

## ECONOMICS OF RATIONAL CHOICE THEORY AND ITS APPLICATIONS IN FINANCIAL DECISIONS

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**Abstract:** Financial decision-making is aided by rational choice theory. Spending meets immediate needs and wants, but saving creates wealth and financial stability over time. Saving requires financial discipline, and it provides financial freedom and peace of mind. Saving empowers people to make informed decisions and enjoy a higher quality of life. Banks use amortisation schedules to recover home loans from borrowers. Rational choice theory applies when deciding between conventional physical gold investments - such as jewellery, coins, bullion, or artefacts - and modern dematerialised (paper) forms of gold investment, including gold exchange-traded funds (ETFs), gold mutual funds, sovereign gold bonds (SGBs), and digital gold. A rational approach to monthly income budgeting after tax is the 50-30-20 rule. Emotions often play a significant role in decision-making, and investors frequently rely on inaccurate or incomplete information, which can lead to irrational behaviour. The art of diversification lies in creating a balanced portfolio of assets. To change one's financial future, it is essential to reassess one's relationship with money

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**Introduction:** 'Efficiency' is the central concept in economics. Simply put, it describes the relationship between ends (goals) and means (resources). Efficiency in production refers to the effective utilisation of resources to minimise waste and maximise output. In the context of allocation, it means making sure resources are allocated for the most beneficial purposes, so that no one can be made better off without making someone else worse off. Efficiency in consumption refers to maximising the benefit (satisfaction or utility) derived from goods and services while minimising resource waste or negative impacts. Government efficiency is achieved by maximising the output of public goods and services while minimising the resources (time, money, effort) used to produce them.

**Economic Efficiency vs Socially Inefficient:** In economics, economic efficiency - both allocative & productive - is a distinct concept that relates to resource optimisation. Economic efficiency should not be quantified by the link between the physical quantities of ends and means; rather, it should be assessed through the relationship between the value of the ends and the value of the means. This is because monetary valuation is required to quantify the physical amounts of means (inputs) and ends (outputs). In that situation, when more goals are achieved using fewer resources, it may appear beneficial, but this can come at the cost of making others worse off. Conversely, when resources are used to produce more than what is truly needed or valued, society as a whole is worse off. In such cases, the overuse of resources can lead to depletion, making them unavailable for future generations. Here, 'value' refers to what genuinely matters – something that cannot be achieved if the means employed are misaligned. In that sense, the outcome is considered inefficient.

**Over View of Rational Choice Theory:** Rational choice theory assumes that people act to maximise their own self-interest when making decisions, usually in terms of utility (pleasure) or financial gain (profit). This premise is a fundamental tenet of economic models and theories, including rational choice theory. In this context, efficiency involves maximising self-interest while minimising costs, weighing cost-benefit in a given situation to achieve the desired results. Therefore, the rational choice theory assumes people are rational actors.

**Invisible hand:** Adam Smith was among the first economists to develop the underlying principles of rational choice theory, using the concept of the 'invisible hand' as a metaphor in his book “ Inquiry into the Nature and Causes of the Wealth of Nations” published in 1776.

The rational choice theory is a normative in nature that explains how people ought to act in various circumstances. This hypothesis rests on the notion that people behave logically; however, studies frequently show otherwise.

**Rational Choice in Financial Decision-Making:** Financial decision-making is aided by rational choice theory. People strive to maintain strong and stable financial health throughout their lifetimes by making trade-offs between spending and saving. A high degree of spending on instant gratification can have a substantial impact on the long-term benefits of saving. There is an opportunity cost associated with every spending choice. Spending meets immediate needs and wants, but saving creates wealth and financial stability over time. For financial well-being, striking an optimal balance is paramount.

**Dichotomy between savings and spendings:** Ceteris paribus, a central question in rational choice theory is whether to save before or after spending. Saving becomes a residual item when people save from whatever portion of their income remains after spending. To put it in an equation:  $\text{savings} = \text{income} - \text{spending}$ . From a rational choice perspective, the first step in creating wealth is to treat spending as the residual item rather than saving. For rational actors, saving comes before spending by rearranging the equation as:  $\text{spending} = \text{income} - \text{savings}$ , while keeping income constant. Like any other budget, individuals should create a savings budget each month. Saving requires financial discipline, and it provides financial freedom and peace of mind. Saving empowers people to make informed decisions and enjoy a higher quality of life. Moreover, saving helps people achieve financial goals such as purchasing a new house, paying for their children’s education, covering business losses, meeting medical emergencies, and planning for retirement. While savings accounts provide a safe place for one’s money, they generally offer low returns. To create wealth, a small portion of savings must be invested over the long term, potentially generating higher returns through the power of compounding. Having said that, rational choice in finance, while aiming for optimal outcomes, inherently involves risk. Generally, many rational actors are risk-averse, meaning they prefer lower risk, even if it means potentially lower returns. As long as the income effect dominates the substitution effect in the labour supply curve, higher wages encourage workers to work less and enjoy more leisure time. The amount of savings, however, determines how people spend their free time, take family vacations, cover unforeseen expenses, and more.

**Steps to consider when making a rational decision about repaying a home loan:** The application of rational choice theory can help borrowers repay a home loan more quickly in order to take advantage of the increase in the value of assets, such as a house, over time. Banks use amortisation schedules to recover home loans from borrowers. This means banks structure home loan interest so that a larger portion of the monthly payment goes towards interest in the initial years, with the portion allocated to principal repayment increasing over time. Longer home loan tenures are generally associated with slightly higher interest rates.

A useful rule of thumb is that a higher down payment reduces the principal amount borrowed, which can lead to lower interest costs. The longer the loan tenure, the higher the total interest burden. However, longer tenures also result in lower equated monthly instalments (EMIs). For example, on a ₹50 lakh loan at 9% interest for 10 years, the total interest paid is approximately ₹26 lakh. Extending the tenure to 15 years increases the interest to about ₹41 lakh, while a 20-year loan raises the interest outgo to roughly ₹58 lakh. One effective repayment strategy is to adjust EMIs proportionately to income growth, though not by the full extent of the increase. For instance, if income grows by 8%,

EMIs could be raised by 4%. Additionally, bonuses, gifts, and other supplementary income can be directed toward early loan repayment. A Home Loan Protection Plan (HLPP), or home loan insurance, safeguards the borrower's family from the obligation of repaying the outstanding loan in the event of unforeseen circumstances, such as the borrower's death, during the loan term. Most home loans in India carry floating interest rates linked to an external benchmark, typically the Reserve Bank of India's (RBI) repo rate. When the RBI raises the repo rate, home loan interest rates generally increase, making borrowing more expensive; conversely, a reduction in the repo rate lowers interest rates, making loans more affordable. The lender determines the reset period—the interval at which the interest rate is adjusted - which is usually quarterly, half-yearly, or annually. The repo rate, or repurchase rate, is the rate at which commercial banks borrow from the RBI by selling securities with an agreement to repurchase them later.

Finally, tax benefits are available on joint home loans. For example, if the total interest paid on a home loan amounts to ₹4 lakh or more in a financial year, each co-borrower may claim a deduction of up to ₹2 lakh under Section 24(b) of the Income Tax Act.

**Types of Gold Investments:** Gold is considered a strong investment option due to its high liquidity and its ability to outperform inflation. Rational choice theory applies when deciding between conventional physical gold investments - such as jewellery, coins, bullion, or artefacts - and modern dematerialised (paper) forms of gold investment, including gold exchange-traded funds (ETFs), gold mutual funds, sovereign gold bonds (SGBs), and digital gold. In terms of theft risk and storage requirements, modern forms of gold investment are hassle-free and serve as substitutes for holding physical gold.

SGBs are government securities issued by the Reserve Bank of India (RBI) and denominated in grams of gold. Bonds are issued in denominations of one gram and multiples thereof. The minimum investment is one gram, and the maximum subscription limits are four kilograms for individuals, four kilograms for Hindu Undivided Families (HUFs), and twenty kilograms for trusts and similar entities. Bondholders earn interest at a fixed annual rate of 2.50% on the initial investment, credited to the investor's bank account every six months. SGBs have a lock-in period of five years from the date of issuance and a total tenure of eight years. Upon maturity, SGBs are fully exempt from capital gains tax, meaning that any profit from redemption at maturity is not taxed. However, the interest earned at 2.5% per annum is taxable as "Income from Other Sources" according to the investor's applicable income tax slab.

**50-30-20 Budget Rule:** A rational approach to monthly income budgeting after tax is the 50-30-20 rule. U.S. Senator Elizabeth Warren popularised this rule in her book "All Your Worth: The Ultimate Lifetime Money Plan". The rule divides budgeting into three categories:

- a) 50% of income for needs – Necessary monthly expenses such as utilities, groceries, health insurance, rent or mortgage payments, and transportation.
- b) 30% of income for wants – Discretionary spending such as luxury clothing and accessories, vacations, entertainment, dining out, and similar non-essential purchases.
- c) 20% of income for savings – This allocation provides financial security for the individual and their family, supports the creation of an emergency fund, and enables long-term goals such as retirement savings, investments in stocks, mutual funds, real estate, and the repayment of debt.

The percentages may be adjusted to reflect changes in individual circumstances and priorities. As financial advisor Todd Murphy observes, "If you live on less than half of your income, you are likely to never experience a personal recession, regardless of the economy."

**Investors Rationality Theory:** Investor rationality theory assumes that all investors are perfectly rational, have access to complete and accurate information, and rely solely on logic and reason when making investment decisions. However, empirical studies indicate that this assumption is unrealistic. Emotions often play a significant role in decision-making, and investors frequently rely on inaccurate or incomplete information, which can lead to irrational behaviour.

Common behavioural biases among investors include:

- a) Loss aversion – perceiving losses as more significant than equivalent gains.
- b) Confirmation bias – relying on preexisting beliefs that contradict prevailing market data.
- c) Overconfidence – overestimating one’s ability to predict market trends.
- d) Herd behaviour – following the actions of the majority without independent analysis.

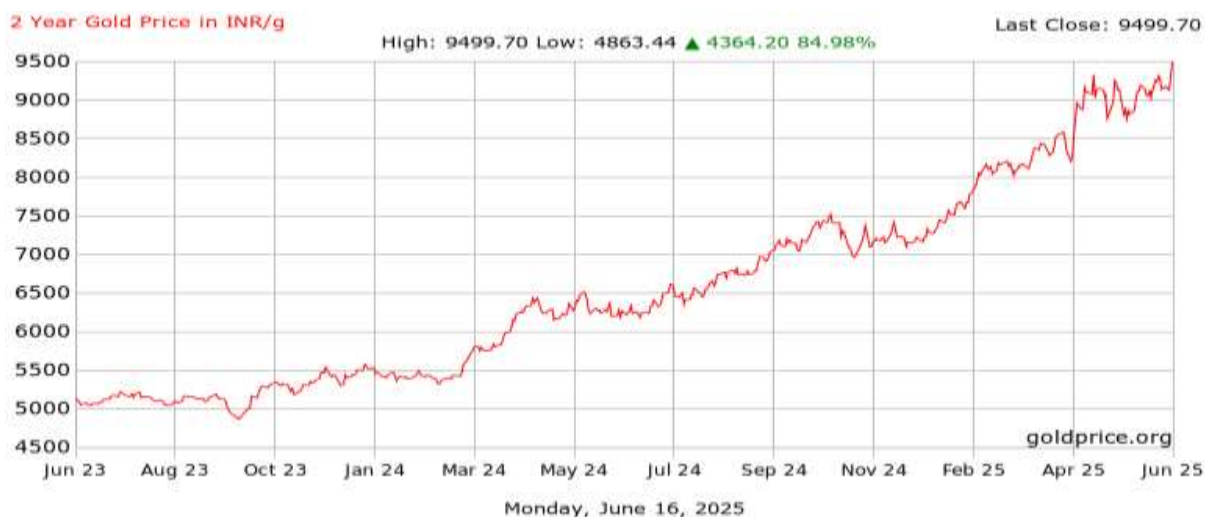
Addressing irrational behaviour requires investors to recognise and mitigate their own behavioural biases, thereby improving the quality of their financial decisions.

**Don’t Put all the Eggs in one Basket:** The investment options available in India include stocks (equities, suitable for investors with a high risk appetite), mutual funds, bonds (debt instruments where the investor lends money to the issuer and receives periodic returns at a fixed rate—generally low risk), unit-linked insurance plans (ULIPs), the Public Provident Fund (PPF), the National Pension Scheme (NPS), fixed deposits, and real estate.

Diversifying a portfolio—also known as asset allocation - is an effective strategy for mitigating market risk and protecting against inflation. In other words, rather than investing all available capital in a single asset class, investors should distribute their investments across multiple asset types such as stocks, bonds, real estate, gold, mutual funds, and bank deposits. Diversification does not guarantee profits or eliminate the risk of loss. However, it helps investors spread the risks associated with individual holdings, keeping overall risk at a tolerable level and enhancing the potential for long-term returns.

The art of diversification lies in creating a balanced portfolio of assets. For instance, if an investor owns shares in an airline, rising oil prices would increase operational costs, and reduce the airline’s profitability and share price. However, if the same investor also holds shares in an oil company, the increase in oil prices would likely boost that company’s share value, partially offsetting the losses from the airline investment.

Different asset classes - such as stocks, bonds, and real estate - respond differently to market conditions. Historical data show that these asset classes do not perform in a linear fashion. For example, in 2015, 2016, 2018, and 2022, when equity returns were subdued, other asset classes, including gold and debt instruments, performed well. The traditional 60-40 equity-debt allocation—once considered the most reliable approach- appears to be losing its effectiveness. Incorporating a small proportion of gold into the portfolio may yield improved results. Notably, between June 2023 and June 2025, gold prices increased by 84.98%. Systematic Investment Plan (SIP) is the most popular way of investing in mutual funds. With SIP, one can start small and gradually build a corpus in a systematic and planned manner. Similar to recurring deposit (RD), SIP involves allocating a pre-determined amount of money every month. A Step-Up SIP is also known as Top-Up SIP.



**Health Insurance is a rational choice:** Health insurance safeguards personal savings by covering substantial medical expenses, including hospitalisation, surgeries, and medications. It provides reassurance, promotes financial security, and contributes to an overall sense of well-being. In 2021, approximately 514 million people in India were covered under health insurance schemes, representing about 37% of the population. However, around 400 million individuals remained without any form of health insurance. Under Section 80D of the Income Tax Act, individuals can claim a tax deduction on premiums paid for Mediclaim (health insurance) policies, subject to prescribed limits. This provision offers both financial protection and tax-saving benefits, encouraging greater participation in health insurance schemes.

As lifestyle changes increase and healthcare expenses continue to climb, having health insurance has transitioned from a luxury to a necessity.

**General Tips for Making Rational Financial Decisions:** Saving is an essential component of securing a stable financial future. The required amount depends on the specific financial goals an individual sets. Strategic financial planning serves as a roadmap, guiding the process of building long-term financial security.

**Short term vs medium term vs long term Financial Goals:** To achieve short-term financial goals, savers must remain focused and motivated. Examples of short-term financial goals include creating an emergency fund, planning a family holiday, purchasing a smartphone, making a down payment for a new home or car, repaying small debts, and buying household appliances such as a television or refrigerator.

The timeline for short-term goals is typically less than one year, while medium-term goals extend up to five years. Common options for achieving short-term financial goals include certificates of deposit, recurring deposits, fixed deposits, and digital gold.

To reach short-term objectives:

- Establish an emergency fund that covers three to six months of essential living expenses. This fund serves as a safety net for unforeseen events such as home repairs, medical emergencies, or temporary loss of income.
- Clear high-interest debts, such as credit card bills and personal loans, which can consume a substantial portion of income.
- Explore passive income opportunities to create additional revenue streams.

Long-term financial goals require substantial planning and consistent discipline. Such objectives - including retirement planning, debt reduction, funding children's education, and accumulating significant wealth - generally take more than five years to achieve and form a critical part of financial

planning and wealth management. Popular long-term investment options include gold, real estate, stocks, bonds, mutual funds, and dedicated retirement plans.

**Expenses must be within the budget:** Monitoring expenses and identifying areas for potential reductions are essential for effective financial management. This practice enables individuals to assess whether their spending aligns with their financial goals and to ensure that a portion of income is allocated to savings and investments before being directed toward non-essential purchases.

**Automation Finances:** An individual can instruct their bank to regularly transfer a specific amount from their savings or current account to a recurring deposit (RD). Alternatively, they may authorize an investment company to withdraw a predetermined amount from their bank account on specified dates.

**Avoid Impulse Buying:** Unplanned or spontaneous purchases are referred to as impulse buying. This behaviour often stems from an individual's emotional state, persuasive advertising strategies, cultural influences, and the desire for instant gratification driven by an initial dopamine rush. Modern social media platforms have evolved from simple networking spaces into dynamic entertainment hubs, offering a wide array of integrated products. This environment creates constant exposure to unplanned shopping opportunities, increasing the likelihood of impulse purchases. According to one study, 56% of impulse purchases made on social media platforms were followed by consumer regret.

While the term 'planned impulsiveness' may seem like an oxymoron, it can be justifiable in certain situations. For example, an individual may intend to purchase a television and then take advantage of special offers or discounts available at the time. To avoid unwise spending, it is advisable not to shop when experiencing strong emotions, as these can trigger impulsive purchases. Taking time to reflect on a potential purchase before finalising it can help ensure it aligns with one's needs and budget. Additional strategies include making purchases primarily in cash, creating a budget, and establishing a savings plan. Ultimately, the goal is to practise mindful impulsive buying - making spontaneous purchases in a controlled and financially responsible manner.

**Relationship with money:** Knowing yourself is half the battle.

To change one's financial future, it is essential to reassess one's relationship with money. Building wealth is more closely tied to wisdom than to social standing. Valuing money with respect - rather than greed - does not make a person impolite or entitled; instead, it enhances their ability to grow wealth. The process begins with believing in your capacity to attract money, then focusing on creating value through skill development, problem-solving, collaboration, and persistence. Money tends to flow toward those who generate genuine value. The key is not luck, but the right mindset combined with consistent action.

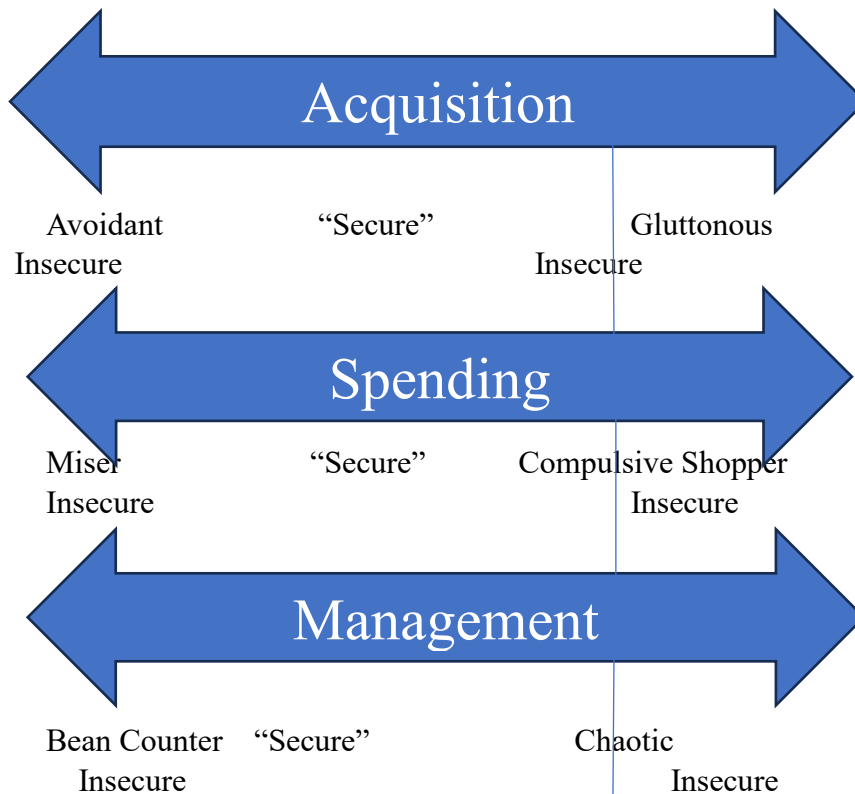
As Robert Kiyosaki observed, money is an intangible idea - something to be understood with the mind rather than merely seen with the eyes. It serves as a representation of value rather than existing solely in physical form. Over time, the idea of money has evolved, with new currencies, payment systems, and technological innovations continually reshaping how individuals, businesses, and governments create, manage, and use it. This evolution is likely to continue.

To avoid becoming enslaved by or obsessed with money, focus on the activities and goals that generate it - your dreams, career, and profession. When pursued with purpose, financial rewards often follow naturally. Affluent individuals are intentional with their time, prioritising meaningful activities over distractions. While money can be earned again, time cannot. True wealth is abundant for those who treat their time as the precious and finite resource it is.

A person's relationship with money is inherently complex and exists along a spectrum (see figure below). At both extremes lies financial insecurity: on one end, excessive frugality driven by constant worry over limited resources; on the other, reckless financial behaviour characterised by uncontrolled spending.

Siblings raised by the same parents do not necessarily share the same relationship with money. This relationship can evolve over time and is often influenced by changing circumstances. Even the cheapskates may ultimately spend their accumulated savings to safeguard their lives in times of crisis. Similarly, major life events - such as the arrival of a child, particularly a daughter in India - can motivate a person to save more diligently.

To improve one’s relationship with money, it is important to understand its three key dimensions. Eileen F. Gallo identifies these dimensions as follows:



**The dimension of acquisition:** This dimension focuses not on the methods of acquiring money (the “how”), but on determining the amount (“how much”) needed to feel secure. People generally hold one of three core beliefs about money: some view it as the “root of all evil,” others believe they “can never have enough,” and some regard it as largely irrelevant pursuit.

When pursuing money, individuals should reflect on their own perspective - whether they lean toward avoidance, insatiability, or a balanced approach. Even people of considerable means can fall prey to the “never enough” mindset, and in extreme cases, this belief may drive them to unethical or illegal actions in their quest for greater wealth.

**The dimension of spending:** The following two extreme stories illustrate contrasting approaches to money. One individual lived with strict frugality, meticulously saving every bit, and ultimately died leaving behind a substantial fortune. In stark contrast, a movie star earned millions over their career, only to end up with nothing. At one end of the spectrum stands the miser; at the other, the compulsive spender.

**The dimension of management:** Acquisition, spending, and management of money are highly individualistic. The compulsive spender often demonstrates poor money management. Proper financial management begins with meeting small obligations—such as paying electricity bills or refuelling a bike—and extends to investing for long-term wealth accumulation.

A meticulous manager tracks every nickel and dime, while a disorganised individual may delay bill payments and remain unaware of their true financial situation.

Both extremes of the spectrum can be detrimental. To feel truly “financially secure” and avoid future difficulties, it is essential to cultivate a healthy relationship with money and maintain balance across all three dimensions.

**Conclusion:** This framework provides a useful lens for understanding rational financial behaviour. However, in reality, decisions are often influenced by emotions, biases, and cognitive limitations, leading to deviations from pure rationality.

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