Taxes are the worst | 28 September 2017

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As Congress considers the first substantial tax reform in more than 30 years, they are tapping into an issue that is deeply felt by many Americans. In addition to their political potency, taxes produce a strong visceral reaction. In fact, studies have found that some Americans see taxes as a loss of personal freedom and a violation of the moral principle that hard work should be rewarded. Similar to the “loss aversion” effect, where investors feel losses more strongly than gains, we dislike taxes so much that we treat the “tax” label more severely than other financial costs.

This "tax aversion" effect was the subject of our recent conversation with Professor Chris Olivola from the Tepper School of Business at Carnegie Mellon University. We see evidence of this effect in everyday life, from our reaction to the litany of taxes on airline tickets, to the pain of filing tax returns, to the dismay caused by the "tax withholding" line item on our paychecks.

While most taxes, such as the income tax, are designed to raise revenue without being avoidable, other taxes are designed to take advantage of tax aversion in order to nudge consumer behavior. When DC implemented a 5¢ tax on plastic bags, grocery shoppers went to drastic lengths to avoid paying the tax. In the immediate aftermath of the new tax, shoppers could be seen cradling milk jugs and vegetables in their arms, rather than pay for plastic bags. And regardless of the tax’s small size and economic impact, it represented enough of a nudge to drastically increase the use of canvas bags. Cigarette and soda taxes are other prominent examples of the power of taxes to change behavior.

Investment taxes

Optimizing around the gamut of investment taxes (e.g. short-term and long-term capital gains; qualified dividends; taxable or tax-exempt interest) is a difficult task for the most rational and educated investor. So it’s no surprise to see that investors tend to skew their investment portfolios to reduce taxes, often at the expense of giving up potential returns. For example, a study showed that municipal bonds are often owned by low-tax bracket investors who would be better off investing in taxable corporate bonds. And many investors are loath to pay any capital gains, even if realizing gains is necessary to rebalance or realign their portfolio to a more optimal or lower-cost strategy.

A [tax] by any other name

Fortunately, Shakespeare’s famous line ("A rose by any other name would smell as sweet") doesn’t seem to apply to taxes, and we can sidestep our visceral reaction with some simple rebranding. Discussing taxes as "costs" – where legally permissible – can be effective in allowing us to evaluate them on an even playing ground. Paying taxes will never be enjoyable, but this can at least dispel some of the odor.

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