS

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Abstract
„Neither a borrower nor a lender be" recommends Shakespeare in Hamlet. The advice seems particularly interesting in nowadays society where a person can be easily found in both approximate situations, in the same time. It goes without saying that saving and borrowing do not describe mutually exclusive strategies of financial management and thus many people retain savings or carry on saving at the same time as having debts. We add to this fact a more pragmatically wisdom, the one of the economist Robert Solow -"We (economists) think of wealth as fungible; we think a dollar is a dollar. Why don't they (the others) do so?" (Solow, 1987) – and we naturally ask ourselves if the mechanism of having simultaneous savings and debts is a rational one, according to traditional economics.Making appeal to the emerging body of behavioral economics literature we reach to the mental accounting theory to see if it can explain savings inclination versus debt inclination. The main research question we want to explore is the following: 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?

Keywords: *mental accounting, savings, debts, behavioral economics.*

Introduction

This year I moved to a new place which needed lot of repairs in order to be habitable. After some thinking and some market research I have came up with a budget and started to plan the operation. Having a clear aversion to borrowing, I thought from the very beginning to use my savings in order the finance the project. However, discussing the situation with various groups of friends, more than once the following idea was advanced: why not take a small loan (more precisely an overdraft credit) for these specific expenditures and just keep my savings for vacations or other things? In the first instance I was quite surprised and confuse on hearing the alternative. It just seemed an unnecessary complication, given the fact that I already had the money. In the same time, something in the argument had an echo in me. Indeed, the perspective of an exotic trip would seem more feasible using my savings and not a loan, making also, by comparison, the perspective of a loan for house expenditures more reasonable. At the time, it was not enough to change my prudent and low-risk profile, thus I have proceeded in accordance with my way of doing things. Still, the thought stayed with me, making me wonder what kind of situations would make me switch towards the alternative, and of course, what determined my friends to suggest this.

As the story reveals, one important acknowledgement is that saving and borrowing do not describe mutually exclusive strategies of financial management. Also, it is usual for many people to retain savings or carry on saving at the same time as having debts (Livingstone & Lunt, 1993). At the first glance, this may seem an ordinary fact, especially in the contemporary period but if we to read it through the lens of standard economic theory an inconvenient immediately appears. To be precise, one of the basic rules of rational economic decision making is the following: do something only if the marginal utility you get from it exceeds the marginal cost of doing it. In our case, the problem is raised by the fact that usually the interest rate for loans is higher than the interest rate of savings. In other words, people fell more at ease to borrow while they maintain some savings, and they are

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willing to pay for this ease feeling a certain amount of money (mainly, the difference between the two interest rates, but also other commissions that may appear when contracting a loan).

The present study is a conceptual one and tries to envisage some potential explanations for the situations described above. Basu (2008) delves on the importance of this topic and proposes a behavioral model of simultaneous borrowing and saving, with time-inconsistent agents, showing, among others, that this strategy can lead to higher lifetime welfare than the conventional approach (of borrowing only when we do not dispose of other means). Taking it from here, we will further explore the concept of mental accounting on this choice, but also the impact of variables like the feeling of confidence, control and security on our decisions regarding savings and debts.

The paper has the following structure. We first review the emerging literature on mental accounting, savings and debts characteristics and dynamics, and discuss the implications for individual self-control. We then report on the extreme scenarios of over consumption and over borrowing, with some specific features on the Romanian society. The conclusions section sets the frame for a future experimental testing of the theoretical reasoning advanced through the manuscript.

Theoretical background

Mental accounting

A key concept of behavioral economics, mental accounting is the subject of consecrated research papers (Henderson and Peterson 1992; Kahneman and Tversky 1981; 1998; Prelec & Loewenstein, 1998; Thaler 1980, 1985, 1999) which have repeatedly shown how people refer to, evaluate and use in different ways resources based on the categories they belong or they have been assigned to. The implicit purpose of this cognitive mechanism is to keep track of expenses and to control consumption, allowing a diverse scale of labels for the accounts: similar goals, reasons, explicit purposes, similar purchase feature etc. In processual terms, there are even some analogies with the principles described in categorization, schema, and script theories.

A derived addition to the mental accounting theory is the mental budgeting construct. Heath and Soll (1996) state that consumers budget parts of their assets to separate mental accounts and then track expenses against the budgets. Furthermore, these expenses deplete the available reserves in the specific accounts and this leads to unlike future purchases. An important consequence of this process is the difficulty to correctly anticipate relevant consumption opportunities. Thus, it can be identified as one cause of over-consuming or under-consuming products from a given category.

In addition, the paper of Prelec and Lowenstein (1998) on the mental accounting of debts and savings is seminal for our discussion. Their article departs from the hypothesis that „acts of consumption and financial transactions call mental accounts to mind", and this structure is considered responsible for a certain state, of pleasure or of pain, determined by the position of the account. These types of mental accounts specific to a transaction can also exert a constraint for consumers to use the purchased goods and not go running for more appealing alternatives.

However, we need to be aware that people create mental accounts not only for spending. There is experimental evidence they do so also for time, in the attempt to balance their time across work and non-work activities (Rajagopal & Rha, 2009).

Another important fact is that the ambiguity that may me noticed around the system of mental accounting has be understood as a positive factor (Chema & Soma, 2006) for the desires of an individual, in the sense that it makes the whole process more malleable, leaving some space for „creative bookkeeping". In other words, there can appear breaches in the self-control system governed by mental accounts.

Account 1: Savings

Popular wisdom says that our savings are the best `umbrellas` for many types of `rainy days`. Thus, we should strive to accumulate them and be careful on how to spend them. Using the motive scale developed by Keynes (1936), this is a matter of precaution and it may easily stand as the most common explanation for contracting a loan and preserve savings for another rainy day. It is also confirmed by traditional theories that explain the savings-debts dynamic, under the label `the option value of savings`. Frequent examples illustrate the fact that under some risky circumstances or other types of emergencies an individual can make appeal to his savings promptly and comfortably. On the other hand, the manner in which we evaluate the gravity of a certain situation it is poorly documented. Assessing that it is the case to use savings or just postpone the action is more likely to be a subjective decision and not the result of an objective and rational line of thought. In this regard, time preferences are essential. More precisely, we refer to the degree in which individuals are likely to consider distant outcomes in choosing their present behavior. This insight can give us a sense of understanding on the type of financial decisions they will make and it was synthesized through the attribute `myopic` for describing the emphasis made by consumers on short-term benefits over long-term benefits (O'Donoghue & Rabin, 1999).

Moreover, behavioral research emphasizes the role of non-liquid savings as a self-control tool (Laibson et al., 2001). Agents conserve their assets for a delayed consumption in the future and prefer to borrow for their present consumption, usually with the help of financial products like overdrafts, debt credit cards and so on. The issues that are usually ignored are the advantages of paying cash: not paying any type of interest (interest which is omnipresent and multivariate, depending on the type of credit card) and having greater probabilities to get some better deals in terms of availability, logistics, delivery etc.

From the mental accounts basic assertion that an individual may value two identical monetary gains differently because they are coded and evaluated through two distinct mental accounts, it was also inferred that the same absolute saving made on an article seems to be more appealing the higher its relative value compared to the initial cost of the article, even in the conditions that the total sum paid for all purchases made remains the same (Moon et al., 1999).

Account 2: Debts

In the attempt of identifying a rationale for the existence of debts in the equation modeling our case, we also stopped at one statement of common sense frequently asserted by consumers: if I can pay off the amount borrowed over a short period of time, I will not disrupt my savings plans. From a behavioral economics point of view, this is a classical illustration of the cognitive bias called overconfidence effect. Due to a miscalibration of subjective probabilities, the individuals `sincerely believe they have expertise, act as experts and look like experts` (Kahneman, 2011). On an operational level, they underestimate future costs and over evaluate present benefits, unconsciously bounding their willpower. The logic applies perfectly to the activity of contracting loans even without a solid motivation, just by ignoring potential future credit obligations, information and transactions costs as additions to the pretty picture depicted in the present. To properly use the economic terminology, we speak of hyperbolic discounting of future costs.

In accordance with the findings on materialism – defined as „the centrality of possession and acquisition in consumers' lives" (Richins & Dawson, 1992) - the results of a study performed by Watson (1998) are pointing out to the following conclusion: people who are highly materialistic have more favorable attitudes toward spending as well as more favorable attitudes toward debt than people with low levels of materialism. What was not yet properly analyzed is the impact of such attitudes towards empirical actions like excessive debt.

From an emotional perspective, the discomfort provoked by being in debt or by having worrying thoughts of not being able to return the money is alleviated by the confidence state given by the existence of savings. However, if we turn to the reasons listed for savings, there is one that comes in a deep contradiction with the simultaneous debt-savings situations: the down-payment motive (Browning & Lusardi, 1996), which aims exactly at using savings for expensive and durable goods or other type payments.

On an operational note, Kilborne (2006) proposes that these behavioral insights may be used to improve the legislative framework concerning consumer debt and bankruptcy, preventing in this way a range of social problems associated with excessive consumer debt: job loss, medical disorders (both physical and psychological), divorces etc.

The „over" puzzle: over-consuming and over-borrowing

In the last couple of years, consumer credit has grown more and more, projecting itself into a positive aura of empowering consumers by increasing their possibilities to choose and finally by making them to live better through a leverage of future earning potential. Most analyses of consumption societies were made at the beginning on the US case and some western European countries, but the consumerist phenomenon has rapidly expanded to China, Middle East and Eastern Europe.

In Romania, before the start of financial crisis, in 2005 and 2006, the credits granted to the population were representing 34,5% from the governmental credit, the percentage registering an increase of 7 percentage points only in 10 months, compared with the 3.7 point in the all 2004 year. Moreover, the population credit has surpassed in value both production and investments credits of the firms. (National Bank of Romania, Report on credit tendencies, 2005). In these conditions, with a level of almost 15% of the GDP, the market for consumption credits in Romania is a leader in the region, considerably surpassing the average of 9.4% and even more developed neighboring countries like the Czech Republic, Poland or Turkey.

More recent data from the media (Business Magazin, 2010), confirm that 30% of the Romanians in the urban environment have loans: 37% for daily expenses, 25% for constructions and renovations, 11% for buying a house, 11% for buying a car, 8% for studies (personal ones or for their children), 3% for refinancing another loan, 3% for going on holiday, 2% for medical services or medicines. It is true that in the last year, the rate of loans has diminished for most of categories apart from housing loans, but also true is the difficulty to find data on the level of savings. The general assumption is that these savings are quite low but even in this case there still remains a problem of transparency. Another information promoted by the media is that Romanians do not compare bank offers. We also need to ask ourselves if this is a matter of ignorance or just a generalized feeling of mistrust

Within this clear context of over-borrowing, we reiterate our initial research question, searching for a potential pattern in our choice that makes us more eager for debts than for savings.

Consumption society may have overleaped the feedback of self-control imposed by mental accounts and, on the same basis of preserving the specific destination of an account, we assist at the refill of an account through loans, even if there are savings available for spending. Not crossing the line and spend them it is indeed a good measure of self-control. However, if the temptation is strong enough, and the financial sector allows, the account can be easily filled through credit, thus invalidating the initial control and indulging anyways into an irrational process of consumption.

Paraphrasing some research that states that in the absence of self-control devices, they may over consume vices and under consume virtues (Baumeister, 2002; Schelling, 1984), we may postulate an overconsumption of debts and an under consumption of savings. This characterization is made possible through the violation of the fungibility principle, largely assumed by economic theory. The principle simply implies that any unit of money is substitutable for another and that the composition of income is irrelevant for consumption. By contrast, both natural field experiments and controlled laboratory ones (Abeler & Marklein, 2008; Frederick, 2005; Benjamin et al., 2006;) have shown that the principles fails to be validated for cognitive reasons. For example, there are findings pointing out that subjects equipped with higher mathematical and cognitive skills are more likely to behave in line with standard economic theory, whereas subjects revealing lower cognitive skills have the tendency to act in accordance with theories of bounded rational behavior.

Conclusions and further research

The paper was born from a personal inquiry: it will be better get loan and preserve my savings, in a given situation? From this point, a large span of questions arises: 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? Do acquiring new debts while maintaining savings generate an individual feeling of security and/or a collective vicious circle of indebtedness?

With the help of mental accounting theory, we wanted to draw bring some new perspective on why we irrationally go simultaneously into debt and over consume in some areas. 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? This is a problem that needs to be approach in an experimental manner because at least at a theoretical level there are some hints that point to a positive answer.

In our further work, we plan to test the following hypothesis: 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? In addition, we are interested in exploring the causality between this behavior, consumption society and subjective well-being.

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