THE IMPACT OF MENTAL ACCOUNTING ON FINANCIAL DECISIONS

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DOI: https://doi.org/10.65672/jfme.2025.1.10

Abstract:

Mental accounting is a concept in which individuals categorize, evaluate, and manage money in various mental accounts without taking into account the fungibility of money. The purpose of this article is to present the methods, consequences and impact of mental accounting on financial decision-making. The study examined expert opinions on the topic that were published on the Internet. Mental accounting refers to the way individuals perceive and categorize their money based on its source and intended purpose. Mental accounting's impact can be categorized as primary and secondary. Individuals divide monetary means into personal and public, owned and borrowed, obtained in a planned and unexpected manner. People tend to focus excessively on one account without considering the full spectrum of financial activities, which is caused by irrational financial decision-making as a secondary impact. Mental accounting manifests itself in various areas of finance, such as personal, corporate, public, and investment. Examining the effects of mental accounting helps to fully explain the dysfunctions of financial mechanisms.

Keywords: *mental accounting, financial decision, money*

JEL classification: *D91; E71; G41*

Introduction

Mental accounting is a concept in behavioral economics that describes how people divide and evaluate economic outcomes based on subjective criteria, leading individuals to sort assets into distinct "accounts", both figuratively and literally (Raymond).

Mental accounting manifests itself when a person assigns different values to the same amount of money based on subjective criteria. (Segal, 2024) This can also manifest itself in human attitudes towards money, when people, instead of treating it as interchangeable, attribute different values to money depending on its source or intended use (Kuhl), (Raymond).

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In this context, the citation of SezenGüngör (2022) is important: „Accounting generally occurs in the forms of recording, classifying, summarizing, reporting and analyzing financial transactions of businesses. It is acceptable for people to need accounting for their own expenses and earnings. However, if this situation only takes place in the mind and turns into invisible journal entries, it will be necessary to mention the mental accounting tendency at this point."

As part of mental accounting, *mental budgeting can be considered a* financial management mindset and is the psychological process of mentally separating income and expenses into different categories or mental accounts to manage spending decisions, rather than relying solely on a physical budget. It involves allocating funds to specific mental budgets for various expense categories, tracking expenses against these budgets, and adjusting behavior when a mental budget is exhausted, as well as making provisions for deferred expenses. Mental budgeting is considered a self-control mechanism, based on pre-commitment to budgets allocated to expense categories. (Antonides, de Groot, 2024)

The main problem with mental accounting is that it creates conditions for irrational financial decision-making, causing people to focus excessively on a single account without considering the full spectrum of financial activities. (Raymond)Different classification of money based on subjective criteriacan, in turn, lead to inefficient financial behavior of people, which may take the form of irrational spending or counterproductive investment decisions. (CFI)

To confirm the importance of mental accounting research, expert James Raymond presents statistical arguments. 80% of professional athletes deplete their wealth within just three years of retiring from sports. 70% of lottery windfall winners end up bankrupt, and the larger the winnings, the more likely they are to go bankrupt.

The purpose of the research was to demonstrate that mental accounting problems are not only related to the direct management of the individual's personal budget, but also extend into broader financial domains, generating important consequences (effects).

Literature Review

The concept of mental accounting was introduced by Richard Thaler in his works by defining it as "a set of cognitive operations used by individuals and households to organize, evaluate, and track financial activities". This author observed that people assign value to money differently, which leads them to make irrational decisions. The concept states that individuals classify money differently, based on subjective criteria, which often causes people to make irrational spending and financially inefficient investment decisions. (Thaler, 1985), (Thaler, 1999)

The psychological aspects of mental accounting have been examined in the work of the research team led by Zhenliang Liu (2017) who demonstrated that consumers mentally differentiate between money and expenses relevant to themselves or others.Also of interest is the research carried out by the team of authors led by Lin Cheng (2023) on the influences of mental accounting on consumption decisions.

The issue of the impact of mental accounting on the investment processwas examined by specialists from the Corporate Finance Institute and authors: Daniel Kuhl, I. Shalika, H. J. R. Buddhika.

The manifestation of the influence of mental accounting in finance was researched by James R. Jr.Hines, Richard H. Thaler (1995), Stephan Muehlbacher, Barbara Hartl, Erich Kirchler

(2017), Johannes Becker (2020), Daniel Nettle, Rebecca Saxe (2020), B. O. Wanas (2024), Thomas F. Epper, Ernst Fehr, Claus ThustrupKreiner, Peer EbbesenSkov (2024)

Regarding the examination of the manifestation of mental accounting in the field of corporate finance, we can present the works of O.M. Anolam, S.N. Okoroafor, O.O. Ajaero (2015) andDan Nicholson (2024).

And the authors Tanaya Das and Sulagna Das (2024) studied the influence of mental accounting on the financial well-being of young adults.

Methodology and Data

The research was based on screening the views of experts in the field of behavioral finance on the phenomenon of mental accounting and its influence on different spheres of financial relations.The accumulated materials were systematized and a synthesis was carried out through the prism of personal finance, investments, public and corporate finance.

Results

The study established the existence of a relationship between mental accounting and other cognitive biases (Pompian, 2019):

Framing bias is a cognitive bias (thinking error) that occurs when a person's decisions are influenced by the way information is presented, or framed, rather than by the objective facts themselves. "Framing" refers to whether an option is presented as a potential loss (negative) or a potential gain (positive), even if both options lead to the same outcome. Whether the same information is presented in a positive or negative light can lead to different choices because individuals prefer gains over losses. (Nikolopoulou, 2023)

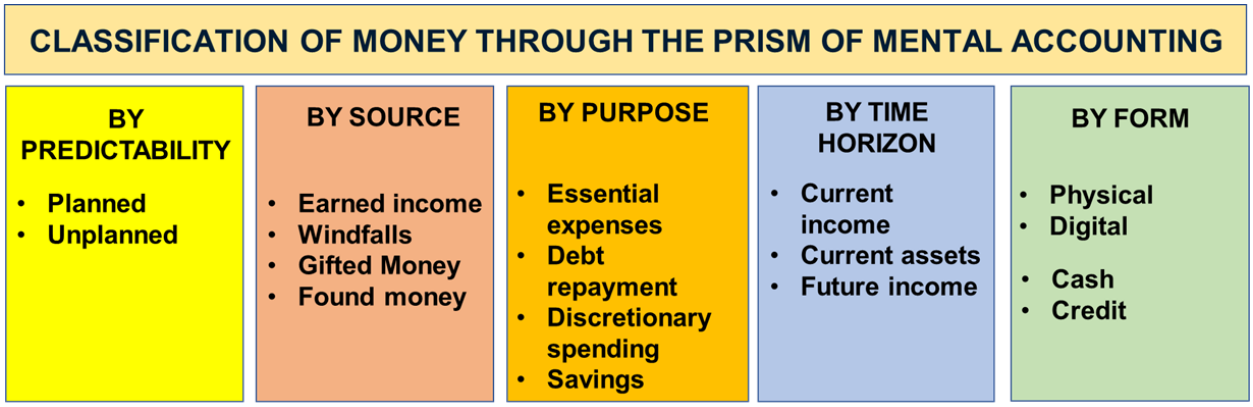
Confirmation bias is a largely unintentional bias related to the tendency of individuals to process information by seeking out or interpreting information that is consistent with their existing beliefs. At the same time, a person ignores information that is inconsistent with their beliefs. Individuals' beliefs in this context can include a person's expectations of a given situation and their predictions about a certain outcome. In other words, this bias reflects the tendency of some individuals to understand and interpret the information they receive in a way that supports their own beliefs, especially when a issue is important or personally relevant to them. (Britannica, 2025)

*Sunk cost fallacy*is the tendency of people to continue an activity or endeavor even when it would be more beneficial to abandon it. Once a person has invested time, energy, or other resources (including money), they believe that it would all have been in vain if they gave up.This reflects the belief that a course of action should not be abandoned because significant resources have already been invested.As a result, the negative results of the inefficient investment decision are exacerbated.(Nikolopoulou, 2024)Mental accounting can lead to the sunk cost error, however it should be noted that the issuerefers to the continuation of an activity due to a previous investment, but not to the mental classification of the money used.

Illusion of control(also known as *illusory control*) is a cognitive bias expressed by the tendency of people to exaggerate their ability to produce a desired outcome, even when those outcomes are largely determined by chance or are entirely uncontrollable.(Baumeister, Vohs) For example, this bias can manifest itself when choosing lottery numbers.

The research found that mental accounting is linked to complex money classification, as shown in Figure 1.

Figure 1: Financial mechanisms of Delayed Life Syndrome



Source: developed by the authors

According to the criterion of predictability, financial resources are divided into two categories:

Planned (or routine) income is obtained in the form of predictable earnings and usually linked to certain economic activities, such as salary. These amounts usually find their place in the family budget to cover current expenses and to form savings for their future use (or to cover financial risks);

*Unplanned (or unexpected) income*refers to money that is not related to current activities, such as lottery winnings, unexpected bonuses, tax refunds, unexpected inheritances, which are often directed towards the purchase of luxury items, financing travel or parties.

Individuals mentally categorize money obtained from various sources, which influences their spending behavior (Kasumi, 2025):

Earned income: This is money received on a regular basis from jobs (paychecks), which in most cases is earned with hard work and is treated with more caution or saved carefully.

Windfalls: Examples of such money are tax refunds, lottery winnings. This money is often understood as found money and is spent more freely.

Gifted money: This is money received, for example in the form of bonuses or gifts, which is usually spent with fewer constraints than earned income.

Additionally, the following categories can be mentioned (Skwara, 2023):

Pride-Tagged Money: Money earned through personal achievements, such as scholarships, which can be spent on meaningful things, such as a gym membership.

Surprise-Tagged Money: Unexpected money, often perceived as a manifestation of luck, such as winning the lottery, which can be used for products that can be shared with others.

Classification of money by purpose of use may include:

*Essential spending*which refers to assuming the daily, unavoidable costs necessary to maintain a basic standard of living, such as paying for housing, food, utilities, healthcare, and transportation.

Debt repayment: These are the funds allocated to make payments related to loans or credit cards.

Discretionary spending refers to optional expenses that are not essential to daily functioning and can be adjusted to fit within a budget. Therefore, individuals can choose to make or reduce them without negatively impacting their basic operating needs. For individuals, these can include costs such as dining out, entertainment, and vacations.

Savings means allocating money to set aside a certain portion of a person's personal income to finance future goals and needs.

The problem of mental accounting largely refers to *inefficient financial decision-making*.

For personal finances, they can manifest themselves in the following ways:

In the case of a tax refund, obtaining a bonus or winning the lottery, money is often used for impulsive purchases, missing the chance to improve the individual's overall financial situation.

The individual's willingness to spend or take risks with unearned money (such as gambling winnings) rather than organizing their personal financial life with regular income.

Prioritizing the use of funds for discretionary expenses over those related to necessities can lead to spending all the money on entertainment and then not having the means to pay the bills.

Keeping money in a low-interest savings account, while simultaneously, resorting to high-interest debt is a financial inefficiency.

According to some specialists, the impact of mental accounting in personal finances can be mitigated through the following measures (Indeed, 2025), (Kuhl), (Mental…, n.d.), (Bajaj Finserv AMC, 2025):

First, it is beneficial to recognize that money is fungible, which means, in particular, that a monetary unit earned from a bonus should be viewed in the same way as money earned from one's own salary.

Further, it is advisable to carry out substantial self-training in the field of financial management.

Then it is necessary to analyze the complete financial picture of personal finances. This can be done on a spreadsheet or within an application to track all cash flows.It would be beneficial to use financial tools that provide a comprehensive picture of total financial resources, rather than focusing on individual mental accounts.

The fourth step is the transition to the development of a formal budget. In order to avoid the biases of mental accounting, the budget must be comprehensive and treat all money as interchangeable, regardless of its source or intended use. The existence of a household budget will prevent the automatic spending of found, donated, or unexpected money, because spending will be made according to established rules, when all money is considered the same. Adherence to the budget will help limit spending, especially on what is perceived as a good deal at the moment.

At the same time, it would be advisable to plan for the use of unexpected income. This plan does not necessarily have to be extremely restrictive, but it is necessary to establish certain rules that help the individual value money equally, regardless of how they get it and the circumstances they find themselves in.Planning for unexpected income, such as bonuses or tax returns, must include adjusting them with the individual's financial priorities, such as paying off high-interest debt.

It is necessary to avoid the temptation to keep money in low-interest savings accounts while resorting to high-interest debt.

In addition to the above, it is possible to seek professional assistance. A financial advisor can provide an objective, third-party perspective on an individual's personal financial situation, helping to support more rational decision-making and develop a comprehensive financial plan.

In the *investment field*, mental accounting may appear as a bias that leads individuals categorize their assets into money they can afford to lose and money they cannot, influencing their risk-taking behavior.(Kuhl)

This mental division leads to decisions to choose between speculative (risky) and safe (conservative) portfolios. (Bajaj Finserv AMC, 2025)

This refers to funds that must be preserved, which are often obtained from regular income (earned through work). Such funds aretypically linked to certain financial goals in the future and are vitally important for the personal or family budget. These are usually placed in financial instruments with a low level of risk, but also with a relatively modest return.

In contrast, additional money (unexpected, unplanned), which investors believe they can afford to lose, is placed in uncertain and speculative financial instruments, therefore with high risk and with the hope of high gains. (CFI)

According to experts from the Corporate Finance Institute, this distinction represents a mental illusion. From a financial management perspective, this is a case of poor mental accounting, as all money is the same and there can be no decision that justifies losing the money held. (CFI)

To mitigate the effects of mental accounting in investment activity, the following recommendations can be made:

•It is necessary to correlate assets with the objectives of the investment activity. When making investments or forming savings, it is necessary to base decisions on the timeline of objectives and the level of risk, rather than on the initial source of the money.

•Periodic rebalancing is beneficial. Even if the money is in separate funds, it is necessary to review the total portfolio every 6-12 months to ensure that the allocation of funds is still on a balanced trajectory.

•It is necessary to avoid emotional labeling. Individuals are advised not to treat money received from gifts, bonuses, or inheritances differently from their regular income.

•It is possible to use specialized programmed applications. These tools help to plan regular investments and withdrawals across the entire portfolio.

The manifestation of mental accountingin *public finance*, in the opinion of the group of authors led by Johannes Becker (2020), has the following features:

People can mentally differentiate public funds from private funds, with specific allocations being assigned to public goods, while private funds are intended for personal consumption.

The flypaper effect, which is a concept in public finance,suggests that a government subsidy to a recipient local government increases the level of local public spending more than an increase in local income of an equivalent size.(Hines, Thaler, 1995) Studies show that public funds can have a greater impact on public spending because they are mentally perceived as belonging to a "common account", influencing how voters demand redistribution from them.

The perceived fungibility (exchangeability) of public money may be limited in public opinion, leading to preferences regarding how these funds are spent.

In terms of the perception of public money by members of society, we can highlight the following aspects:

When taxes are collected, taxpayers may not immediately think of this money as a reduction in their personal wealth, but rather as funds flowing into a separate "public funds" account.

Voters may be more willing to support government spending from an unexpected amount of public money (for example, from external financial support) than if the same amount came from new taxes or private revenues.

Mental accounting can lead to a strong positive correlation between the classification of government spending and its rationalization, suggesting that it impacts how people perceive and justify government spending. (Wanas, 2024)

Mental accounting in public finance influences the willingness to fund programs by causing individuals and policymakers to classify funds differently based on their source and intended use, rather than treating all money as fungible. This bias can make public funds appear free or tied to specific uses, increasing the willingness to fund programs from a large public pool, compared to a private one. Policymakers can capitalize on this by designing programs that fit mental accounting behaviors, for example, by tying funding sources to specific objectives or by framing benefits to influence public support. The way public funds are framed can affect people’s willingness to fund public programs. (The Decision Lab)

Mental accounting impacts support for public policies. A larger public fund may lead to greater demands for redistribution, especially from low-income voters, demonstrating a link between mental accounts and support for public policies.

Some studies link mental accounting to inequality aversion. Individuals often have an aversion to seeing large disparities in wealth or income. When a public fund is larger, low-income individuals may perceive this as an opportunity to reduce inequality by advocating for greater redistribution. Their mental accounting may perceive this fund as available for redistribution to those in need. (Epper et. al., 2024), (Nettle, Saxe, 2020)

In the examined context, the mental framing of accounts can be mentioned. The way in which public funds are framed can influence how people perceive them. If a fund is labeled as emergency support (aid), it could be more easily allocated to specific needs than a general fund. This framing can shape voters' mental accounts and their support for specific policies. (Muehlbacher et. al., 2017), (Nettle, Saxe, 2020)

Mental accounting can influence how individuals perceive the value of public money. Mental separation makes individuals less likely to view public services (financed by taxes) as expensive because the cost is not paid directly from their personal spending account. These

funds are seen as coming from a government spending account. Thus, public services financed by general taxes may appear less expensive because their cost does not come directly from an individual's personal budget, such as money for shopping or vacation funds. This mental accounting can lead to a systematic bias, in which people are less likely to recognize the true financial burden of public services on their general finances, which can lead to less critical involvement in public spending and policy decisions.

One aspect of the manifestation of mental accounting in public finance is anchoring.In this case, the size of the common public account can act as an anchor, and people's decisions are influenced by it, rather than by the objective merits of the situation. Individuals are often inclined to support larger transfers under the influence of the availability of a larger public fund, even without individual mental accounting. (Becker et. al., 2020)

Mental accounting can have an influence in the field of *corporate finance* in the following ways:

In the area of corporate investment activity, a company might be reluctant to use funds from a general operating account for a project, considering that financing from a specialized research and development fund would be more appropriate, even if the latter is less profitable. (Nicholson, 2024)Similarly, the sunk cost fallacy can manifest itself in corporate investment. Businesspeople may continue to invest in a failed project because of previous mental investments, instead of cutting their losses based on present value.Companies may also be driven to prioritize funding projects within a set budget category, even if there are better investment opportunities elsewhere.

Mental accounting may be linked to loss aversion. Managers may exhibit greater loss aversion for certain mental accounts (such as those reserved for capital projects) than for others, creating cognitive biases that steer them away from rational choices.

In considering opportunity costs, a company might focus excessively on a single account, neglecting to consider whether that money could be better used elsewhere in the company.

In the area of budgeting and resource allocation, managers may be reluctant to reallocate funds between different mental accounts (e.g., different project budgets), even if such reallocation would be financially optimal for the company as a whole.

Mental accounting can manifest itself in corporate budgeting as follows:

Companies often create budgets by mentally categorizing funds into different accounts, such as those designated for research and development, operating expenses, or marketing.

Instead of treating all available funds as interchangeable (fungible), company managers may perceive money from different sources as having different perceived values or purposes, such as viewing bonus money as discretionary and harder to save.

When mental accounts are kept separate, decisions about spending or allocating resources from a single account may not take into account the larger financial picture or the overall health of the company.

There are possible situations where one department of the company might face financial difficulties, while another department has surplus funds, but the surplus is not transferred because it is in another mental account.

Mental accounts can also contribute to inflexible budgets, making it more difficult for companies to adjust their financial strategies in response to changing market conditions or unexpected opportunities.

When it comes to strategic and tactical spending, a company might spend too much from a discretionary or mental account of "fun" money on a non-essential project, while restricting expenditurefrom another account intended for essential operations, creating an illogical spending pattern.

Mitigating mental accounting in corporate finance is possible in the following ways:

Encourage managers to view corporate finances from a unified, financial results perspective, rather than focusing on individual, separate budgets.

Focus on a view of all corporate funds as interchangeable and fungible, as well as on overall financial health and potential returns, rather than on arbitrary internal categories.

Use effective central financial controls to ensure that resources are allocated based on overall strategic priorities and not just department-specific mental accounting.

Implement flexible budgeting methods that allow for easier reallocation of funds between departments or projects when circumstances change.

Focus on using objective financial data to guide resource allocation, rather than relying solely on the perceived purpose or source of funds.

Apply tools that provide a complete overview of the company's financial position, making it easier to view the entire financial picture, rather than isolated accounts.

Conclusions

Mental accounting represents a specific cognitive process and constitutes an important area of study within behavioral finance. Essentially, it is a behavioral bias related to the fact that some people attribute different values to money depending on its source or intended use.Mental accounting is linked to a complex system of perceiving and evaluating money based on various criteria. When mental accounting turns into an obsessive behavior, it may serve as a major contributing factor to personal financial difficulties. Likewise, the phenomenon of mental accounting is increasingly observed in the spheres of investment, public, and corporate finance.

Since mental accounting has been studied relatively extensively to this day, various measures have been developed to mitigate its negative impact.It is also advisable to integrate them into financial education programs.

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