Why we perceive ourselves as richer than we think we are

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A man browsing the shoe department in a shopping centre. Cn he really afford new shoes? Credit: Alex Buirds/Wikimedia, CC BY-NC

Everyday billions of people make countless decisions that have economic implications. Buying new clothes, having dinner at a Japanese restaurant, renting a house: most of our decisions determine how much money we spend or save. Some of our decisions also increase the amount of debt we have accumulated, such as when we buy a book and pay by credit card or when we obtain a loan to buy a new car.

Do people always weigh up pros and cons, use all the available information and commit to their long-term goals when making such decisions? Research in behavioural economics suggests this is not the case.

For example, even though many Americans argue that they should be saving more for retirement, they declare that they frequently do not commit to their saving decisions.

In general, psychologists and behavioural scientists have long found that the gaps between people's intentions and their actual behaviour are often due to cognitive biases – systematic errors in thinking that affect individual decisions and judgements.

Cognitive biases explain why our economic decisions often appear to be flawed by self-control problems, myopic behaviour, changes in preferences over time and other behavioural inconsistencies.

For instance, scholars have found that people have a cognitive bias that often leads them to underestimate the true cost of debt, thus borrowing more than what they can afford.

As another example, research in economic psychology has shown that the perceived cost of an item is lower than the actual cost if people compare it to greater, rather than smaller, financial resources.

For instance, even though a person knows that the objective cost of a T-shirt is 25 euros, that person is more likely to buy the T-shirt if she mentally compares the cost to the money in her bank account (for instance 23,000 euros) rather than the money in her wallet (let's say 100 euros).

The bias on wealth perception

Following this line of research, at the Complexity Lab in Economics (CLE) of Università Cattolica del Sacro Cuore in Milan, I have recently started a new project, "Cognitive biases, perceived wealth and macroeconomic instability", with the help of a postdoctoral scholarship by the AXA Research Fund.

By combining findings from behavioural economics and social cognitive psychology with the techniques of experimental economics, the project essentially tests the hypothesis that some people tend to spend more than they "should" because they have the wrong perception of how wealthy they are.

In other words, our working assumption is that, depending on the value of leverage (that is, the ratio between debt and net worth), people may feel wealthier even when their net worth has not changed, and that this makes them psychologically more prone to increase their spending, as well as their borrowing. We call this the "leverage bias hypothesis".

At CLE we have run some preliminary laboratory experiments to test the presence of the leverage bias. Our first results (to be published) confirm that around 78% of the participants have a wrong perception of the amount of wealth owned and this perception changes based on *how* wealth is composed, even when the net value remains constant.

We postulate that this misperception of wealth may play a significant role at explaining individual consumption and borrowing decisions that do not appear rational based on canonical economics.

Indeed, the potential implications of a cognitive bias of this type are substantial. An individual with a distorted perception of wealth may feel financially better off, consume more, borrow a larger amount of loans and overestimate her ability to pay back her debt in the future.

This behaviour would have consequence not only for the borrower, but also for the lender: a borrower's inability to meet the debt obligations would result in the accumulation of non-performing loans on the balance sheet of financial institutions in the credit market.

Partial explanations for massive crash

By extending this reasoning to a greater scale, it is also possible that macroeconomic fluctuations be (at least partially) explained by the excess spending and debt accumulation trigger by the leverage bias. This is the case when a large number of people perceive themselves as richer than they actually are: consumption can rise in the aggregate to the extent that such people possibly increase their debt being inaccurately confident that they will be able to pay it back.

Before the 2007 financial crisis the level of household debt skyrocketed, going beyond 100% of GDP. In those years, the American society easily and quickly moved from debt-led to debt burdened.

While almost certainly not all personal debt accumulated in society could be attributed to behavioural fallacies, it is worth investigating whether distorted perceptions of wealth may have tremendous costs not only at the individual level but also at the macroeconomic one.

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