

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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