AN EXPERIMENTAL EXPLORATION OF ECONOMIC BEHAVIOR ON KINKED BUDGET SETS

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Abstract. Individuals face non-linear incentives in myriad situations including incentives for retirement savings, tax preferences for labor supply, bulk pricing of retail goods, as well as service rates that vary upon usage. How individuals respond to non-linear incentives is an empirical question with important economic consequences in a number of domains. This paper reports the results of a laboratory experiment designed to analyze individual choice in a setting of non-linear incentives characterized by kinked budget sets (i.e. piece-wise linear and convex) and answer questions that are beyond the reach of what market data can reveal. We find that, while choice data in kinked budget sets follows similar patterns of rationality as data from linear budgets, the choices from both settings cannot be explained by a common decision rule. Almost half of the subjects display such *coherently arbitrary* preferences that are, in turn, associated with significantly lower price-responsiveness when facing non-linear incentives. Finally, we show that this behavioral departure from the rational benchmark has important consequences for the welfare analysis of non-linear pricing schemes and non-linear taxes as well as for policies that advocate the provision of information regarding marginal incentives.

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