

## BEHAVIORAL PUBLIC FINANCE CONFERENCE

The Office of Tax Policy Research recently co-sponsored a conference with the USC-Caltech Center for the Study of Law and Politics entitled “Behavioral Public Finance: Toward a New Agenda.” Approximately 50 people attended the conference held on April 23–24, 2004 in Ann Arbor, Michigan. The conference featured twelve papers from leading scholars in economics, law, and psychology describing the latest empirical, theoretical, and normative research on the application of behavioral economics to tax and government expenditure programs. One of the main goals was to begin to sculpt an agenda for this nascent field by relating the research to a set of key questions. The research ranged in approach from theoretical investigations to field experiments to laboratory experiments to econometric analyses. The conference discussions were highly interactive and highlighted the advantage of an interdisciplinary approach to these questions. Funding for this conference was provided by the Russell Sage Foundation and The Lynde and Harry Bradley Foundation. Descriptions of the papers follow.

### Statistical and Identifiable Victims: New Findings and Implications for Public Finance

*Deborah A. Small, Carnegie Mellon University*  
*George Loewenstein, Carnegie Mellon University*

This paper presents results from a series of studies designed to examine different facets of the identifiable victim effect—the tendency for people to care about more and contribute more to identifiable victims than to otherwise comparable statistical victims. The studies include (1) laboratory and field studies showing that simply *determining* victims, even without revealing any information about them, increases concern and contributions; (2) studies showing that there is an analogous *identifiable perpetrator effect*, suggesting that identifying people generally tends to intensify emotional reactions to them; (3) studies showing that the effect is mediated by greater *emotional* reactions toward identified than toward statistical victims; and (4) studies examining the

impact on sympathy toward identified and statistical victims of teaching people about the identifiable victim effect. The paper discusses implications of these findings for public finance.

### Distinguishing Between Cognitive Biases: Beliefs vs. Time Discounting in Welfare Program Participation

*Hanming Fang, Yale University*  
*Dan Silverman, University of Michigan*

This paper presents a simple model of welfare program participation that nests two well-documented cognitive biases that economists have recently incorporated into their analyses: projection bias and present bias. In the context of this simple model, we show that standard data can be used to distinguish the projection bias from present bias model, and each from a standard model. This result also suggests an alternative, reduced form method of distinguishing between these two biases that exploits the fact that agents in the two models may exhibit different *ex ante* and *ex post* attitudes toward restrictions on welfare eligibility such as time limits.

### Optimal Policy to Influence Individual Choice Probabilities

*Eytan Sheshinski*  
*The Hebrew University of Jerusalem*

This paper presents a model in which government may affect outcomes by manipulating individual choice probabilities through the design of the domain of choice or the use of fiscal instruments. Such manipulations

#### *In This Issue*

BEHAVIORAL PUBLIC  
FINANCE CONFERENCE

OTPR IN EUROPE

are ineffective when individuals are perfectly rational, provided all alternatives are permitted. However, even a small deviation from perfect rationality is shown to call for policy that substantially manipulates choice probabilities. This policy aims to lend weight to alternatives preferred by individuals who are prone, more than others, to make mistakes.

At very low levels of rationality, when choices are largely random, it is always socially optimal to entirely eliminate individual choice in order to prevent the errors generated by such choice. It is better to impose one alternative that is not the preferred one for some individuals instead of inducing a completely random draw by everybody.

### Masking Redistribution (or Its Absence)

*Jonathan Baron, University of Pennsylvania*

*Edward J. McCaffery, University of Southern California Law School and California Institute of Technology*

Research has shown that people vary widely in their support or opposition to progressive taxation. This paper argues that the perception of progressiveness itself is affected by the nature of the tax system and by the way it is framed, or presented. Experiments conducted over the World Wide Web and using within-subject design demonstrate that subjects suffer from a range of heuristics and biases in understanding and supporting progressive or redistributive taxation. After reviewing some prior results, we report three new studies. Two of them indicate that people do not sufficiently appreciate the reduction of progressiveness that results from the use of tax deductions to partly reimburse private expenditures. The third indicates that people do not fully appreciate the reduction in progressiveness that results from cuts in government services.

### Does the Political Process Mitigate or Accentuate Individual Biases Due to Mispredicting Future Utility?

*Bruno S. Frey, University of Zurich and CREMA*

*Alois Stutzer, University of Zurich and CREMA*

In important situations, individual decision making is systematically biased. When deciding (rather than consuming), extrinsic attributes of choice options are more salient than intrinsic attributes. People overestimate extrinsic attributes and therefore put too much effort into acquiring

income and gaining status, lowering their utility level. These mistakes are accentuated in authoritarian systems and at least carried forward in a perfectly competitive democratic system of party competition. In modern democracies, public discourse puts people's partial awareness of their anomalous behavior on the political agenda. Various policies can help people to overcome biases due to misprediction.

### Hyperopic Tax Preferences

*Lee Anne Fennell*

*University of Texas School of Law*

People often behave myopically, discounting the future excessively or hyperbolically. However, sometimes they appear to do just the opposite, excessively weighting the future over the present. I term this latter bias "hyperopia"—the opposite of myopia. This paper examines the relevance of hyperopic time preferences to taxpayer behavior and to public finance generally. It seeks to provide a better positive account of a familiar puzzle—income tax overwithholding—by examining the behavioral antecedents of this apparently hyperopic conduct. The paper suggests that time preferences work poorly as final explanations, but can point us to underappreciated behavioral and contextual factors that might be driving the conduct.

An understanding of hyperopic tax preferences can inform law and policy design in the public finance arena. Translating psychological insights about time preferences into normative suggestions requires confronting tensions introduced by interpersonal and intrapersonal heterogeneity in time preferences and, even more importantly, in the behavioral and contextual factors driving those preferences.

### Value Added Tax Compliance

*Paul Webley, University of Exeter*

*Caroline Adams, University of Plymouth*

*Henk Elffers, Netherlands Institute for the Study of Crime and Law Enforcement*

These studies aimed to uncover the factors that influence value added tax (VAT) compliance in the United Kingdom. Four different studies are described. In the first study, three groups of business people were interviewed (restaurant owners, flooring retailers, and builders). Three important factors emerged from these interviews—feelings of inequity, the significance of sanctions, and mental accounting (the 'ownership' of VAT monies). The second

and third studies (large survey studies of restaurant owners and floor retailers which combined information from questionnaires with information on compliance provided by the UK tax authorities) showed that equity, mental accounting, and guilt are also important factors in predicting compliance. The fourth study explored the role of mental accounting and equity experimentally, through a Web-based simulation and show that both these variables are relevant.

### Fewer Audits, Less Cheating?

*Terrence Chorvat*

*George Mason University School of Law*

This paper examines how the institutions facing taxpayers frame tax compliance decisions and how these frames affect their decisions. The paper discusses how both enforcement and reciprocity based mechanisms might increase tax compliance, however reciprocity based mechanisms have additional beneficial effects and therefore ought to be preferred when a choice is to be made between them. It presents a model which incorporates the effects of trust and incentives not only on the tax compliance decision, but also on the level of trust in society as a whole. The model is based on psychological and neurological evidence, as well as evidence from economic experiments. This model illustrates how trust-based tax systems can either increase or decrease social welfare depending on the level of pre-existing trust, as well as expectations concerning what is appropriate for the government to do.

### The Artful and the Artless Dodger: Responses to the Challenge of Instrumental Tax Evasion

*John Cullis, University of Bath*

*Philip Jones, University of Bath*

*Alan Lewis, University of Bath*

The conference presentation is in two parts. In the first part results from a experimental/questionnaire study are presented assessing instrumentality, framing, and socialization effects on the tax evasion decision. It seems that some framing effects allied to prospect theory are “universal” in this domain while instrumentality is unevenly distributed across individuals, regardless of the motivating instructions participants receive. In the second part, a model of the tax evasion decision is developed as a least-cost solution, where people are assumed to be more than narrowly self-interested.

### Accounting for Social Security Benefits

*Howell E. Jackson*

*Harvard Law School*

This paper addresses the personal statements that the Social Security distributes to Social Security participants each year. Consistent with the cash-flow accounting of the Trust Funds’ annual reports, these personal statements describe Social Security benefits in terms of monthly cash payments to be paid once participants reach retirement age or otherwise become eligible for benefits. The paper reviews the strengths and weaknesses of the current structure of Social Security statements and then describes how these statements could be modified to include estimates of the current and projected accrued value of Social Security benefits for individual participants. In addition to making Social Security statements more comparable to the financial statements for 401(k) plans and other sources of retirement income, such a change in Social Security statements would give participants a more accurate measure of the value of Social Security benefits and would facilitate comparisons with alternative benefit arrangements available under proposals to substitute individual accounts for traditional Social Security benefits. The paper concludes with a review of several potential drawbacks of reforming Social Security statements in this manner, including the possibility that such statements would make it more difficult to change Social Security benefits in the future and the political implications of making redistributive aspects of the Social Security system more transparent.

### The Path of Least Resistance

*James Choi, Harvard University*

*David Laibson, Harvard University and NBER*


*Brigitte Madrian, University of Pennsylvania and NBER*

This paper assesses the impact on savings behavior of several different 401(k) plan features, including automatic enrollment, automatic cash distributions, employer matching provisions, eligibility requirements, investment options, and financial education. We also present new survey evidence on individual savings adequacy. Many of our conclusions are based on an analysis of micro-level administrative data on the 401(k) savings behavior of employees in several large corporations that implemented changes in their 401(k) plan design. The analysis identifies a key behavioral principle that should partially guide the design of 401(k) plans: employees often follow “the path of least resistance.” For better or for worse, plan administrators

can manipulate the path of least resistance to powerfully influence the savings and investment choices of their employees.

## Toward an Agenda for Behavioral Public Finance

*Edward J. McCaffery, University of Southern California Law School and California Institute of Technology*  
*Joel Slemrod, University of Michigan*

This essay sets out an analytic structure for behavioral public finance based on three broad, but not exhaustive, aspects of behavioral public finance: 1) form and framing, 2) self-control and present-biased preferences, and 3) tax compliance and overcoming the free-rider impulse. The paper develops the implications of these three categories for both positive and normative public finance. The challenge posed by this potential new field is simple to state: Does consideration of these aspects of behavior change the answers to traditional public finance questions, and/or introduce important new questions to be asked? 

## OTPR IN EUROPE

During the 2003–2004 academic year OTPR Research Director James Hines is on leave from the University of Michigan and visiting the London School of Economics. This spate of interjurisdictional mobility affords him the opportunity to view from close range the formation and effects of European tax policies.

Professor Hines reports that the clearest effects of European taxes are to be found in Dublin, Ireland, where he visited Trinity College in the fall, where the corporate tax rate is a mere 12.5 percent, and where economic activity has, as a consequence, been growing rapidly for the last 25 years. Corporate tax rates are significantly higher elsewhere in Europe, a fact not lost on some European governments who prefer harmonization of tax bases and tax rates within the European Union (EU). Current EU rules require unanimous decision making in tax matters, which in practice currently permits countries such as Ireland to feature favorable business tax climates without undue interference from the EU. Among the countries joining the EU in 2004 is Estonia, with no corporate tax at all, thereby contributing to the heterogeneity of tax regimes. Two looming developments that might change this tax landscape are the new European constitution, now in draft stage, and increasing tax activism on the part of the European Court of Justice, whose legalistic and sweeping pronouncements on tax policies cannot be vetoed by individual EU members.

The desirability of tax competition within a federation has been the subject of extensive theoretical and, more recently, empirical research. Professor Hines has taken time from his busy travel schedule this year to do some of both, summaries of which will appear in future issues of *Tax Research News*.



### Office of Tax Policy Research

**University of Michigan Business School**  
 701 Tappan Street, Room A2120  
 Ann Arbor, MI 48109-1234  
 (734) 763-3068  
 fax (734) 763-4032  
<http://www.otpr.org>  
 Joel Slemrod, Director  
 James R. Hines Jr., Research Director  
 Mary Ceccanese, Coordinator

### *Regents of the University of Michigan:*

David A. Brandon, Ann Arbor  
 Laurence B. Deitch, Bingham Farms  
 Olivia P. Maynard, Goodrich  
 Rebecca McGowan, Ann Arbor  
 Andrea Fischer Newman, Ann Arbor  
 Andrew C. Richner, Grosse Pointe Park  
 S. Martin Taylor, Grosse Pointe Farms  
 Katherine E. White, Ann Arbor  
 Mary Sue Coleman, *ex officio*

The University of Michigan, as an equal opportunity/affirmative action employer, complies with all applicable federal and state laws regarding nondiscrimination and affirmative action, including Title IX of the Education Amendments of 1972 and Section 504 of the Rehabilitation Act of 1973. The University of Michigan is committed to a policy of nondiscrimination and equal opportunity for all persons regardless of race, sex, color, religion, creed, national origin or ancestry, age, marital status, sexual orientation, disability, or Vietnam-era veteran status in employment, educational programs and activities, and admissions. Inquiries or complaints may be addressed to the University's Director of Affirmative Action and Title IX/Section 504 Coordinator, 4005 Wolverine Tower, Ann Arbor, Michigan, 48109-1281, (734) 763-0235, TDD (734) 647-1388. For other University of Michigan information call (734) 764-1817.