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**Behavioral Dimensions of Tax Reform**

Edward J. McCaffery\*

\*USC and Caltech, emccaffery@law.usc.edu

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# Behavioral Dimensions of Tax Reform

Edward J. McCaffery

## **Abstract**

These are powerpoint slides from a presentation at a joint UCLA-Tax Policy Center Conference on Tax Policy in the Obama Era. The basic insight is that it will be difficult to raise significant revenue through the current tax system. Behavioral perspectives suggest that a series of small (or large) cuts, aiming towards a flattened rate structure – as we have seen in the Ronald Reagan and George W. Bush Administrations – are likely to be extremely popular. Undoing them with tax increases will be disproportionately psychologically hard. Given that President Obama faces the perceived need for short term stimulus, likely meaning more small tax cuts, meeting his ultimate goals of reducing deficits and restoring more progression to the tax system will be difficult, if not impossible. Ultimately, the insights of behavioral economics may be most important in reconsidering the institutional mechanisms that produce tax and spending policy.

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# Behavioral Dimensions of Tax Reform

Ed McCaffery

Tax Policy in the Obama Era

UCLA School of Law-Tax Policy Center

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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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Contact me:

[emccaffery@law.usc.edu](mailto:emccaffery@law.usc.edu)