Getting Redistribution Right

In Economics, tastes or (as we call them) preferences are assumed to be exogenously determined. Put simply, we are supposed to develop our preferences in early life and then once they are in place, together with prices they determine our choices throughout life. This is even supposed to work outside market contexts with “shadow prices” replacing market prices, so this is supposed to apply to everything from how we vote to how we choose a life partner. However, despite the ubiquitous nature of this assumption in Economics, it has not been unchallenged. Numerous experiments and field studies have made this idea seem less and less tenable: people routinely make very different choices over time even when prices remain constant, giving rise to so-called “preference reversals”, and accusations of irrationality, and in response to this the idea of “endogenous preferences” has begun to take hold. Our work takes this forward in several dimensions. First, we go beyond simple individual preferences into the domain of social preferences: preferences for redistribution and taxation within society. Second, we examine when and why social preferences might change in rapid and sometimes dramatic ways.

Our methods are experimental: we asked several hundred paid participants to carry out two sorts of tasks. One requires effort: adding up numbers in a tight time constraint. If they get enough correct, then they succeed in this effort task. The other is entirely luck-based: they have a 50% chance of winning a lottery. The next stage is to determine which of these tasks matters for them: depending upon which one matters they might (if they have succeeded in the task) win a bonus payment becoming “rich” in the context of our experiment. If they have failed in the task that matters for them, they receive no bonus and so become “poor” in our experiment. Next participants have the chance to choose tax rates. They can select one to levy on the “rich” who got rich by winning the lottery when that mattered for them (the “lottery tax”) and one to levy on the “rich” who got rich by succeeding in the effort-task when that mattered for them (the “additions tax”). The choices of one of the participants in the room are selected and applied to everyone (except the tax-setter, so that person doesn’t have to worry about facing her own tax rates). Finally, we ask them to undertake a test that is new to Economics, called the “Wason Task”: this requires them to answer some simple questions with clear right/wrong answers. The twist is that getting the answer right might entail damaging your own self-image. For instance, you might have to reveal (as part of the right answer) that you got rich through nothing more than luck.

Our experiment has some nice features. We can see how readily people are willing to tax what might be seen as the “deserving” (hard-working) rich as opposed to the “undeserving” (lucky) rich. Our first result is that people do very much prefer to tax luck more than effort. Next, we can see the extent to which performance in the experiment changes the way people set taxes. In particular, we can identify those who became rich or poor, those who put in high effort or did not, and those who got lucky or did not, and even identify subgroups (for example, those who worked hard but became poor nevertheless). We find a number of interesting results, most interesting in the context of social preferences being that they appear to be very malleable. While generally everyone likes to set higher taxes on the lottery and additions, that gap narrows significantly for those who got rich through lottery winnings. Remember that they will not face their own taxes so this is not about setting low taxes so you will end up paying low taxes: people are setting the taxes for others and so this is all about preferences for taxation and redistribution. The fact that a short (and frankly low stakes relative to real-life wealth levels) experiment can result in dramatic changes in what people perceive as fair taxes on others is remarkable and not only shows just how endogenous social preferences can be but also highlight the importance of motivated reasoning.

Motivated reasoning is a situation in which people reason in ways that are best for themselves. This can mean getting things wrong or ignoring information that is useful in terms of getting the answer right, in order to reach conclusions that are consistent with what people want to believe. If things go well then people like to think that is deserved, maybe because of the hard-work they put in or because they are gifted, skilful high-ability types. When things go poorly, then those self-same people might prefer to believe it was down to bad luck, a corrupt system or errors made by others. People are generally willing to adjust the way they think to preserve their own positive self-evaluations. In our experiment this extends into the realm of social preferences: people who have benefited from chance (for instance, by winning the lottery) act as though that good luck is partly down to effort on their part (pulling tax rates down closer to the level they normally set on high effort), and remember that this is not about taxes they themselves will face but what they perceive as fair for society as a whole. Our Wason task findings back this up with people routinely making errors when it helps them to preserve their own positive self-image.

What this all means for public policy is clear. Even when incentivized to do the right thing, and quite possibly subconsciously, people adjust their views on what is fair based on their own life-experiences. It is hard for a rich person who got rich partly through good luck to see just how lucky they were and so hard for them to see the sort of influence luck has on life, and this in turn makes it more likely that they will see the rich as deserving. This makes it all the more important that public policy and taxation is determined in as objective a way as possible, whether that be through democracy in which large numbers vote (knowing they are unlikely to be decisive) or through careful analysis by tax experts. Of course even experts and politicians are not immune from the sort of biases we identify which makes it all the more important for us all to keep analysing, debating and challenging the right way to set taxes and redistribute income in society.

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