

# Behavioral Dimensions of Tax Reform

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Tax Policy in the Obama Era

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# Overview

- Problems confronting Tax Policy in the Obama Era
- Ground Rules for Behavioral Perspectives on Tax Policy
- Behavioral Problems with Incremental Reform
- Problems with Incremental Behavioral Reform
- Behavioral Challenges to Comprehensive Reform

# Problems Confronting Tax Policy in Obama Era ☹️

- (1) Need more revenue
  - Present and structural deficits rising
  - But recession (or worse?) today
    - So may also need (2) short term stimulus
- (3) Rising Inequality

# Problems (continued) ☹️ ☹️

- This means changing both the size of the tax burden and the slope of progression, at same time, and after an initial stimulus tax cut.
  - Behavioral economics (and common sense, and politics) suggest that this will be hard to do, because there will be very large losers at upper end
    - Identifiable victims bias (Loewenstein, Small and Strnad 2006)
    - Rhetorical battle here is over the baseline, the attempt to undermine sympathy for “victims” (note on campaign rhetoric from Clinton and Obama)
    - Joe the Plumber suggests this will be uphill battle
    - Fundamental lessons of economics (Mirrlees 1971, incentives matter!) still apply
    - Better to change *structure* with surplus (lost opportunity of 2001/03), or revenue-neutrally (cf. Reagan, TRA 86)
      - And note transition costs are real costs
- Behavioral reasons why deficits persist (McCaffery and Baron 2008)
- Behavioral reasons why redistribution gets lost in mix (McCaffery and Baron 2006, Bartels 2005)

# Problems (continued) ☹️☹️☹️

- Obama's approach, in general and to tax in particular, seems all but certain to be *incremental*
- This may often (generally?) be a good thing, but problematic in tax, especially with behavioral perspective:
  - Incremental reform is inclined, for political and behavioral reasons, to small cuts (Homer gets \$500!) and salient fixes (e.g. carried interest, AMT)
    - Failure to index was the great tax increaser throughout income tax history
    - Republicans pursued incremental cuts on path towards flat tax (see Norquist and Moore, quoted in McCaffery 2005a at 937)
    - Now going to be hard to reverse course
    - and structure needs change!
      - Income tax has (predictably) evolved into wage tax (McCaffery 2005a)

# Ground Rules

- Theory matters
  - BE supplements, does not replace, traditional economics analysis (McCaffery 2008)
    - No more dangerous idea than that behavioral biases mean that people can be tricked without cost or effect
      - E.g., hidden taxes have real effects (McCaffery and Baron 2006)
      - E.g., incentives matter!
- Institutions matter
  - Arbitrage, pro and con, can work against tax reform

# Behavioral Problems with Incremental Reform

- Homer and the Isolation Effect
- Incremental reform is inclined towards giving away benefits, or quick patches to salient problems (e.g., carried interest, AMT), not to seeing structural problems
- Fundamental asymmetry:
  - incrementalism is better on cuts (Norquist and Moore strategy), changes baseline, hard to reverse course (lots of small cuts good, lots of small increases bad)
    - Cf Starve the Beast strategy
- Recall Clinton era tax policy (great complexifiers)

# Problems with Incremental Behavioral Reform

- Case study: Pro savings policies within income tax
  - Note theoretical incoherence
  - Ability to arbitrage by borrowing today with traditional IRAs/401(k)s in place
  - Why?
    - Myopia!
    - Strong private market incentives to develop institutions to encourage debt (Bill Gale anecdote)
  - Proof: tax “subsidy” for savings > new savings (McCaffery 2005b, 2008)
- Argument for shoving not nudging (cf. Thaler and Sunstein 2008)

# Behavioral Challenges to Comprehensive Reform

- If comprehensive reform needed, can we get it?
- Hard:
  - Complexity, isolation effect, fear of unknown, status quo bias, loss aversion
- Main challenge from Behavioral Public Finance perspective is to the structure of politics, preferences and attitudes
  - No arbitrage mechanism in politics, like a market
  - So e.g. hidden taxes prevail (efficiency suffers), regressive status quo sticks (unnecessary equity-efficiency tradeoff)
- Change the way we do things, as prelude to changing what we do?
  - PAYGO rules, balanced budget amendments, independent commissions, role for experts

# Last Words

- Any hope?
  - Come back in four years, for Obama II 😊

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