Tax puzzles the US experiences

- Why have Americans severely limited the estate and gift tax - ostensibly targeted at only the very wealthy - but greatly expanded the subsidies to low-wage workers through the Earned Income Tax Credit?

- Why do social commentators bemoan the rise of inequality, but ordinary individuals routinely embrace the astronomical salaries paid to sports stars and entertainers?
Why do people hate the property tax so much, yet seemingly revolt against it only during periods of economic change?

Why are some groups of taxpayers more obedient to the tax authorities than others, even when they face the same enforcement regime?

Why do many people “chisel” on their taxes but some non-compliers suddenly become social pariahs?
In tax policy, we give great deference to expert ideas of fairness and justice:
- Economists, philosophers, legal theorists.
- Focus is often primarily distributional.

Everyday notions of justice or folk justice differ in important ways from expert ideas of justice:
- These have a psychological foundation and behavioral roots.
- Focus is often process or procedure.

Since actual tax policies are formed in a political environment, we have to be sensitive to the differences between these two ideas.
Questions raised today

- What are the primary psychological foundations of folk justice?

- Do concepts of folk justice have explanatory power for important areas of taxation?

- How can behavioral insights influence our thinking about the role of tax agencies?
Psychological foundations

Five areas in the psychology of justice and fairness that are quite relevant for tax policy. Each has a well-established empirical basis.

- **Procedural Justice**
  - Fairness in process and respectful treatment
  - Voice (ability to express one’s opinion)

- **Equity and Social Exchange Theory**
  - Fair relation of inputs and outputs in social exchanges enforced

- **Qualified Perceptions of Fairness**
  - Familiar results from ultimatum game
  - Qualified by sense of property rights and entitlements

- **Moral Mandates**
  - Outrage beyond mere fairness or violation of process
  - Leona Helmsley, Stanley Tools inversion, Bernard Madoff

- **System Justification Theory**
  - Need to justify position in social realm. “Just world”
  - Stronger during “bad times”
Examples we will consider today

- Psychology and tax compliance
- Equity theory and structure of income taxation
- Macro behavioral economics for agencies
Taxpayer compliance

- Expert theory
  - Standard deterrence model (evasion is a gamble)
  - Debate about empirical applicability

- Public opinion
  - Strong evidence for existence of tax morale
  - Process matters
  - High levels of moral outrage
    - Individual (Helmsley)
    - Corporate (Tax Shelters)
Psychology and compliance

- Procedural Justice, Process
  - Tale of Kalgoorlie Miners in Australia and garden-variety tax shelters
  - What mattered was violation of fair sense of process

- Procedural Justice, Voice
  - Experimental work on public goods and compliance
  - Empirical work of voter participation and compliance (Feld, Frey and others)

- Qualified Fairness and Equity Theory
  - Large body of literature that shows perceptions of others’ contributions and general compliance levels matter
Equity theory and income taxation

- Expert opinion focuses on redistribution
  - Mirrlees tradition
  - From Kaplow
    - Most social welfare functions imply lots of redistribution
    - Optimal tax theory suggests having high inframarginal rates and having a number of non-workers. More efficient than high marginal rates

- Public opinion
  - Quite split on redistribution
  - Prefer direct spending on poor (e.g. food stamps)
  - Support workfare even it is presumptively inefficient
Survey data on redistribution (Tax Foundation)

“Would you support or oppose the government redistributing wealth by a much higher income tax on high income earners?”

Figure 1: Support for Government Redistribution

Note: 119 respondents who were "not at all sure" are excluded from the table.
Evidence of self interest
NPR-Kennedy School-Kaiser survey

Table 1
Government Should Reduce Differences in Income Between:

<table>
<thead>
<tr>
<th></th>
<th>High and Low Income People</th>
<th>High and Middle Income People</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>[1]</td>
<td>[2]</td>
</tr>
<tr>
<td>Strongly Disagree</td>
<td>246</td>
<td>203</td>
</tr>
<tr>
<td>Somewhat Disagree</td>
<td>123</td>
<td>106</td>
</tr>
<tr>
<td>Don't Know</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>Somewhat Agree</td>
<td>126</td>
<td>124</td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>160</td>
<td>204</td>
</tr>
<tr>
<td>Refused</td>
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<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>678</td>
<td>661</td>
</tr>
<tr>
<td>Weighted Mean</td>
<td>2.99</td>
<td>3.26</td>
</tr>
</tbody>
</table>
Explaining income tax perceptions

- Equity and exchange theory suggest natural limits to redistribution. Fairness tempted by sense of earnings and entitlements.

- What about workfare? Equity theory
  - Concerns about “shirking” from near neighbors which would be a sharp violation of equity theory

- Mickey Kaus: “The American ‘welfare state’ is not really a welfare state—in the American sense of welfare—at all. Most government programs have been ‘work tested’ since their inception.”
Traditional Behavioral Economics

- Traditional BE largely rooted in cognitive psychology from Kahneman and Tversky
  - Heuristics and Biases literature
  - Framing
  - Prospect Theory

- A second major front was time-inconsistency and self control
  - Can be seen as a problem of intertemporal decision making with non-exponential discounting
  - Importance of Present-Biasedness
Gold Standard Implications

- The most significant and replicable findings from behavioral economics
  - Loss Aversion (can be derived from Prospect Theory)
    - Endowment effect
    - Status-quo bias
  - Present Biasedness (beta-delta models)

- Suggested leverage for policy and incentives
  - Frame incentives as losses
  - Place incentives up front in time
  - Recent work by Levitt et. al on student learning and teacher incentives.
  - Use of defaults (status quo bias) (opt-in; opt out)
  - Has explanatory power for taxpayer behavior (e.g. erring on side of getting refunds)
But much more social psychology in behavioral accounts

- Numerous studies (including for taxes) have included:
  - Peer effects (electricity use)
  - Dual systems (activating market vs non-market norms)
  - Reciprocity (positive and negative)
  - Trust (in securing social cooperation)
  - Social norms (conformity experiments)
  - Perceived fairness (in compliance)
  - Resources directed to public goods/charities (compliance experiments)
- Much of this relates to folk justice
  [Sheffrin, Tax Fairness and Folk Justice]
At best, bronze standard

- Just as psychology has many contested theories, the social part of behavioral economics also has many competing explanations, controversies.
- Controversy over replicability of “priming” studies in social psychology. Kahneman open letter warning the field. “For all these reasons, right or wrong, your field is now the poster child for doubts about the integrity of psychological research,
- Calls for the use of random controlled trials (RCT) to see “what works” in the field.
New Direction: Macro Behavioral Issues

- **Macro** behavioral issues can be defined as actions taken by an organization that define the character and perception of the organization as seen by the public and stakeholders.

- In turn, the character and perception of the organization may affect social interactions and organizational effectiveness.

- Attitudes toward organizations could be trust, fear, responsiveness, efficiency, or reliability.

- A series of micro actions taken as a group could generate unintended macro consequences.
First Macro Example

Two System Issues

- Return to the two system issue: Do market interactions override non-market social systems?
- Or, do market incentives override intrinsic motivation?
- Long history of this debate/experiments in social psychology and economic contexts.
  - Titmuss paying for blood donation controversy
  - Israeli daycare example (fine is a price)
  - Low incentives can reduce performance in incomplete markets (Fehr and Gachter) or for routine tasks (Deci, Hidden Costs of Rewards)?
- Implications for IRS and enforcement?
Two Systems: Tax Context

- Two system issue recently reviewed by Leandra Lederman with regard to tax enforcement.
- While endorsing enforcement overall, she did worry about effects of “no-change” audits on subsequent decline in reporting income.

Hypotheses

INFORMATIONAL
- New information about IRS capability
- Got away with it (IRS did not find all non-compliance)

PSYCHOLOGICAL
- Adverse effect on tax morale (loss of intrinsic motivation)
- Chump (IRS does not know much, others must be cheating)
Second Macro Example

- Rapid and escalating growth of IRS phone scams
- Headlined “Dirty Dozen” in 2016
- As of Feb 2016, Inspector General was aware of:
  - 896,000 contacts since October 2013
  - 5000 victims
  - $26.5 million paid out

- Since then, even more. Massive Indian call-center arrests and hard to believe systematic use of iTune gift cards used as cash conveyance instruments.
This message is for Kiran Sheffrin. Hi Kiran this is Officer Charlie King and I am calling you from tax audit department of IRS. Now the nature of my voicemail is to inform you that we have received a legal notification notice against your name so before this matter goes to the federal claim courthouse and before you get arrested, call us back at our number 669 978 1047. I repeat it’s 866 978 1047 Don’t disregard this message and do return the call as soon as possible. Have a great day!
What does this fraud epidemic tell us?

- Basic Question:

**WHY THE IRS?**

And *not* the power company, cable company, Social Security Administration, or City Hall.
This fraud is different—based on fear

- Most scams and frauds are based on **GREED** e.g. Nigerian email scams, “lost” money to be found.

- Social engineering techniques (such as generating reciprocity or familiarity) often play off greed.

- But here we have **FEAR** (go to jail, be arrested, be deported)

“Why is it so easy for people to believe that the IRS is about to arrest them for a crime they weren’t even aware of having committed?” Megan McArdle
Why it works?

Alternative Hypotheses:

- **Effective social engineering techniques**
  - Using 202 area codes, official sounding names, generating gratitude for settling a potential claim.
  - Possessing other information (home address, SS number)
  - Free-floating guilt of undetected actions

- **Perceptions of IRS and Tax Law**
  - IRS power is unbounded.
  - IRS agents are extremely aggressive.
  - Kafkaesque complexity so you never know if you have filed correctly.
Macro Considerations

- The public does not have complete information about the motives and operations public agencies (e.g. IRS).
- Neither do public agencies have complete information about themselves and their dispositions. (Particularly for large and multi-tasked organizations)
- Related to idea of self-signaling in economics and psychology where actions reveal underlying dispositions to self and others (Prelec, Benabou-Tirole)

**LEADS TO QUESTIONS**

- What image does an agency wish to create?
- What scope of actions will generate the self-image that the agency desires?
Macro Questions for IRS

DESIRED IMAGE? WISH TO BECOME LIKE

- Public utility company (with right to shut off power)?
- Centers for Medicare and Medicaid or SSA
- Local police or J. Edgar Hoover FBI?

ACTIONS TO REACH THAT IMAGE?

- Communication strategy (just use letters or 21st century social media?)
- Auditing strategy and methods (TCMP or NRP?)
- Enforcement strategies (quiet or noisy?)
- Scope of agency tasks (reach overtly political areas?)
Asking the Questions?

- **How** should these questions be posed?
  - It is not just agency PR but goes to underlying effectiveness

- **Who** should address them?
  - Agency executives?
  - Taxpayer Advocate?
  - Principals (Congress, White House) who can structure incentives to affect image of agencies?

- **What data** should be collected to answer them?
  - Public surveys?
  - Stakeholder input
One positive example

- State tax agencies often do not attract the same animus as IRS. **WHY?**
- California Franchise Tax Board.
  - Customer focused at top management created culture
  - Interested parties meetings for regulations held to all parties exhausted themselves.
  - Systematic and serious outreach to preparers, taxpayers.
  - Open meetings to air complaints about audits.

- This similar level of intensive participation (procedural fairness) and consultation worked in tax reform contexts—e.g. Wales revaluation under council tax. (Sheffrin Folk Justice)
Take away messages

- Need to consider folk justice
- Insights from behavioral economics, can take us in three directions
  - Exploiting predictable biases (loss aversion, present biasedness) to lever policy or explain behavior
  - RCT’s to explore administrative interventions
  - Macro-behavioral effects to shape the character of an institution
    - Least developed in behavioral literature, but bears a family resemblance to organizational behavior. Perhaps biggest payoff.