

## Do Incentives Affect Behavior? Would an Economist Know?

By Gene Steuerle

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As part of their effort to examine the effect of policy incentives on behavior, my colleagues at Tax Analysts asked me to jump into the fray. As a card-carrying member of the “I don’t know” school of economics — a school promoted by the famous economist Herbert Stein — I should probably just pass on the assignment. But the more I think about it, the more I realize that I do have something to say, which largely centers around being wary of claims made by many economists on that subject. Of course, there is a danger of hubris in my stance as well. I am reminded of Socrates’s wonder why the Delphic oracle found him wiser than many of his fellow citizens, and his conclusion that it had to be because he was wise enough to realize that he wasn’t wise. So am I claiming that I know more about what I don’t know than many economists know about what they do know? I don’t know.

Several trends in recent decades have converged to give economists great weight in debates over incentives. Modern economists’ training puts extraordinary emphasis on issues of efficiency, which largely center on the opposite — barriers to efficiency including tariffs, taxes, agents who represent their own and not their clients’ interests, monopoly, pollution that has no cost to the polluter, disincentives to work in government expenditure programs, and so forth. Dissertations in fields such as public finance typically examine distortions in the economy caused by some set of incentives or disincentives as well as explore whether there are ways through public policy to use incentives to promote policy objectives while minimizing or removing distortions.

At one level the theory is relatively straightforward. If Johnny gets \$10 to go to the store and nothing for staying at home, economic theory and common sense suggest that he has an incentive to go to the store. (We economists always add *ceteris paribus*, or “all other things being equal” — the Latin adds to our ability to convey the notion that we ponder deeply. The phrase means that there are a million other things that will affect Johnny’s behavior besides the \$10. For instance, he might be three months old, or there may be no store within 100 miles, or some other factor that we might not examine.)

Among the many factors we traditionally have ignored have been nonfinancial influences on action, such as the psychology of the individual or the sociology of the crowd. The supposition is that, usually, people see through veils, so that it is the net economic value of an

incentive that matters regardless of how apparent or hidden that incentive and regardless of those other forces that affect behavior.

While common sense would tell one that it is a bit silly to ignore other factors, it is sometimes convenient or even necessary to limit the scope of an analysis for statistical reasons. If Johnny has \$10 worth of incentives from one parent, but Mary has \$11 through three relatives, and Sue gets \$12 through a trust fund and a friend at the store, converting the total incentive into a simple comparative number — money is usually the standard — allows the researcher to make summary statistical comparisons of the reactions of Johnny, Mary, and Sue that might otherwise not be possible. Moreover, even when people can’t calculate the value of their incentives, they still experience them and may react as predicted. Johnny may not realize why his allowance goes up by \$10, but every time he goes to the store he somehow finds he is richer and happier, so he goes more often anyway. Individuals similarly may not know their tax rates when they work, but they will still react to those rates in making work decisions since they do understand, at least implicitly, their net gains from work.

Still, I have long believed that the failure to take into account other psychological and sociological motives for behavior, as well as the effect of complexity on the behavior that results, is a fundamental source of error in much of the economics literature. That narrow approach, led by some economists who often found the real world and other social sciences inconvenient, may be waning. There is a movement afoot to grant so-called behavioral economics new recognition; what that means in practice is that other long-recognized motives for behavior are now more accepted for analysis in the “top” economics journals and are no longer restricted to other journals.

Unfortunately, limited accounting for multiple behavioral causes is only one of many sins. Economics often fails miserably as a science. Studies measuring the effects of incentives are almost never replicated, and when they are, the results are often widely divergent. Economic “scientists” almost never come together to try to find impartial ways of conducting experiments or performing analyses. They typically divide into camps. When government programs are examined, one camp tends to emphasize positive effects of government involvement and the other the negative effects. They commonly change their techniques or statistical methods to support their prior conclusions in response to new evidence from the other camp. On many questions, name the researcher and one can predict the conclusions that he will reach long before he has conducted the research.

What is researched, in turn, is heavily influenced by the source of the money. To be fair, that is somewhat true of all research. Medical researchers have more incentive to find expensive ways to treat the chronic effects of AIDS than to find less expensive cures. When it comes to

government programs, however, the funders themselves — whether it be the executive branch, a foundation, or an institutional supporter — are likely to fall within a particular political camp and want to see a particular result. They may not necessarily dictate how the research is done, but they often influence what research is undertaken in the first place.

Consistency or follow-through is not a strong attribute of those funders. Those who worry about the negative behavioral effects of very high tax rates for some reason seem to be concerned only if the rich lose 40 percent of additional earnings, but not if the poor lose 80 percent. Those who don't worry about high tax rates on either rich or poor don't seem to worry about behavior one way or the other, whatever its cause, as long as they get some of the redistribution they want. Those who believe in extra incentives for business often don't believe in extra work incentives for the poor and vice versa.

If economists are unable to agree on the adequacy of model specification and reliability of data, experiments fail to be replicated, and research is often funded only if it reaches preordained conclusions, should one conclude that incentives aren't effective? Not necessarily. The claims of empirical proof on the effect of incentives simply must be discounted.

At the same time, I have come to believe in the great power of some incentives even if they can't be measured well. Clearly, the incentive to shift portfolios can be strong, whether the issue is selling capital stock to

diversify or borrowing to buy tax-preferred investments. Here the empirical evidence is fairly striking. When it comes to work and saving, behavioral reactions are harder to verify empirically. Nonetheless, symbols and crowd behavior are very important even if hard to measure precisely. For instance, as I look at data on retirement, it is clear that people really began to retire much earlier once an early retirement benefit was available from government retirement programs. Social Security tells us we are old at age 62 even though by today's standards, a majority of people at age 62 have close to 20 years of life expectancy remaining. Government's declaration that many middle-age people are old has a large impact on when people decide to retire. Similarly, crowd behavior and reactions can be very important. We often decide to retire or marry or work according to what we see our neighbors do. Thus, government can send signals that powerfully affect aggregate crowd or societal behavior even if small differences in incentives do not cause much individual distinction among members of the crowd.

How much, then, do incentives change behavior? It depends on such factors as the size of the incentive, the way it is presented to the public, the ease with which the financial reward can be obtained through mere portfolio shifts rather than real changes in work or saving, the lag in time before people react, and, often most importantly, the power of the signal on crowd or societal understanding. *Ceteris paribus*, I don't know.

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