



April 2026

How Mental Accounting Shapes Our Financial Choices

Andrea Caceres-Santamaria, Senior Economic Education Specialist

“We think of our money as being in different pockets, but the economy doesn’t.”
—Richard Thaler

What Is Mental Accounting?

Imagine you get \$20 for your birthday. Now imagine you earned \$20 from a part-time job. It’s the same amount of money, but you may not value or treat it the same way. Gift money often feels easier to spend, while earned money feels harder to let go of. This difference stems from a psychological phenomenon called **mental accounting**—the tendency to mentally assign different categories and values to money rather than treat all money as having the same value; this categorization affects how people decide to spend and save, and it can lead to irrational financial decisionmaking. Understanding mental accounting is crucial because [it reveals how our minds work against our wallets](#), influencing habits that can impact our financial future.

Why We Treat Money Differently

Economics teaches us that money is **fungible**. This means that every dollar has the same value, no matter where it comes from or what you plan to use it for. Economist Richard Thaler explains in his book *Misbehaving* (2015) that people consistently violate the assumption that money is fungible, treating dollars differently based on their own mental categories. We may think of some money as “rent money,” other money as “fun money,” and still other money as “gift money” or “refund money.” This can simplify financial decisionmaking, but it can also lead people to manage their spending emotionally rather than rationally.

This is where behavioral economics comes in: It is a field that studies how people *actually* make financial decisions, rather than how they should *theoretically* make them.

The differences between fungibility and mental accounting are summarized in the table below.

Fungibility vs. Mental Accounting

Feature	Fungibility	Mental accounting
Core idea	Every dollar is identical and interchangeable.	Money is mentally assigned different categories/values.
Source of funds	Where money comes from doesn't matter.	“Gifts” and “refunds” are spent more easily than earned wages.
Decision style	Rational: The highest financial need (such as debt) is prioritized.	Psychological: The subjective value of a category is prioritized.
Payment method	All payment forms (\$20 cash vs. \$20 credit) feel the same.	“Pain of Paying”: Credit card payments feel less “painful” than cash.

Mental Accounting in Action: Framing Losses and Gains

One important example of mental accounting is what researchers call the “pain of paying.” Behavioral economists Drazen Prelec and George Loewenstein describe how [spending money can feel emotionally uncomfortable \(PDF\)](#) because paying feels like a loss. When you pay with cash, you physically hand over bills and watch your wallet get thinner, which makes that loss feel real and sometimes painful. However, when you pay with a credit card or tap your phone, the [pain of paying is reduced](#) because the money doesn’t leave your account right away, making it easier to spend without fully feeling the cost.

Behavioral economist Dan Ariely studied how the pain of paying affects college students. He found that when students use credit cards, they spend more because they don’t feel the immediate cost; over time, this can lead to credit card debt. Now imagine tax season has come around. Students may face the choice of using their refund to either pay off their credit card debt or pay for something fun, such as a spring break trip.

Windfalls and Found Money: Focusing on Tax Refunds

Many people treat tax refunds as “bonus money” rather than as delayed income; they mentally categorize refunds as **windfalls**—lump sums of money perceived as unexpected or extra rather than as a source of income. Behavioral research shows that people spend windfall gains more freely than regular income. At the same time, paying off high-interest credit card debt produces little immediate emotional reward and instead can feel like a loss. Those who do mental accounting preserve the psychological satisfaction of getting a “bonus” while postponing the less-emotionally satisfying task of debt reduction. Mental accounting can influence individual consumers as well as policymakers as they make decisions about taxes and spending.

From a fungibility perspective, a tax refund is not extra money. It is simply money that the taxpayer has owned all along—an overpayment returned by the government. If people were entirely rational and treated money as fungible, a refund would be handled just like regular income. In that case, using the refund to pay off high-interest credit card debt would usually be the best financial decision.

Conclusion

Financial decisions are shaped not only by math, but also by how we think and feel about money. Mental accounting reveals that we don’t always treat our dollars equally; we categorize them by source and purpose, which can drive our behavior. This explains why tax refunds, gifts, and bonuses often feel like “extra” money even though they’re economically identical to earned income; it’s why we’re more likely to splurge with unexpected funds while our credit card debt continues to grow.

The good news is that awareness is the first step toward making better financial decisions. By recognizing mental accounting patterns in your own life, you can make more intentional choices. Ask yourself: Am I treating this money differently just because of where it came from? Would I make the same decision if I viewed all my money as interchangeable? Is this mental budget helping me or preventing me from addressing a more critical financial priority?

Understanding mental accounting doesn't mean abandoning the use of mental categories; it means using them wisely. The goal is to align your spending and saving decisions with long-term financial goals rather than short-term emotional rewards, and to recognize when your mind is playing tricks with your wallet.

Glossary

Fungible (money): Having the same value, no matter where it comes from or what you plan to use it for.

Mental accounting: The tendency to mentally assign different categories and values to money rather than treat all money as having the same value.

Windfall: A lump sum of money perceived as unexpected or extra rather than as a source of income.

References

Ariely, D. and Kreisler, J. *Dollars and Sense*. New York, NY: HarperCollins, 2017.

Broekhoff, M-C. and van der Cruijssen, C. "Paying in a Blink of an Eye: It Hurts Less, But You Spend More." *Journal of Economic Behavior & Organization*, May 2024, 221, pp. 110-33.

Heath, C. and Soll, J. B. "Mental Budgeting and Consumer Decisions." *Journal of Consumer Research*, June 1996, 23(1), pp. 40-52.

Prelec, D. and Loewenstein, G. "The Red and the Black: Mental Accounting of Savings and Debt." *Marketing Science*, 1998, 17(1), pp. 4-28.

Thaler, R. H. "Mental Accounting Matters." *Journal of Behavioral Decision Making*, July 1999, 12(3), pp. 183-206.

Thaler, R. H. *Misbehaving: The Making of Behavioral Economics*. New York, NY: W. W. Norton & Company, 2015.

Name _____ Period _____

Reading Q&A

How Mental Accounting Shapes Our Financial Choices

After reading the article, complete the following:

1. Which situation best illustrates mental accounting?
 - a. A student chooses the lowest-priced option to save the most money overall.
 - b. A student saves money based on interest rates across all accounts.
 - c. A student spends birthday money more freely than money earned at a job.
 - d. A student compares prices before making any purchase decision.
2. What does it mean when economists say that money is fungible?
 - a. Money has different values depending on how it is earned.
 - b. Each dollar has the same value regardless of its source.
 - c. Money should be saved before it is spent.
 - d. Cash is more valuable than digital payments.
3. Which behavior violates the idea of fungibility?
 - a. Paying off debt with the highest interest rate first
 - b. Comparing prices before making a purchase
 - c. Treating gift money differently from earned income
 - d. Creating a monthly budget for expenses
4. According to mental accounting, why do people categorize money?
 - a. To simplify decisions as they manage spending emotionally
 - b. To maximize interest earnings across accounts
 - c. To increase the total amount of money they have
 - d. To ensure all purchases are planned in advance
5. Why does paying with a credit card often reduce the pain of paying?
 - a. Credit cards lower the actual cost of purchases.
 - b. Credit cards eliminate the need to repay money later.
 - c. The interest rate is always lower than cash payments.
 - d. The payment is delayed and less physically noticeable.

6. Why do people often treat tax refunds as “bonus money”?
 - a. Refunds increase a person’s total tax burden.
 - b. Refunds are earned differently than wages.
 - c. Refunds are legally required to be spent quickly.
 - d. Refunds arrive as lump sums and feel unexpected.

7. From a fungibility perspective, how should a tax refund be treated?
 - a. As extra income that should be spent freely
 - b. As delayed income that should be treated like wages
 - c. As money meant only for discretionary purchases
 - d. As a reward for overpaying taxes

8. Which statement best summarizes the potential harm of mental accounting?
 - a. Emotional labels override important financial priorities.
 - b. It encourages people to track spending carefully.
 - c. It helps people stick to a budget.
 - d. It encourages saving for future goals.