

# Russell Ackoff Doctoral Student Fellowship for Research on Human Decision Processes and Risk Management: 2013 Application

---

## Expense Neglect in Forecasting Personal Finances

### **Jonathan Z. Berman**

Doctoral Student  
Wharton Marketing Department

### **Mailing Address:**

Suite 700 Jon M. Huntsman Hall  
3730 Walnut Street  
University of Pennsylvania  
Philadelphia, PA 19104  
Email: JBerm@wharton.upenn.edu

### **Faculty Advisor:**

A handwritten signature in black ink that reads "Gal Zauberman". The signature is written in a cursive style and is positioned above a horizontal line.

---

Gal Zauberman, Marketing Department

### **Requested Support:**

\$ 3,465.00

## Descriptive Summary of Project

In economics, “life cycle” consumption models postulate that consumers borrow and save across time periods in order to account expectations about changes in income and expenses over time. But it is a nontrivial problem to predict future income and expenses, and therefore whether it makes sense to consume now, to save or to borrow. Any mistake in the forecasting of one’s finances can cause serious negative consequences, such as derailing a future retirement plan or driving someone into long term-debt. How, then do people form their expectations about how much money will be available in the future? Zauberman and Lynch (2005) demonstrated the role of perceptions of spare money (i.e., money slack) in influencing people’s intertemporal preferences. But we know little about what inputs drive these perceptions of spare money, and in particular, whether people are sensitive to changes in income and expenses as they form these judgments

In this project, we investigate how people form judgments about their finances in the future. Across four studies, we demonstrate that even though people think their expenses will rise in the future, they neglect or under-weight expenses when forecasting their future spare money. For every additional dollar that a person expects to earn or spend in the future, their available spare money should also increase or decrease by a dollar. That is, the role of earning or spending money should have an equal weight on an individual’s future finances, independent of how much money that individual expects to earn or spend. However, we find that while people expect that both their income and expenses to increase in the future, they are much more sensitive to changes in income rather than changes in expenses when forecasting their future finances.

In Studies 1a-c, we sampled a wide range of participants with varying financial conditions. Our sample included fully employed and part-time employed adults, unemployed adults, and adults not currently in the labor force (Study 1a); university students (Study 1b); and business executives (Study 1c). Participants were asked to tell us how much spare money they currently have this week and how much spare money they expect to have over a fixed time in 3 months and over a week in 12 months from now (1 = “Very little spare money” to 11 = “Lots of spare money”). In addition, participants estimated how much they expected their income and expenses to change in 3 months and 12 months from now (-5 = “I expect my income[expenses] to greatly decrease” to +5 = “I expect my income[expenses] to greatly increase”).

For each sample, we ran a regression that included expected income change and expected expense change as independent variables, and expected change in spare money as a dependent variable. The results show that the growth in spare money is fueled by the expectation that income will be higher at more distant points in the future than it is today. Interestingly, people do not factor in their expense growth when estimating their future finances, and consequently, their expectations about spare money are determined primarily by their expected change in income rather than their expected change in expenses.

In Study 2, we examine whether the previous results are due to the possibility that participants evaluate income and expenses on different scales. To test this, some participants were asked to evaluate their expected income and expense growth on a standard likert scale, whereas other participants were asked to evaluate their expected income and expense growth using a modulus

that normalizes judgments on a single scale. We find that regardless of scale, participants consistently neglected to incorporate expenses when judging future slack.

Study 3 rules out the possibility that participants under-weigh future expenses because they believe that future expenses are more uncertain than future income. Participants were first asked to make judgments of their future income and expense growth and were then asked to state how confident they were in their estimate. Surprisingly, we find that participants felt more confident about their future expenses growth ( $M = 8.09$ ), than their future income growth ( $M = 7.83$ , paired- $t = 2.27$ ,  $p = .024$ ). Furthermore, we again replicate our previous results, suggesting that even though participants are highly confident about the extent to which their expenses will grow in the future, they still do not sufficiently account for expenses when estimating future slack.

Studies 4 rules out the possibility that these results are due to a bias caused by the manner in which we ask participants to estimate their available spare money. In particular, asking participants about how much slack they have may be priming them to think about the driver of spare money (i.e., income). If so, then asking participants to think about how financially constraint they are may cause participants to think about the driver of financial constraint (i.e., expenses). In this study, half the participants are asked to estimate how much slack they have now and in the future, whereas the other half is asked to estimate how financially constraint they are now and in the future. We find that a focus on constraint does not eliminate expense neglect.

I hope to utilize the support of the Ackoff Fellowship to build on this research. Although we currently have demonstrated an interesting and important effect, we have still not been able to determine the exact mechanism driving an expense neglect, and also how to debias individuals to get them to consider the role of expenses when forecasting their future financial situation.

The financial support of \$3,465 that I am seeking will be used for two purposes within this research project: to fund data collection and to share the results of my research at two conferences. In order to build on the mechanism we hope to target populations that have (a) high variability in their sources of income (b) high variability in their sources of expenses, (c) expect a shock in income in the near future and/or (d) expect a shock in expenses in the near future.

In addition, I anticipate that this research will be of great interest to marketing, psychology, and economic audiences as well as to the general public. I hope to present my results at two relevant conferences: the Association for Consumer Research (ACR) North American conference in Chicago, IL; and the Society for Judgment and Decision Making (SJDM) conference in Toronto, CA. The budget outlined below reflects estimated costs of lodging (at conference room rates) and travel to and from the conferences. While the Marketing Department allocates some funding for research and travel, it is sufficient to cover only a small portion of the expenses I will occur in the near future. In addition, because I expect to be on the job market this summer, I will likely run out of department funds in order to attend the AMA Summer Conference before the start of the 2013/14 school year.

If you have any questions, or if there is any further information I can provide, please do not hesitate to call or email me. I greatly appreciate any support the Ackoff Fellowship can provide. Thank you for your consideration.

## Budget of Anticipated Expenses

<b>Item Description</b>	<b>Cost per Unit</b>	<b>Number of Units</b>	<b>Total Cost</b>
Payment for Subjects (data collection)	\$5.00	300	\$1,500.00
Society of Judgment and Decision Making (Toronto, CA):			
Conference Registration	\$150.00	1	\$150.00
Conference Travel	\$500.00	1	\$500.00
Conference Hotels	\$115.00	3	\$345.00
Association for Consumer Research Conference (Chicago, IL):			
Conference Registration	\$225.00	1	\$225.00
Conference Travel	\$400.00	1	\$400.00
Conference Hotels	\$115.00	3	\$345.00
<b>Total Costs</b>			<b>\$3,465.00</b>