Mind Over Money

How to avoid the mental mistakes that can send renovation costs through the roof

BY GARY BELSKY

Michael Burns is still trying to figure out how his renovation got so big. The original plan was simple: Burns, a college professor in western Massachusetts, wanted to put in a new kitchen and then convert two of his several bedrooms into offices. "It was supposed to take three months and cost in the high five-figures," he says. But the project grew, ultimately including makeovers of the master suite, the living room, and one of the bathrooms. "We finished a year later, and it cost three times as much as our original budget," Burns recalls.

The house turned out great but, by vastly widening the scope of his project, Burns had succumbed to renovation's strongest temptation—doing, and spending, far more than was initially planned.

Burns's tale is common, if extreme. The National Association of the Remodeling Industry estimates that 90 percent of renovations exceed their budgets—by 15 to 20 percent, according to most contractors. Even construction pros are vulnerable to the ballooning-project syndrome. "We just did a major renovation at my house, and the same thing that happens to clients happened to me," says Houston contractor Dan Bawden. "It took longer and cost more. It was almost as if a hidden force was at work."

Bawden is right, but in his and Burns's and thousands of other cases, the force emanates from the mind, where a variety of subconscious inclinations can contribute to wallet-busting financial decisions.

"Remodeling is a minefield of mental money mistakes," says Thomas Gilovich, a Cornell University psychologist and an authority in a new field of research called behavioral economics, which combines the twin disciplines of psychology and personal finance. He and others have sought to understand how people make financial decisions—about stocks and savings, as well as bathroom sinks—and why those choices are often inconsistent and sometimes downright irrational.

Considering the intense emotions that people bring to a renovation—a jumble of desires, hopes, and dreams for making home sweet home even better and nicer—it's no wonder that fiscal restraint often dissolves into deepening debt. But it doesn't have to, says Gilovich. "Understanding how mistakes are made can go a long way toward helping you resist them," he says. "It may seem like a mind game, but it can help you stay on top of the money game."

ILLUSTRATION BY LOU BROOKS

Here are some of the mental money mistakes most likely to cause renovation inflation, and the surest ways to avoid them.

MISTAKE #1: IT'S ONLY MONEY

In the middle of building a large deck, a contractor approaches the owner with a proposal to upgrade the decking, railing, and balusters from pressure-treated pine to mahogany. Producing a piece of the obviously better-looking tropical wood, the contractor says it would raise the cost from $10,000 to $12,000. The owner says he'll think it over and heads for his home office to check out the balance on his $50,000 home-equity line of credit. Seeing that he's only burned through $35,000 so far, he says to himself, "What the heck; I've got 15 grand left." He goes for the mahogany.

What our homeowner has done is demonstrate a subconscious preference to "integrate" his losses. Explains Gilovich, "It's easier to disregard an expense if you can hide it from yourself in a bigger expense." Thus spending an extra $2,000 for the mahogany seems negligible compared to the $10,000 he's already committed to.

Renovation budgets are particularly vulnerable to this tendency because more often than not the money is borrowed, and buying on credit leads people to spend more than they might otherwise. The interest is tax deductible, and at today's rates a few extra thousand dollars of long-term debt costs only a few dollars a month. Bawden, the Houston contractor, sees it happening all the time. "Clients decide they can afford something because it just means borrowing more," he says.

PREVENTION: To the extent possible, finance renovations with savings. "The hardest money to spend is money you've saved," says Gilovich. If you must take out a loan, calculate its real cost by including interest expenses. You might find an $800 ceiling fan isn't a necessity when you take on $700 in long-term interest.

MISTAKE #2: LITTLE THINGS DON'T MEAN A LOT

While renovating her bathroom, a homeowner buys a medicine cabinet at a kitchen and bath store that costs $100. When she gets home, she sees in a newspaper ad that the same item is on sale for $75 at a home center, five miles away. She immediately gets back in her car, returns the $100 cabinet and goes for the lower price. The next week, she's back at the store, about to buy a toilet for $300, when a neighbor says he's seen it on sale at the other place for $275. This time, the homeowner just shrugs and spends $300.

The homeowner's inconsistent response to two versions of the same opportunity—drive five miles, save $25—is one of the most common and costly forms of what Gilovich calls the "bigness bias": the tendency to dismiss or discount small numbers or percentages as insignificant.

PREVENTION: When you're spending thousands, or tens of thousands, it's easy to lose track of small sums or tell yourself that they don't count. This is especially true when purchases are stretched over a period of time. Keep track of the small stuff—it can add up to big money and big costs.

MISTAKE #3: WISHFUL THINKING

A young couple have a baby on the way soon, and dearly want to remodel one of their bedrooms. It's a little too small, but mainly it needs new everything: flooring, trim, lighting, a bigger closet, plasterwork, paint—the works. If the couple can get the face-lift they want—and get it fast—they'll live with the space problem. So they call in a few contractors, show them the plans, and talk schedule. One week to completion? All but one of the candidates say, No way, it's a three-weeker for sure. They hire the contractor who says yes to the one-week time frame.

In this scenario, owners and contractor alike have fallen into the same trap—called "the planning fallacy"—which is a fancy way of describing the tendency to underestimate what it will take in time, effort, or money to complete a task. Both parties want to believe that a project will finish on time and on budget, and thus they reinforce each other's desire, even though it's utterly unrealistic.

Homeowners can be excused for being ignorant of the reality that renovations almost always take longer and cost more—even if there are no upgrades or add-ons—but contractors should know better. And too often, they don't—even the most honest and well-meaning ones. "Everybody has experience with the planning fallacy," says psychologist J. Edward Russo, co-author of *Decision Traps*, "but nobody factors that into their thinking."

PREVENTION: Guard against fantasy estimates by getting at least three detailed bids. Scrutinize each to determine the differences, and question each contractor about those variations. "In addition to providing you with realistic prices for all products and materials, your contractor should give you a cost breakdown for every day of labor. That way he will have a hard time justifying being late," says Chicago builder Jack Philbin. The contract should also include work-delay penalties. "It's not foolproof," Russo says, "but you're less likely to have delays if the contractor has an economic stake in it."

MISTAKE #4: ADDING ON—AND ON AND ON

Now let's go back to Michael Burns, the New England professor whose renovation took so long and cost so much. He fell into what is often called the While-You're-at-It Syndrome. Homeowners in the throes of this common but costly condition pepper contractors with add-ons during a project, either widening the scope of the work or tacking on extra goodies, or both. "Someone who'd never spend $200 for a bathroom towel bar will suddenly decide they can't do without one," says Bawden. "It doesn't seem like that much when you're already spending $10,000 on a bathroom." Predictably, the inclination to make changes grows with the amount of money involved (which is why this mistake often occurs along with integrating losses, discussed earlier).

PREVENTION: The National Association of Home Builders estimates that Americans will spend $126 billion on remodeling and maintenance this year, and a lot of checks they write will cover major cost overruns. According to Philbin, the best way to avoid this predicament is to select fixtures and materials early. "I make sure everything is chosen before we go to contract," he says.

University of Chicago behavioral economist Richard Thaler recommends an additional strategy for controlling costs: "Ask yourself if you'd be willing to pay $1,000 for a sink—if that's all you were doing. By breaking down the components of a large purchase, you can remove the psychological biases that might make you spend more than you want."

This Old House contractor Tom Silva offers this advice to potential renovators: Expect the unexpected—in fact, plan for it. "I always tell people to subtract 10 to 20 percent from their budget before making renovation decisions,"he says. "If you have $100,000 to spend, contract for $85,000. More likely than not, you'll end up spending the $100,000." ■