The Importance of Fairness in Tax Policy: Behavioral Economics and the UK Experience

Simon James, Business School, University of Exeter, Exeter, UK

ABSTRACT

One of the key areas where behavioral economics offers major insights into developing successful policy involves issues of fairness. Taxation offers many examples, ranging from the Boston Tea Party of 1773 to the UK’s unsuccessful community charge, often called the ‘poll tax’, of the early 1990s, where a failure to appreciate fully taxpayers’ perceptions of fairness led to unexpected outcomes. The use of behavioral economics to supplement mainstream economic analysis might not only reduce the risks of such tax disasters but also improve the development of tax reform more generally. This paper shows how such additional explanatory power contributes to our understanding of the success or failure of UK tax policy arising from the ‘natural experiments’ of the successful introduction of value added tax in 1973 and the contrasting difficulties associated with the community charge in 1990 and, more recently, the abolition of the 10% rate of income tax in 2008.

Keywords: Behavioral Economics, Fairness, Tax Policy, United Kingdom (UK), Value Added Tax

1. INTRODUCTION

James E. Meade, joint winner of the Nobel Memorial Prize in Economic Sciences in 1977, once stated: ‘I am an economist and have tried to give you an economic solution for an economic problem. Please do not argue that I am a rotten economist on the grounds that the economic solution is politically unacceptable. The really difficult part of our present problem is political’ (Meade, 1979, p. 9). To achieve successful tax reform a political solution may also be required as indicated by many episodes from the famous Boston Tea Party of 1773 and its role in the developments leading to the American War of Independence (see, for example, Labree, 1964) to the ill-fated UK community charge or poll tax examined below.

Economics has not always had such clear distinctions of the sort described by Meade. Edwin Cannan (1946, p. 4) took the view that there ‘is no precise line between economic and non-economic satisfactions, and therefore the province of economics cannot be marked out by a row of posts or a fence like political territory or a landed property.’ Indeed, Adam Smith

DOI: 10.4018/ijabe.2014010101
has been described as a behavioral economist - his ‘world is not inhabited by dispassionate rational purely self-interested agents, but rather by multidimensional and realistic human beings’ (Ashraf et al., 2005, p. 142). However, as an academic discipline, economics shifted substantially towards a narrower approach, beginning in the 19th Century. As Edgeworth (1881, p. 6) put it: ‘Economics investigates the arrangements between agents each tending to his own maximum utility’ and the ‘first principle of Economics is that every agent is actuated only by self-interest’ (p. 16). As Jevons (1881, p. 581) remarked: the ‘fearless manner in which Mr Edgeworth applies the conceptions and methods of mathematical physics to illustrate, if not solve, the problems of hedonic science, is quite surprising’. Nonetheless, it was an approach that was widely followed for a range of reasons, not least because of the appeal of precise analysis which can also generate useful and powerful theories. However, there have been many distinguished economists who have acknowledged the possible role for behavioral factors. For instance, Herbert Simon (1986, p. S299) wrote ‘it is sometimes useful to enrich the model of economic agents by explicitly introducing a behavioral factor that is ignored in the standard theory’. A very important area consists of issues of fairness. Kahneman et al. (1986, p.S285) point out that the absence of considerations regarding fairness from standard economic theory is one of the most striking contrasts between economic theory and other social sciences. It also means that standard economic analysis has significant limitations and in recent years behavioral economics has begun to extend the study of economics back towards territory it once occupied.

The number of contributions from behavioral economics has grown enormously in recent years. Introductions are provided by both Schwartz (2008) and Wilkinson (2008). Altman (2006), Loewenstein (2007) and Maital (2007) have edited books of behavioral economics papers. Taxation has also been the focus of analysis. McCaffery and Slemrod (2006) produced a book of papers on behavioral public finance and James (2006) a paper on behavioral economics and tax in general. Regarding particular aspects of taxation with respect to behavioral economics, Congdon et al. (2009) examined tax policy, Reeson and Dunstall (2009) the Australian tax and transfer system and James (2012b) some implications for tax administration.

Behavioral economics has been described as increasing the ‘explanatory power of economics by providing it with more realistic psychological foundations’ (Camerer & Loewenstein, 2004, p. 3) though it also draws on other disciplines. Its approach involves modifying ‘the standard economic model to account for psychophysical properties of preference and judgement, which create limits on rational calculation, willpower and greed’ (Camerer & Malmendier, 2007, p. 235) and further analysis is presented by Tomer (2007).

Fairness is a very significant aspect of behavioral economics and, to gain an idea of its relative importance, the present author surveyed the indexes of three standard behavioral economics texts - Camerer, Lowenstein and Rabin (2004), Schwartz (2008) and Wilkinson (2008) - to measure the number of pages referenced for each topic. Of course, this was not an exact exercise. A reference does not directly indicate the importance of a topic. Many of the concepts overlap – for example ‘decision-making’ is part of a variety of effects and there are differences in the way the books are indexed. Nevertheless, the number of pages on which different concepts were referenced varied enormously. Fairness was the topic the most frequently referenced by far – there were references to fairness on 136 pages. In addition, ‘inequality aversion’ - another description of fairness - had its own references to 44 pages of the three texts. It might be noted that references to fairness considerably exceeded those to the second most referenced topic, which was prospect theory (mentioned on 106 pages). Furthermore, the references to fairness included many pages of immediate relevance to the contribution of behavioral economics to tax reform.
A Motive Analysis as a First Step in Designing Technology for the use of Intuition in Criminal Investigation
[www.igi-global.com/article/motive-analysis-first-step-designing/2934?camid=4v1a](www.igi-global.com/article/motive-analysis-first-step-designing/2934?camid=4v1a)

[www.igi-global.com/article/new-teaching-and-learning-methodologies-in-the-smart-higher-education-era-a-study-case-wikipedia/222712?camid=4v1a](www.igi-global.com/article/new-teaching-and-learning-methodologies-in-the-smart-higher-education-era-a-study-case-wikipedia/222712?camid=4v1a)