Behavioral Economics and the Law: Tax

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Abstract

This chapter argues that a behavioral law and economics approach to tax is deeply needed for a wider normative analysis of the impacts of law on social welfare. The absence of traditional markets to serve as arbitrage mechanisms in public finance means that suboptimal tax and fiscal systems can arise and persist for long periods of time. Most of the current scholarly applications of behavioral approaches to tax, however, fail to take into account the institutional settings in which tax laws exist. The common recommendation for tax-favored savings plans to counteract a persistent individual-level myopia that leads to under-savings for many suffers from the possibility of being undercut on account of the ability to borrow tax-free under the current income tax system, combined with . . . individual-level myopia. Similarly, a recent trend of scholarship that argues for “low salient” taxes to help ameliorate persistent fiscal crises (themselves exacerbated by pervasive behavioral biases playing out in a setting absent effective arbitrage mechanisms) ignores or underplays the real costs of even hidden taxes, both allocatively and distributionally. The chapter concludes that the most critical work for a behavioral law and economics approach to tax lies ahead.
1. Introduction: Situating the Task for Tax

The extension of a behavioral approach of law and economics to tax law came somewhat late in the day (McCaffery 1994; Hill, 2010; McCaffery and Slemrod 2006; Gamage and Shanske 2011; Galle 2013). On one hand, this is surprising, given the importance of tax to the economy of all developed nations, not to mention the deep political importance of the subject. Further, individual behavior has always been a central concern of public finance in the rational choice branch of economics, for policymakers need to pay attention to how individuals react to tax law changes in order to predict and respond to the revenue effects of reforms. Thus the field of optimal tax (Ramsey 1927) and optimal income tax (Mirrlees 1971), centerpieces of the traditional rational choice economic approach to tax, revolve around individual elasticities, or the changes to prices and the behaviors brought about by tax law changes.

On the other hand, the late arrival of tax to the behavioral party is understandable, given the historic development of the field (Jolls, Sunstein and Thaler 1998), and the challenges (which are still being worked out) of applying a behavioral approach to public finance (McCaffery and Slemrod 2006; Gamage and Shanske 2011). Behavioral law and economics first developed in the context of private law subjects such as contracts, torts, and property (Sunstein 2000; other chapters in this volume). In the public law context, early efforts looked at such specific matters as risk regulation (Noll and Krier 1990). This made sense because the wider field of...
behavioral economics arose as an alternative model of consumer or individual level choice, especially in situations involving risk (Kahneman and Tversky 1979; Thaler 1980). By framing and other manipulations, ordinary subjects could be found to make inconsistent choices, which can lead to preference shifts or reversals.

The choices to be made in tax – to work or be unemployed, to save or spend, to give to charity or refrain from doing so, and so on – seemed in contrast to be straightforward, not about risk, and not necessarily the object of manipulation, because the government was more-or-less dictating tax law, without any individual-level negotiation in play. At first glance, framing does not appear to be relevant. Empirically-minded public economists simply measured the facts of behavioral changes without pausing much to consider the reasons behind the changing behaviors; this is consistent with the traditional economics view of accepting individual preferences as is, and as being rational at least until proven otherwise. Rationality for these purposes means simply acting consistently with a well-defined utility function (Becker 1962; Sen 1977). Substituting leisure for work or consumption for savings in the face of increased taxes on work and savings seemed perfectly rational, and thus did not generate any grounds for deeper exploration.

In contrast, within more micro-level private markets where consumers spend most of their time, inconsistent individual level decisions were easy to spot, once scholars started looking for them. Thus early applications of the endowment effect, status quo bias, or loss aversion, featured tales and experiments of individuals valuing items, such as mugs, more if they owned them, or thought that they owned them, than if they did not (Kahneman, Knetsch and Thaler 1990; Hoffman and Spitzer 1982). Damages in civil tort actions could easily be affected by framing manipulations (McCaffery, Kahneman and Spitzer, 1995; Kahneman, Schkade and Sunstein 1998). Defaults in contractual terms could be sticky (Korobkin 2000). Government risk regulations were targeted at individual-level actions, and so it made sense to study them from a realistic behavioral perspective (Noll and Krier 1990).
Soon a paradox emerged and haunted the development of behavioral law and economics for some time. It seems abundantly clear, from both common sense and vast empirical observations, whether via controlled experiments or real-world observations (Camerer 1998), that individuals suffer from a variety of heuristics and biases in our individual decision-making: we all like our glasses half full, not half empty. We are not, that is, consistent. Still, the school of law and economics, acting as a subset of the rational actor economics tradition, was able to gain a good deal of traction ignoring all this and acting “as if” consumers were indeed rational (Posner 1972), even as counterindications continued to be found and to abound. Behavioral law and economics struggled to make specific policy prescriptions that could make any impact in the real world, and the whole endeavor was beset by charges of paternalism; specifically, of attempting to override consumer preferences, and violating the sacred consumer sovereignty principle. (Sunstein and Thaler 2003; Camerer et al 2003).

Lingering tensions set the subject matter up for a seemingly never-ending war between two camps – one holding that individuals are indeed rational, the other that they are not. From a distance, one could see in this very struggle one of the most common biases – the all-or-nothing effect. Scholars and others assumed a binary choice between “rational” and “behavioral” approaches, and much ink was spilled and many trees felled hashing it all out.

Even at the time, however (and certainly now after decades of debate), the war of worldviews seemed a bit silly. Yes, rational actor models have been enormously helpful in understanding the law as it is and in prescribing reform, and we should be grateful for them. But yes, too, everyone one of us makes mistakes in reasoning all the time, measured simply on a within-subject basis as inconsistency. How can this be?

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2 The field of behavioral economics has featured a wide array of methodologies, including: real-world observation, anecdotal reasoning, and experiments in the classic economics tradition featuring incentive-compatible stakes, using cash or other words to attempt to elicit true preferences, and comparing results across or between individuals. The initial (Kahneman and Tversky 1979) approach to behavioral economics was to use within-subject experiments or surveys (McCaffery and Baron
The answer lies to a great extent on another side of the coin too often ignored in the early academic wars: the institutional and social structure in which decisions are made. Here there is a large difference between private markets and public finance – indeed, we might best refer to the public domain as a nonmarket one. Simply put, in private markets there are markets that serve as arbitrage and debiasing mechanisms. This is why Adam Smith (1776) saw markets, or the price system, as the “invisible hand,” and why Karl Popper (1945), in a wider social and political context, saw an “open society” as central to innovation and growth. As the United States politician and president Abraham Lincoln put it, “you can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time.” Most of us need an escape, a curative, from our own biases and mental shortcomings at least a good deal of the time. Markets supply this, in large part because they give power to the few who are not fooled. Thus, the recent work questioning the endowment effect (Zeiler and Plott 2011) has mainly served to establish what should have been obvious all along: given a proper institutional design, individual-level inconsistencies in choices can be eliminated or at least significantly lessened.3

To illustrate, casually, I suspect that few if any readers know the marginal cost of supplying just about any product they purchase, such as a box of cereal. (Or the marginal cost of running a dishwasher, in a famous example from the literature (Liebman and Zeckhauser 2004)). It would not be difficult for a seller, in isolation, to trick us into thinking that the fair and accurate price was quite a bit

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3 A series of subsequent studies have called Plott and Zeiler’s basic findings into question. (Knetsch and Wong (2009); Koh and Wong (2011); Isoni, Loomes and Sugden (2011)). See Korobkin, this volume, for a discussion. I have no particular brief in this debate, although I have some confidence that some debiasing mechanisms can work. The point is rather that the kind of debiasing that at least sometimes obtains in private markets is altogether absent, or present in very different ways, in the public, nonmarket, realm.
higher than it is in reality. But in a fully competitive economy, sellers do not exist in isolation. In terms of pricing, competition helps to drive away or lessen any cognitive or behavioral advantage.\textsuperscript{4} Marginal cost pricing, one of the central findings of the competitive general equilibrium theory, obtains notwithstanding consumer’s limited understanding – indeed total ignorance – of the marginal cost of inputs in just about any good or service we purchase every day. So it is still not completely clear that behavioral approaches to law and economics have all that much practical application, where private markets exist to counteract pervasive bias.

Now let us turn our attention directly to tax, the subject matter of this chapter. And here, ironically, we can quickly see why a behavioral approach should be more powerful in regard to tax law than just about any other subject. After all, the central problem in tax and public finance is the almost complete absence of any institutional mechanism to offset or “arbitrage” against persistent individual-level cognitive bias (McCaffery and Baron 2006).

The point deserves emphasis. It is not biases in individuals’ real-world reactions to a tax ((for example, failing to appropriately reduce consumption of a good that is subject to a tax later imposed at the cash register, even where the information that the tax will be imposed is readily available (Chetty, Looney and Kroft, 2009)) that concerns me, as much as it is the failure of citizens to react consistently or rationally to tax law proposals put forth by politicians. Gamage and Shanske (2011) helpfully

\textsuperscript{4} Once again, I am aware that this proposition is not without controversy on the private market side. According to Oren Bar-Gill, for example, in a competitive market, suppliers are expected to compete over who exploits consumer biases more effectively. It seems especially likely that biases may affect non-price terms – not surprising, given that price is typically the most salient feature of a good or service in a private market, and behavioral economics strongly suggests that ordinary subjects have a hard time focusing on multiple dimensions. Bar-Gill (2012). Yet once again, this is not my case to argue out in this chapter – I mean rather more humbly to point to how the analysis, especially of the effect of arbitrage or debiasing mechanisms, should proceed very differently in private market domains versus public nonmarket ones. And, finally, I meant to stress that the project of analyzing the effect of nonmarket mechanisms on those biases in play in public finance systems is woefully lagging parallel research projects in private market domains.
distinguish between “market” and “political” salience: the problem in this vocabulary is the low political salience of many real world taxes. There are markets in politics, of course, but these markets are designed to get politicians elected. They do not necessarily give governments any incentive at all to debias the electorate. In fact, they tend towards the opposite. Thus, politicians favor hidden or low-salient taxes, such as corporate, payroll or value-added ones, over more transparent ones, because they get government revenue at minimal psychic pain (salience) in order to fund high salient expenditures. “Hidden” taxes have real effects, however, in terms of efficiency and on both “horizontal” (the norm of treating likes alike) and “vertical“ (the norm that the rich or better-able-to-pay should pay more, in absolute and perhaps percent terms) equity grounds. Thus we may—and, I have argued, have—ended up with a tax system that is sub-optimal, as measured by our own better informed lights, in terms of both its social cost and its distributional properties (McCaffery and Baron 2005).

Taxes of any sort are hard to increase and attractive to cut, for obvious rational and behavioral reasons (McCaffery and Hines 2010). Government spending programs, the other half of the fiscal equation, are conversely easy to raise and hard to cut, also for both rational and behavioral reasons. The net result, of course, is deficits of all sorts and at every governmental level. This is a perfectly predictable outcome of pervasive cognitive biases, playing out in a setting almost wholly lacking in institutional mechanisms to offset them.

It would seem, then, that the normative task for a behavioral law and economics approach to tax is to come up with ways to debias or counteract widespread behavioral biases and their effects, as evident in broad-level questions of tax system design. Such a project, however, has barely begun, and the early efforts in this direction, discussed below, seem tentative at best. In the meantime, advances have been made in other subfields, as scholars look to pluck the low-hanging fruit first.

The two major sets of “practical” recommendations to emerge thus far in tax and behavioral law and economics literature, however, suggest more that caution needs to be used when adapting behavioral economic findings to real-
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world public policy contexts than anything else. One application is to advocate the use of tax or otherwise favored savings plans to help cure persistent individual-level myopia. This suggestion suffers from a lack of a wider context and deeper analytic understanding of tax: when the facts of tax are better understood, one can see that the “cures” for myopia are likely to be undercut by . . . myopia.

The second application is the policy recommendation that governments should choose taxes with low “market salience,” and take steps to keep their “political salience” low. This line of reasoning suffers both from a certain obviousness – politicians, if they know anything, know this – and from a naïveté about the real-world effects of even hidden taxes, and about the possibilities of counteracting these effects by other tax law changes. Both of these examples are discussed at greater length below. They show us that there is still a long way to go from observation, and even experimentation, to prescription when it comes to the relevance of behavioral economics to tax.

The balance of this chapter first considers the more specific subjects of tax compliance and using tax as part of social behavioral modification. Afterward it turns to the relevance of behavioral approaches to tax-system design and, finally and most particularly, to the increasingly urgent question of fiscal balance.

2. Compliance Matters

Given the historical development of behavioral law and economics discussed above, it is not surprising that one of the earliest and still most developed applications to tax has been in the matter of tax-law compliance. Whether or not to pay one’s taxes, especially in a largely self-reported tax system such as the income tax in the United States (and world-wide) is a choice, and one that involves a certain amount of risk – classic territory for a behavioral law and economics approach.

At the core of the compliance issue seems to be a rational choice calculus: comparing the marginal cost of compliance (paying all of one’s taxes when owed) with the marginal benefits of non-compliance (taxes saved minus the penalties for non-compliance). In equation form, a rational
individual, concerned only with dollars and cents in his pocket, should pay his tax, \( t \), only if that tax is less than the sum of the probability of getting caught and forced to pay the tax, \( p \), times the tax otherwise owed, plus the costs of any government fine or penalty for non-compliance if caught, plus the cost (if any) of non-compliance, \( c \) (I ignore for simplicity the costs of compliance):

\[
t \leq pt + (1-p)0 + pf + c, \text{ or}
\]

\[
t \leq p(t + f) + c
\]

The problem is, by just about any light, there is far “too much” compliance with the law, and far “too little” government commitment to either increasing \( p \), by devoting more resources to tax-law compliance, or \( f \), by increasing the penalties for non-compliance (Alm et al 2010; McCaffery and Slemrod 2006). Does this mean that there are behavioral biases in play?

Perhaps, but this would seem to be an area where new approaches also have their limits. The answer to the puzzle of excessive private compliance and sub-optimal government enforcement, if that is what it is, seems to lie in the fact that there are other things going on. Politically, aggressive tax enforcement, at least of highly salient taxes, such as the personal income tax in the United States, is unpopular. Also, compliance does seem to turn on whether or not the government has mechanisms for checking on self-reporting (Slemrod 2007). There is considerably more compliance where third party reporting exists to aid the government, as where employers must report wages paid, by law and in order to get their own tax-law deduction for salaries paid, and employees are told what is reported to the government. In contrast, in cases where such third party reporting does not obtain, such as sole proprietor income, non-compliance is far more common. This is all perfectly rational.

Nonetheless this field has been studied, and research in the area is growing of late. Scholars look to whether patriotism affects compliance, for example, or if other framing manipulations might be in play. (Konrad and Qari 2012). Bruno Frey (2007) explains compliance within the
framework of basic deterrence policy, in which people consider tax evasion in terms of the probability of detection and the degree of punishment. But Frey also suggests that forces such as the perceived behavior of others and whether the taxpayer believes that she received a “fair share” of the public good can affect compliance (Frey 2007).

Still, “over” compliance may be due to risk aversion, or to a sense of duty, neither of which seem “behavioral” in the sense of being irrational. Granted, there is almost certainly widespread cognitive error when it comes to calculating the costs and risks of noncompliance – actually putting numbers to the compliance equation set out above. Yet although it is clearly a worthwhile social project to study and better understand the ways in which compliance with tax laws might improve, there seems something at least a bit untoward in attempting to “debias” individuals from their “excessive” obedience to the law.5

3. Behavioral Modification

Another category of application of behavioral economics to tax law has been to embrace the fact that taxes can affect behavior, and then to look to see if tax can be the “answer” or corrective to certain behavioral biases perceived as being harmful to individuals.

Many biases cluster under the heading of time-inconsistent preferences: people do things today, failing to account for their longer term effects, and then later come to rue the day that they neglected the now-present future (Loewenstein and Elster 1992). Note that this is distinct from the more general topic of “sin taxes”. Taxes on goods or

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5 The topic of compliance to tax laws raises an array of other issues that I set aside in the interests of space. There are, for example: (a) Issues relating to when non-compliance is more likely, such as the difference between people who owe money on their taxes and those who are entitled to a refund Robben et al. (1990); (b) Different ways to bolster deterrence using cognitive biases that are specific to taxes. See, for example, Guttel and Harel (2008), considering the “audit lottery” in tax enforcement; and (c) Recent findings relating to behavioral ethics and motivated reasoning might also be relevant to tax compliance. For example, Feldman and Teichman (2009) argue that legal uncertainty in the tax code might generate a perverse effect with respect to compliance; see also Scotchmer and Slemrod (1988). The topic of the behavioral dimensions of tax law compliance could easily fill a separate chapter or even volume, and I apologize for the brevity here.
activities with negative externalities, and negative effects on those who consume them, such as cigarettes or alcohol (or under President Obama’s healthcare plan, on not being insured), after all, fall within the “rational actor” side of things: people will do less of any activity if its price is higher, and taxes can raise the price of an activity. This idea harks back at least as far as Pigou (1920), although modern public finance scholars have employed more sophisticated models, using behavioral insights to supplement the neoclassical perspective. (Gruber and Köszegi 2004).

The behavioral approach adds that individuals, on their own lights, may be failing to optimize because of time-inconsistent preferences. Smoking and any other self-harming activities can fit the bill: the self who is doing the harmful thing is irrationally (inconsistently) discounting the future self who will suffer the consequences. In the tax-law context, the canonical example has been the failure to save, which could equivalently be called over-consumption. “Rational” models of savings suggest a smoothing out of consumption over one’s life cycle (Modigliani 1966), and perhaps even an extremely or hyper-rational savings across generations and in reaction to government fiscal policies (Barro 1974). Behavioral economists have countered with a “behavioral life-cycle” model in which, lo and behold, most people most of the time fail to do the optimal thing, and make a wide range of mistakes in their saving and spending decisions (Shefrin and Thaler 2007). Simply put, most people seem myopic in their savings decisions and therefore they under-save – again, in a behavioral economics vein, as measured by their own consistent preferences over time. The idea has led to perhaps the poster child for a behavioral approach to public policy: tax-favored and highly salient savings plans, such as individual retirement accounts (IRAs) under United States law, and/or provisions requiring employees to default into employer-provided retirement plans, relying on the status quo bias (or, more simply, inertia), to keep them there (Thaler and Benartzi 2004; Choi et al 2002; Korobkin, this volume).

But there is a problem with this particular set of policies which points to a more general danger with a behavioral approach to public policy (McCaffery 2006). As
noted above, behavioral biases exist in context. Generally speaking, institutional forces such as competition or markets can ameliorate biases. Other times, in contrast, aspects of institutional design can undercut a behavioral patch. The case for making pension or other retirement plans both tax-favored and defaults turns on the fact that people suffer from myopia, an excessive concern with the present (and a corresponding devaluation of the future). The idea is to use one bias, the stickiness of the status quo, to offset another, myopia.6

To be fair, the strategy of making savings easy, salient, and sticky might work. The idea certainly makes sense in the abstract. The problem is that we do not live in the abstract. Aspects of institutional design – in this case, the analytic structure of tax – do not go away because we are not looking at them; indeed, the most general behavioral bias can be seen as an isolation effect, in which individuals, including policymakers, ignore facts and factors seemingly offstage or not salient at the time another decision is being made.

More specifically with tax-favored savings plans, the problem begins with the fact that the tax system as presently structured has a large bias in favor of present consumption, and against savings. (McCaffery 2005). A major aspect of this structural bias is that debt, or consumer borrowing, is not taxable “income” when incurred. A United States taxpayer using a “traditional” Individual Retirement Account (IRA) is thus able to borrow, tax-free, in order to come up with enough cash to fund a contribution to a retirement plan. Today, this generates a tax deduction (often literally today, as the deadline for making a tax-deductible IRA is generally the due date of the return, i.e., April 15.)

A taxpayer, such as a hypothetical Jane, can reduce the taxes she must pay within minutes by this trick. Jane borrows $2000 on a credit card. She then puts that $2000 into an IRA or other tax-favored vehicle, all on the same day, April 15, also known as Tax Day. Why would Jane do this? Perhaps because she is myopic: the very behavioral trait

6 The chapter by Pi, Parisi, and Luppi, found in this volume, discusses the issue of using one bias to offset another.
leading to the policy recommendation in the first place. The moves allow Jane to reduce the taxes she owes, today, by perhaps $600 if she is in a 30% marginal tax bracket. The taxes Jane would otherwise owe fall by $600, or her refund increases by that much. She has, today, another $600 to spend, today. Now there is no free lunch here – the $600 tax bill lies in wait, until Jane withdraws the $2000 from her IRA. But that withdrawal, and its tax obligation, will not come today. So Jane doesn’t think much about that ultimate cost. Why? Because she is myopic. Now how you might ask could Jane possibly know of this seemingly sophisticated arbitrage technique? Perhaps because the financial institutions that collect fees from IRAs and interest from consumer loans have told her about the idea – again, we must always consider the institutional setting, here a private market, in which individual actions take place.

Note that in this example, wherein Jane borrows with one hand and saves with the other, there is no net savings; the positive savings in the IRA ($2000) are offset by the borrowing outside of it (-$2000). Indeed, if Jane goes forth and immediately spends the greater tax refund she gets ((as the behavioral concept of mental accounts (Thaler 2008) and as myopia suggests that she will)) there is reduced aggregate savings. Further, taxpayers like Jane fail to account for the taxes implicitly due from their retirement accounts, though these are inescapable, even after death. A kind of money illusion leads people to think that they are richer than they actually are because of their ignoring of the built-in tax liability. This could easily lead to less saving going forward. Admittedly, this is speculative, based on a conjoint consideration of the analytics of current tax law design and familiar behavioral biases (McCaffery 2006). But some confirmation can be gained from the fact that the costs of the pro-savings provisions, in the form of foregone revenues (what tax experts call “tax-expenditure” analysis) seem to exceed the amount of new savings actually being produced in the United States each year (Bell, Carasso and Steurle, 2004).

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7 A traditional IRA under United States law is funded with pre-tax dollars. IRC § 408. If a taxpayer holds an IRA until death, either the ultimate beneficiaries will pay ordinary income taxes when they receive distributions, or the decedent’s estate itself will pay tax, as “income in respect of a decedent,” or IRD. IRC § 691.
This relates back to a previous warning. The point I am making is not a concern over paternalism, or which preferences to count when individuals are inconsistent over time. It is simply that ad hoc patches to behavioral biases may not work, precisely because they are ad hoc. Water finds its own level. A persistent myopia will lead to “too little” savings, until and unless institutional structures are properly designed to counteract the bias. Ad hoc cures can be circumvented and only serve to make the web of tax more tangled, and the problem of under-saving worse.

4. Tax Law System Design

So far this chapter has considered that behavioral approaches might be limited in their practical applications for tax law compliance and for curing “problems” such as too-little savings through ad hoc patches. These happen to be the two most common domains where behavioral approaches to tax law have been invoked thus far. Does that mean the task for a behavioral approach to tax law is limited?

No. Getting back to my initial comments, all or at least many roads of a behavioral economics approach to tax seem to lead to a path less taken: considering the relevance of behavioral perspectives to the broad question of tax-law design. Here the various mechanisms of arbitrage that lessen and perhaps eliminate the effects of bias – or, at a minimum, affect how biases play out – are almost altogether lacking. Politicians get elected or not based on pleasing the electorate, and hearing about taxes is rarely pleasing. How does widespread cognitive error play out in the nonmarket domain of public finance? This is a large and challenging project, which naturally breaks down into positive and normative dimensions.

4.1. Positive Findings

Let us begin with some positive or simply descriptive findings about popular perceptions of tax.

It is hardly surprising that people do not generally like taxes. There is thus a tax aversion, related to the more general behavioral bias of loss aversion. (See generally Zamir, this volume). In sum, people react to a perceived loss more
negatively than the “mere” failure to obtain a gain, even of the same absolute magnitude, and even with the same end points. Thus, famously, Thaler (1980) observed that customers would use cash to avoid a penalty for using credit cards ($3.90 a gallon versus $4.00, say), but would use credit cards and forswear a “bonus” for using cash ($4.00 versus $3.90). Such biases would seem to extend to the purely formal matter of how a government exaction is labeled, whether as a “tax,” a “surcharge,” a “user fee” or something else. Although experimental evidence does not cut simply in any one direction (McCaffery and Baron 2006) it seems clear that the label “tax” alone creates negative attitudes.

Tax laws in advanced democracies are complex and have many dimensions. For broad-based comprehensive taxes, such as the income tax in the United States, which rely on a pattern of progressive marginal tax rates, there is a persistent confusion between marginal and average tax rates (see illustratively Liebman and Zeckhauser 2004). Thus individuals may react to the highest marginal tax rate and judge a tax accordingly. A somewhat related bias – at least a similar failure to understand the math of the matter – is the metric effect (McCaffery and Baron 2003). Simply put, citizens favor more progressivity when taxes are stated in the metric of percent rather than in absolute dollar terms, as even a flat-rate percentage tax generates an appearance of progressivity when stated in absolute dollars. A flat rate 25 percent income tax means that a family making $50,000 pays $12,500 in taxes, and one making $200,000 pays $50,000. Comparing $50,000 to $12,500 makes the system look progressive, though, in a “better” metric, looking to average tax rates, it is not.

More generally, individual judgments about tax seem highly vulnerable to framing effects, or preference reversals based on the purely formal presentation of a choice set (Kahneman and Tversky 1979). A simple example is that individuals support “child bonuses” in the tax law, but recoil from the idea of “childless penalties” – although these are, analytically, the same thing, just different ways to put the same point, measured off of different baselines (McCaffery and Baron 2004). Thus, the tax system could tax couples at $5000, but give a $1000 tax break (“bonus”) to
couples with children, or the system could tax all couples at $4000 and “penalize” taxpayers without children by $1000. Either way, a couple with children pays $4000, and a couple without pays $5000. Yet the “bonus” frame is widely liked whereas the “penalty” one is widely disliked. Progressivity, another dimension of many comprehensive individual tax systems world-wide, exacerbates the problem, as Schelling (1981) first speculated. Thus in a system without accommodation for children in the baseline, individuals support adding on child bonuses that are higher for the poor than for the rich. But in a system with accommodation for children already factored in, individuals support childless penalties surcharges that are higher for the rich. That is a double inconsistency: supporting progressive bonuses while opposing regressive penalties (McCaffery and Baron 2004).

Salience is key to many behavioral effects: individuals over-react to highly salient matters, and under-react (or fail to react at all) to low-salient ones. The concept of salience has led to a small explosion of scholarly work of late. The seminal piece in this field is the real-world experiment staged by Chetty, Looney and Kroft (2009), in which the authors found that consumers had little if any reaction to taxes applied to store goods when the tax was added on at the cash register, as opposed to stated on the sticker price on the store aisles, even when the fact that the taxes would be later applied was made readily available to them. (Chetty 2009; Galle 2013; Gamage and Shanske 2010, 2011; Schenk 2010). In a behavioral (or commonsensical) vein, this finding is hardly surprising, confirming individual predilections for “hidden” taxes, the more hidden the better (McCaffery 1994). It is the normative and public policy ramifications of this finding that still need development, as discussed in the next subsection.

There are still more behavioral biases at play in tax. A failure to add is central to many biases, such as subadditivity. In tax, individuals seem more willing to accept a set of smaller taxes than a single, large, tax, even where the former add up to more than the latter. (The seminal paper on subadditivity in general is Tversky and Koehler (1994)). This bias works hand in glove with issues of salience, for a series of low-salient taxes produces less psychic pain than an
equivalent, large, transparent tax. People also generally fail to account for the deficiencies in one tax – measured by their own preferences – by adjusting another. Thus, people do not always act consistently when a single tax system is broken into pieces: if one tax on wages, such as the payroll tax, is considered to be too flat or even regressive, subjects still under-adjust another tax, such as the income tax, to accommodate for the perceived shortcomings (McCaffery and Baron 2003). Taxes can also become bundled with spending programs, with a similar disaggregation bias in play. Thus if the government ceases to provide a certain good or service, leading, ceteris paribus, to a reduction in taxes, individuals have difficulty adjusting the tax cut to maintain the same degree of progression that had obtained when the publically provided good was bundled with the tax (Baron and McCaffery 2006).

Suppose, to illustrate this latter point, the government provides some benefit – schools, roads, healthcare – worth an average of $5000 per household. The benefit is financed with a progressive tax that, to keep things simple, imposes a $2500 burden on the poorest half of households and a $7500 burden on the richest half. If the government stops providing the good and eliminates the tax funding mechanism, not only will the good no longer be publically provided, but also the cross-subsidy will end. If households need to come out of pocket to provide the good or service for themselves, the poorer half will “lose” $2500 because the cost to them will double; the richer half will “win” the same $2500 by saving on the cost (taxes plus out of pocket). Yet we found that subjects, even when told explicitly of this possibility, under-adjusted the residual tax system such that progressivity fell with privatization. (McCaffery and Baron 2006).

No doubt there are more biases in the popular perception of tax to be noted and verified. For example, I strongly suspect that there is a form aversion, under which individuals more intensely dislike a tax if they must complete paperwork in order to pay for it – one of the many features that favors payroll, sales or value-added taxes over income-based ones. (Other factors in the United States include that the payroll tax system, the highest tax for some
eighty percent of Americans, has been labeled a “contribution,” is nominally collected one-half from one’s employer, and does not feature a salient bottom-line amount (as the income tax with its annual form does), and more (McCaffery 1994)).

4.2. Normative Analysis

Scholars in all veins of law and economics, behavioral or otherwise, tend to shy away from normative analysis, believing that their task is solely descriptive. But aside from a certain naïveté in separating out descriptive from normative scholarship, the questions raised by tax and public finance seem unavoidably normative (Gamage and Shanske 2011). What “should” the citizenry choose for its tax and other fiscal policies? Competition, at least the sort of competition that obtains in private markets, discussed above, will not settle the matter. Here, in contrast to the more targeted behavioral patches of the pro-savings plans discussed above, is where behavioral approaches have much to add to thinking about tax law.

I cannot in a brief chapter (also intended to survey recent literature) set forth and defend a complete and compelling normative approach to tax. Nevertheless, I can and do note a certain “optimal” approach to law and economics, as set forth by others, most famously Kaplow and Shavell (1994, 2002), and note its potential application to tax and public finance, for the limited but important purpose of sketching out a role for a behavioral law and economics approach to tax.

In Kaplow and Shavell’s view, which builds on neoclassical welfare economics theory, the law serves two functions: allocative and distributive. In its allocative function, the goal of the law should be to maximize wealth, or, equivalently, to obtain efficiency – to make the celebrated social pie as large as possible. Kaplow and Shavell argue that this should be the sole task of all private law subject matters, perhaps at least if important individual rights are not at stake. Then the tax system can be used to most efficiently redistribute the greater social pie resulting from step one. I have argued with my coauthor Jon Baron (McCaffery and Baron 2005) that such an approach can extend to tax as well: tax systems should be chosen for their efficiency properties.
and then redistribution should follow. (See also Gamage and Shanske 2010.) The issue is that a behavioral approach to tax calls any such neat bifurcation into question.

The most simple statement of the positive findings about tax law design canvassed above (which, like almost all behavioral economics findings, finds ready support in common sense and popular understanding) is that people do not like taxes. Politicians will search for low-salient taxes to fund the high-salient spending programs that people also like (more on this anon). Now there is a widespread tendency, even in the academy, to think that if tax and other public finance systems appeal to popular perceptions, it is a good thing. There is a psychic gain from putting the pain of tax in its most pleasing light. Thus a recent rash of scholarship, building on the rather limited findings of Chetty, Looney and Kroft (2009), has argued that governments “should” seek low-salient taxes, and take whatever steps needed to reduce their “political” salience as well (Galle 2013; Chetty et al 2009; Gamage and Shanske 2010, 2011; Schenk 2010). But this simple view of the matter seems incorrect, or at least far too quick, for several reasons.

First, psychologically pleasing taxes, including “low salient” ones, have real effects. In particular, they can be inefficient, which violates the first prong of the optimal welfare economics analysis. Chetty, Looney and Kroft (2009) consider a rather modest sales or value-added tax. But the corporate income tax in almost all developed economies is a better, bigger, and more pervasive example of a hidden tax. Although the tax seems to please people, (specifically in the sense that it does not strike them as a “tax,” or at least not one that they pay) a corporate tax has real effects on prices and other allocative decisions. If the distorting costs of the tax are higher than those of any alternative equal revenue raiser then, ceteris paribus, society is paying a real cost, in terms of welfare, for its psychic preferences. This is a straightforward application of the Kaplow-Shavell neoclassical welfare approach. The first prong of the optimal welfare economics approach (maximize the social pie) cannot be followed because the people will not accept efficiency-enhancing reforms; a potential pareto-improving reform is not taken.
The Chetty, Looney and Kroft (2009) and other related findings are not surprising. Much of behavioral economics suggests that individuals will underreact to, and perhaps completely ignore, a tax to be imposed later, even minutes later. But moving this fact out to any meaningful set of public policy recommendations is problematic at best. On one hand, it all seems rather obvious and unnecessary. Politicians have every incentive to choose low-salient taxes to begin with. This is a statement of the central problem, not the cure. Yet scholars have taken the Chetty, Looney and Kroft findings to argue that low-salient taxes have virtually no “substitution” effects and thus no costs whatsoever (Chetty 2009; Gamage and Shanske 2010). Low market salience taxes seem to promise a free lunch. (The public finance concept is that taxes have two effects: a substitution one, as to which goods or services are purchased, and an income one, from taking money away from people. The income effect is a pure “transfer,” so neoclassical economics tends to focus on the substitution effect, where misallocations can arise.) But of course there is no free lunch – it is a behavioral bias, an excessive degree of optimism, which leads anyone to think that there is or can be one.

The “use low-salient taxes” recommendation is thus another illustration of the dangers of an overly quick application of behavioral insights to tax law. It is quite a leap from the idea that buyers do not include, in the short term, taxes that later get applied to the goods they have selected, even where they are given information that the tax will be applied minutes later at the cash register, to the idea that there is “no” efficiency or substitution effect in such cases. Certainly, hiding the tax can mute the substitution effect, and it is possible that there could be no substitution effect at all if the taxpayer is not told at the proper moment about the tax. People continue to buy the now taxed good as before. But there will be an effect, at least an income effect, as discussed next. In this case, we can say in response to a statement that low-market-salient taxes have no substitution effects, and therefore should be chosen by a welfare-maximizing government, that “everything follows except the ‘therefore,’” because income effects are central to the normative analysis of tax systems. Further, query whether or not any “low” or “no” market salient tax would remain so.
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if the device were pushed out to an extreme, as a real-world political system, starved for revenue, would be motivated to do: a kind of “winner’s curse” (Thaler 1980) may haunt the tax system, whereby the taxes that best survive democratic political processes are the most flawed, from a normative perspective.

Continuing the analysis, note that second, equity can suffer in a move towards low-salient taxes. Equity can be pitted against efficiency in a tradeoff not mandated by an optimal approach. Even if there is no substitution effect from low market salient taxes, as the optimistic scholars argue, there must be an income effect, or the government is not raising the revenue that is the point of the whole exercise. This is especially true as “low” or “no” salience taxes are almost certain to be ones featuring a wide base and low rates. You can fool all of the people for a few cents here and there, but you cannot fool too many of them for too long over large sums. As noted above, individuals do not typically properly add together taxes to form consistent judgments about them. Again we see policymakers suffering from heuristics and biases themselves. When scholars are considering and arguing for low-salient taxes on the basis of their having “no substitution effect,” they are looking at small taxes on individual items, the pennies or at most cents added on at the cash register. But in moving out to discuss income effects, one should, rationally and fairly, consider the aggregate dollars lost to the tax, indeed, all taxes. A 10 percent sales tax added to some but not all goods in a grocery store may not lead an individual consumer to substitute away from taxable to nontaxable goods, as she rationally should. But a household that spends, say, $12,000 a year on groceries subject to the levy will have $1,200 less in its budget set over an annual period. Something has to give. There are or ought to be normative concerns.

In the abstract, psychically pleasing taxes may not, and generally will not, be as progressive as subjects themselves desire taxes to be. Chetty (2009) and others (Gamage and Shanske 2011) speculate that the income effect of low-salient taxes may not be distortionary if it results in the consumer cutting back on “luxury” items, or if the consumer is not “credit constrained.” Here again we see
cognitive biases in play. Gamage and Shanske (2011) rightly applaud the empiricism of Chetty, Looney and Kroft (2009). Yet atop a rather modest empirical finding they attempt to construct a prescriptive mountain, resting on . . . hopeful speculation. What low or middle-income consumer today, in any advanced democracy, already subject to a panoply of low-salient taxes, is spending a great deal of residual income on “luxuries” or is not “credit constrained”? Are these not the very same consumers and individuals, by and large, who are saving “too little” by their own lights, as the other principal behavioral economics inspired policy recommendation for tax law, that of tax-favored savings accounts, considered? But if people are saving too little, they are credit-constrained or at least have a non-luxury item, savings, to which to devote their resources. Yet the policy recommendation for low salient taxes is not to use the money “costlessly” appropriated from ordinary consumers to fund savings plans for these very same consumers. This concept is in fact intriguing, but one that could suffer from arbitrage and other problems (e.g., government appropriation). The policy reason behind the proposal is, rather, to use the tax revenue for a general economy in an age of massive fiscal deficits.

Gamage and Shanske (2010) argue, in the manner of Kaplow and Shavell (1994), that any skew in distribution from the imposition of low or no market salient taxes could be counter-balanced by changes to the residual tax system, such as the income tax. They do note a caution that “even when offsetting tax-rate adjustments are theoretically capable of resolving distributional concerns, political or administrative limitations may prevent the implementation of the offsetting tax-rate adjustments” (Gamage and Shamske 2010). Indeed, but reality is worse, and less hopeful than that quick statement would have it be. Precisely as persistent myopia, given the status quo, can undermine behavioral patches designed to address myopia, so could and almost certainly would salience undercut any attempt to offset low-salient broad-based, low rate level regressive taxes with other taxes. Those “other” taxes will be, by necessity, highly salient and concentrated ones. This is precisely the kind of tax increase that the proponents of the
proposal themselves would also find to be widely unpopular.

If the isolation or disaggregation effect were not so widespread, any equity effect from the widespread imposition of low-salient taxes may not matter all that much. Society could have as many regressive taxes or surcharges as it desired, as long as it had a single system, such as the individual income tax, in which to redistribute. But we have seen many times over that ordinary subjects will have a hard time understanding extreme progressivity in any single system, when viewed in isolation (McCaffery and Baron 2003, 2006). The reformer concerned with redistribution needs to look at all tax systems, individually, because the polity will not adequately integrate them. In the case of these low-salient tax policy proposals, the extent of the increase to the individual income tax needed to offset the lack of progressivity in any significant low-salient tax would have to be extreme – and hence, on this account, highly salient. If citizens do not support highly salient taxes, how can highly salient taxes be used to correct for low-salient ones? Recent political history in the United States, at least, for well over two decades now, suggests that it is virtually politically impossible to raise marginal tax rates under the individual income tax, the most salient, and progressive, major tax in existence (McCaffery and Hines 2010).

The same tension is evident in what has been called the privatization effect (McCaffery and Baron 2006). The two-part optimal welfare economics analysis suggests that efficiency, alone, should dictate whether or not government provides any particular good or service. However, because ordinary subjects once again have a difficult time integrating the effect of spending cuts, or government downsizing, on the residual tax system, bottom-line redistribution can suffer on account of even an efficiency-enhancing reform. The paretian constraint will not hold, the rich will get richer, and the poor, poorer. This is troubling.

Third, the resolution of public finance matters can be fragile, and volatile, as equivalent frames can shift public opinion. Instability in public finance systems is itself, ceteris paribus, a bad — a welfare-reducing phenomenon. Note that psychological studies suggest that preference shifts or
reversals can obtain with no change in the underlying substance. So, it is not a matter of people seeing the light and adopting “better” resolutions of public finance systems. People will simply choose more progressivity if they can be led to think in percent terms, and less in dollar terms; they will choose policies that can be understood as bonuses and reject them when they see them as penalties. This back and forth, on purely formal grounds, is problematic. Worse, it leads to another concern.

Fourth, given the importance of framing and related effects, politics will reward rhetoric over substance. “Great communicators” will be prized, not because they advocate “better” policies, but because they make their policies sound better to voters. In and of itself, this diverts political resources from the potentially welfare-enhancing study of substantive policy effects, to the purely formal rhetorical presentation of matters. And this leads, lastly, to an especially great concern.

Fifth, finally, and perhaps most disturbingly: a skilled politician or political party can manipulate public opinion and get a public finance system in place that is in conflict both with the public good and with prevalent democratic preferences. Suppose that some politician or party wanted to reverse the course of a particular society and reduce the degree of redistribution prevailing throughout a public finance system. Insights from behavioral economics provide an eerie road map for success. Many findings suggest that a policy position to lessen social redistribution would likely lose in a straight up or down vote, both because the majority of people favor at least moderate redistribution and because of a persistent status quo bias. But the rhetorically skilled politician could influence a collective preference reversal. She might first choose hidden or low-salient taxes, with a regressive incidence, and raise money through a series of relatively flat surcharges that are not labeled as taxes. People would support these, and a surplus might even result. Larger surpluses might follow from selective “privatization” of current publically provided goods and services, reducing the need for taxes. Cuts could then be made to the most salient tax alone, the individual income tax, and that tax could be brought to reflect moderate progressivity, even as
its importance in the overall budget declined. Indeed, the politician could take this all a step further, and separate out the topics of tax and spending cuts, cutting taxes (again, the highly salient income tax) now, and postponing spending cuts until later. The resulting deficit, itself a form of a hidden tax, would curtail government growth, and could lead to replacement taxes that are less progressive (and salient) than the initial baseline. And so on: we would wake up one day with a smaller government, less dependent on the single remaining progressive tax system, and that tax system would continue to have only moderate levels of progressivity while various replacement taxes were more regressive. Over all, this series of steps would lead to dramatically less redistribution than the people themselves wanted, at the outset, and the cumulative changes would also fail to meet the basic paretian constraint.

Of course, the astute observer might notice that this is what has been done in the United States, beginning with Ronald Reagan in 1981.

4.3. A Case Study

I shall use a more recent and specific example to illustrate some of the points just articulated. As the United States careened toward a self-created “fiscal cliff” set to obtain on January 1, 2013, the press was full of febrile leaks and rumors of impending deals between the Obama Administration and the Democrats, on one side, and the House Majority Leader John Boehner and the Republicans on the other side. Both sides faced a problem, and a strictly rhetorical one: How to “score” the tax changes being considered.

A large reason behind the fiscal cliff “crisis” was that the tax cuts of 2001 and 2003, ushered in during the administration of President George W. Bush, were each set to expire on January 1, 2013, meaning that there would be a return to the higher tax rate levels that obtained in the year 2000. Both political parties clearly and consistently agreed that “no taxpayer earning less than $250,000” should see a tax increase. There was therefore no real chance that what Congress would ultimately enact would be anything other

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8 This subsection draws from McCaffery (in progress).
than a tax *cut*, on balance; elected officials were not going to let the tax cuts expire for the masses. Since, as the law stood, all income taxpayers were set to face a tax *increase*, and since all political roads were leading to a resolution in which only *some* of them would get the tax increase that was due (that is, the “rich,” or “high-income”), the new law cutting the taxes of most while leaving in place the already legislated tax increases of a few would have to be a tax *decrease*. This is indeed how the Congressional Budget Office officially “scored” the ultimate law. Only that would not do, politically.

So both sides, happily aided and abetted by the media, began talking about what they were doing in terms of making changes from the 2012 baseline – 2012 being a year in which both the 2001 and 2003 tax cuts were in full force and effect. Consequently, this conceit stood the legal reality on its head perfectly: it “scored” the tax changes to be enacted as if the Bush era tax cuts were *permanent*, as opposed to what they were, which was *expiring*. But, more importantly, it would allow both sides to claim a tax increase on the rich from the failure to extend their tax breaks, while not highlighting the sound analytic fact that everyone else was getting a tax cut.

This might just be another story of business as usual inside the Beltway, not playing a major role in this chapter, except for the twists and turns occasioned by one other further inconvenient truth. Taxes on January 1, 2013 were *also* set to go up by virtue of the expiration of the “payroll tax holiday” that President Obama had enacted for 2011, and which Congress had extended (in late 2011) for 2012. The “holiday” was a two percent break (in absolute terms) from the 6.2 percent employee share of the social security payroll tax, applicable to earnings (in 2012) up to approximately $110,000 per individual. The “holiday” could thus save an individual over $2,000 and $4,000 for a couple, each member of whom earned $100,000. This provision was set to expire just like the Bush tax cuts. Only both sides, Democrats and Republicans, very quietly agreed to let it die a quiet death.

The resolution of the rhetorical embarrassment, occasioned by the fact that what Congress was doing was actually a tax *decrease* in a time of fiscal crisis, was to use a
2012 baseline to measure increases off of it. This same accounting construct (measuring changes from 2012’s law) would allow President Obama to count the tax increases from the payroll tax holiday’s expiration as tax increases. This would seem to be a good thing, as politicians were scrambling to meet proposed revenue-raising targets. More specifically, President Obama led off the negotiations with a proposed revenue-raising target of $1.6 trillion over ten years -- all tax increases get scored over a ten year period, these days. Republicans had countered with $800 billion, and both sides seemed to be inching towards the obvious and inevitable compromise figure of $1.2 trillion.

The optics of meaningful aggregate tax increases and deficit reduction, not to mention logical consistency, suggested “counting” the payroll tax increase. But the optics of redistribution suggested otherwise; in order to maintain a rhetorical claim about the “top two percent” bearing all of the new burdens. The truth was going to be what it was: the payroll tax holiday was going to expire, but the (misleading) optics of redistribution prevailed. The Obama Administration did not “count” the tax increases from the payroll tax holiday’s expiration as part of the fiscal cliff tax increases, although this meant, logically, the numbers being used could only be described as “tax increases over a 2012 baseline, but not including matters not addressed in a new law,” or something similar. The Republicans, hardly chafing at the bit to tout any tax increase, readily played along.

What are the dollars and cents of all of this? Official sources and the mainstream media reported tax increases from the law ranging from $600 to $700 billion (a sum total below even the Republicans’ opening bid), almost all falling on the “rich” in some sense. Here is an illustrative description, from the progressive group, Center for American Progress (2013):

The American Taxpayer Relief Act of 2012—the fiscal cliff legislation agreed to in a deal between President Obama and Senate Minority Leader Mitch McConnell (R-Kentucky)—will raise approximately $617 billion
in higher revenues from 2013-to 2022, compared to what the tax code would have generated if we had simply extended all the Bush tax cuts, which were scheduled to expire at the end of 2012. More than 90 percent of the increase will come from households making at least $1 million a year. (Emphasis supplied)

As for the expiration of the payroll tax holiday? This was estimated to bring in an additional $100 billion per year or $1 trillion over a decade, meaning President Obama could have claimed to make his $1.6 trillion mark after all. But he did not, because only a very small percent of the $1 trillion gained from letting the payroll tax cut expire would come from households making at least $1 million a year.

In sum, roughly 62.5 percent of the aggregate tax increase in the fiscal cliff package came from a tax that applies only to wage earnings and which has a floor of zero (meaning it applies to the first dollar earned, regardless of family size or anything else) and a ceiling of $110,000. But this major tax increase was not listed in the official reports or scoring, in order to maintain a rhetorical claim that 90 percent of the tax increases would fall on millionaires only. We end up with not so much a hidden tax, although the payroll tax is much better hidden than the income tax in multiple regards, but rather a hidden tax increase, buried in the self-serving rhetoric of both parties inside the Beltway. This is what politicians do with their behavioral approach to tax law design.

5. Fiscal Balance

The final application, or potential application, of a behavioral economics approach to tax law concerns the wider question of fiscal balance, now arguably the major issue facing advanced capitalist democracies worldwide. In some sense this is simply an instance of the prior topic (tax law design) because a failure to generate adequate revenues is a primary cause of the sovereign debt crises brewing globally (and this view of the problem has been explicitly
invoked in defense of the low-salient tax policy recommendation (Schenck 2011)). But the comprehensive importance of the subject matter warrants separate attention, and also brings in the other side of the fiscal equation: government spending programs. Behavioral economics, in its canonical findings such as loss aversion and the status quo bias, are clearly relevant to this piece of the puzzle. See Zamir (2012) and this volume, discussing inter alia loss aversion and its relevance to the “tax expenditure” budget — tax expenditures being a form of government spending through tax breaks, itself both a widespread phenomenon and one rife with behavioral elements.

Various polls and other experimental findings support the idea that most individuals, out of context and in the abstract, support balanced budgets (Baron and McCaffery 2008). Yet we do not make decisions in the abstract, and policies do not take effect out of context. How can deficits get started in a democratic citizenry that opposes them? Behavioral economics supplies a set of answers. The key is to match specific tax cuts today, which individuals will support out of tax aversion, with the abstract, general idea of spending cuts tomorrow, which individuals will also support today. On one hand, if tax cuts today must be matched by specific spending cuts today, then an opposition to both specific spending cuts and to deficits is likely to preserve the status quo of balance. On the other hand, if the tax and spending decisions can be separated in time and (logical) space, then the specificity of the spending cuts can recede, and a disaggregation bias effect can take hold. Individuals tend to focus on the tax cuts alone, whereas a generic tax aversion will lead them to support cuts, resulting in a budget deficit. Once this deficit is created, the preference for fiscal prudence causes people to want to raise taxes and limit spending. But these desires are not strong enough to reduce the deficit to zero, even when people are asked about the “long run.” And a more persistent and pervasive status quo bias means that it will be difficult to ever obtain fiscal balance once deficits have become accepted.

The classic element of a behavioral approach, inconsistency, is present here. The inconsistency does not seem to follow from a simple optimism bias. It is not that
people have a naive belief that things will be better tomorrow, and deficits will miraculously be closed without the pain of tax increases or spending cuts. Rather, it is a failure to properly anticipate the depth of the difficulty in making specific cuts tomorrow — the depth, that is, of an *endowment effect*. At a high level of generality, deficits arise or increase when specific (salient) tax cuts go along with abstract (non-salient) sets of spending cuts. This conceptualization suggests two broad ways for governments to avoid deficits. One is to keep everything abstract: to pass laws in the form of constitutional restrictions about balanced budgets, a form of collective self-binding to the mast (Elster 1984). Many state governments in the United States are indeed required to have balanced budgets each year, and the United States government has occasionally tried to bind itself in advance by various budgetary rules. This approach could also have the virtue of making a non-elected body, (the judiciary) the “bad cops,” playing the role of an arbitrage mechanism to help debias the citizenry away from its pervasive biases. Central bankers around the world, or collective entities such as the European Union or International Monetary Fund (IMF) might play this role, too, imposing “austerity conditions” on member states, or as a condition of financing. These tactics have had mixed political and financial success to date, but also point towards a depressing fact — democracy itself might have to be curtailed because of the widespread and harmful effects of behavioral biases on fiscal systems.

An alternative takes the opposite approach: to make everything concrete and specific. We could break taxes down into categories earmarked for particular services, such as, nominally, in the case of the various wage taxes in the United States (which are earmarked for social security payments and the like). If citizens come to think of each tax as linked with a particular service, they may be less willing to cut taxes; indeed, this could explain why the social security and Medicare tax in the United States, now the largest tax for most American taxpayers, the one major federal tax that has never been cut until just two years ago. This alternative would probably lead to a larger, more active government than the first method (binding in the abstract).
These are complex and difficult topics, which point to ultimately complex and difficult political solutions or cures. But these are also ideas worth exploring, in the ongoing quest for a practical, real-world and normative role for a behavioral economics approach to tax law. It is past time to accelerate the pace of our thinking about behavioral economics and tax.

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