The Importance of Fiscal Illusion in Public Choice

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This article intends to stress out a fiscal matter, firstly explored by Puviani, known as fiscal illusion. This a case of observing and reacting upon key fiscal parameters, which could ultimately impose distortion of fiscal choices made by the electorate. There are numerous elements like tax structure, public expenditure, that are largely concealed so the voters don't have the true information about the cost of providing certain public services. In the countries with high public expenditure there is a high rate of indirect taxes present, because they obscure the tax payer perception about the amount of tax paid. This is how they gather larger amount of tax revenues which are used for financing public sector. The high percentage of indirect taxes in public revenues affects the demand for public services, because the benefits are clear as day but not their expenses. That kind of misperception of public sector expenditures upon existence of indirect taxes is clear example of fiscal illusion. If the level of fiscal illusion is high, then the citizens are not in position to clearly see the government expenses which complicates the control of public money usage. The stimulus for money control is lower, because expenses are considered lower then they really are.

Keywords

Fiscal illusion, public choice, public expenditure, personal income tax, corporate tax, tax deductions.

1. Introduction

Almost 60 years ago, Downs (1957) considered that the representative voter poses imperfect information on which makes decisions on public-sector activities. The costs of acquiring information imply, of course, less than perfect knowledge for private-sector choices as well. According to him, the strives to gather information on the benefits and costs of government programs are fewer than those for private programs. The individual voter is very unlikely to have serious effect on public sector outcomes, which is why it doesn't care about the benefits and costs of alternative government programs. The individual tries to acquire investment information through his his own pattern of purchases and consumption of private goods. But considering the public choices, there will be little effort in order to learn about government progams. As Downs (1957) concludes: 'Ignorance of politics is not a result of unpatriotic apathy; rather it is a highly rational response to "the faces of political life in a large democracy' [1].

However, imperfect information does not mean fiscal illusion. It is a necessary, but not a sufficient, condition for its existence. Fiscal illusion refers to a systematic misperception of fiscal parameters - a recurring propensity, for example, to underestimate one's tax liability associated with certain public programs. Imperfect information alone might well give rise to a random pattern of over- and underestimation of such tax liabilities. Fiscal illusion, in contrast, implies persistent and consistent behaviour. As such, it will give rise to recurring, and presumably predictable, biases in budgetary decisions. It is by no means clear in which direction fiscal illusion will tend to bias public-sector outcomes.
In the previous analysis was assumed that individuals value alternatives in a just way until to the degree anticipated with the individual behavior. This does not mean that only true observed factors are relevant, because then the institutional influence on the decisions would be neglectable. In addition, the institutions can influence on information's, certainty in predicting certain outcomes, individual motivation for participation and other elements of choice without illusionary behavior.
Behavior distinctions in case of ignorance and/or uncertainty and behavior in case of illusion is subtle. In either case, the behavior would not be the same in absence of event. If the voter does not possess adequate information for alternatives and is unsecure, then he treats alternatives imperfectly. If he is under illusion, then he will perceive alternatives on wrong way. However, the effects on his voting behavior may be identical. It looks that probability factors are more significant for the first, then the second situation. There is no need to use this aspect in order to made distinction in the results from several reasons.
First, the illusion itself can be predicted with higher or lower certainty, then the one that real factors insinuate. Secondary, and even more relevant, the probability issues are subjective and can not be monitored. And at the end, both illusions can be pessimistic and optimistic [2].
The illusionary conduct is not irrational. The person that acts illogical makes inconsistent choices and does not behave like an external supervisor. Opposite of that, the individual that reacts in presence of illusion will be consistent, and in a given situation, in separate opportunities, he will intend to make the same decision, presuming that learning from experience will not affect the illusion and presuming that his function will not change in between. If the external observer knows the effects from the illusion on the voters conduct, then he can make the necessary predictions [3].
The illusion appears because of the perception of the alternatives from the individuals. Therefore, example for that kind of illusion will be the vision of water in the desert, a manifestation known as mirage. The artist, upon his knowledge, can intentionally create illusion, knowledge consisted from ordinary perceptions. It is obvious that institutions of social choice can create illusions and that's why they are significant for study.

2. The Contribution of Puviani.

It is surprisingly that for so long time the fiscal illusion was not analyzed in detail. Institutions in which the individual must participate in order to make fiscal choices can create illusionary effects that could significantly modify his conduct.
The Italian economist Amilcare Puviani had given the essential contribution in this area. His approach on public financing is based upon the assumption that the government is monopolistic. In fact, the state or political entity in this context are not envisioned as independent, "supra-individual" entity. The state represents agency through which one group of people, which poses power, influence or look down on other group of people, dominie. This is theory of political force, the model of governing class [4]. Political concept is more developed in details by Pareto and Mosca, who oversaw the citizenship divided in two groups, domineer and dominie. The concept is based on the impossibility to create effective democratized order. Under the model of government class, the fiscal structure is presented as institutional tool through which this class in charge for community decisions may extort funds from dominie groups for securing or funding those goods and services demanded by the first group. The

members of the dominee group may react on the newly found conditions, respectively never initiating action in direct sense. The group will oppose on the governing class efforts, term used by Puviani, to impose responsibilities and of course they will be less aware or will not collaborate with governing political group. The goal of this group is to create or organize the fiscal structure in order to minimize the resistance towards the effects on dominie class with securing solid revenues.

Under such fiscal system, the assignment of the fiscal theorist will be to explain the governing class behavior in the organizational structure of the system in making fundamental decisions for public economy and explaining the conduct of the exploited class in the reaction and opposition of imposing tax responsibility.

Puviani approached the theory of fiscal organization with the following question: If the governing group wants to minimize the resistance of tax complaint on every level of tax revenue, how will be able to set the fiscal system?

He discussed the action undertaken by governing group motivated by short term goal, selection of alternative with lowest resistance on every individual choice. The answer of the question will be in form of hypothesis. The efforts of the governing group to generate fiscal illusions has effects on tax payers expressed with comprehension that taxes imposed to them are less burdening then they seem to be. Simultaneously, other illusions are created through which the users of goods and service are persuaded that their value is higher then the real. The numerous institutions for tax and expenditure are organized so they could create this set of illusions. Then Puviani had tried through existing fiscal structures to test the fundamental hypothesis.

Fiscal illusion in implementation of new taxes. The illusion in implementation and collection of taxes can be illustrated in several specific ways, which are equally important and relevant [5].

- correlation of the total amount of funds, which are actively used for production and supply of public services, and every individual share in this amount can be vague for the tax payer. In other words, individual shares in the opportunity costs of public expenditure can be hidden. This form of illusions can be generated in minimum five separate tax institutions.

  The first institution includes the use of *public sector income* for financing government activities. In this case, the individual tax payers didn’t figure out that if the income was not completely used for that purpose, then it would be returned in form of reduced tax rates. Historically, the public sector had acquired substantial amount of public revenues, but in the last century this kind of revenue source had become relatively omissive in capitalistic countries.

  In socialist countries, the profit of public enterprise is utilized for financing of public services, an illusion point out by Puviani again takes its place as a factor for persuading expansion of this form of services.

  The second institution is more significant for the analysis. The illusion is formed when the tax is taken in account when the individual makes payments for acquiring private goods and services. This situation is characteristic for *specific taxes on consumption*, where the tax is integrated in the price of private goods and services. The individual here needs to adjust his/her purchases so that the price, that contains the tax, be in the same proportion with any other price, as to the proportion of the relative marginal benefits of two private goods. The explicit acknowledgment of paid public goods and services is not included in the individual adjustment. Therefore, the subject it’s not completely aware for the amount of tax paid, and occasionally even for the total tax. According to this author, the illusion is more complete when the tax had been active for some time. When the prices of the private goods and services are increased as a result of tax, then the impact on the buyer would be evident. However, with the prevail of the institution in the upcoming periods, the opportunity cost would be neglectable by the tax payer.

  The third institution, that Puviani included in his broader category is *public debt*. He accepted the essential Ricardian suggestion that paying alone one-time tax and paying certain percentage from this amount through yearly tax are eternally equivalent. However, according to him, individual tax payers does not behave like the two alternatives are same. He did not discus the potential mistakes of tax payers regarding the discount, capitalization, future tax payouts, like crucial elements in the process of public debt emission.

He argued that there will be no defiance for new loan through emission of government securities intended for paying off yearly tax in the same way as through one-time tax. This kind of illusion emerges, because in case of public loan plan the subject detains supervision over capital value, which remains acceptable, even when is completely neutralized through obligations that emerge from the capitalization of future tax payments. Because of this asset control, the individual refers to pay taxes in future. According to Ricardo, government securities present future tax payments, which are equal to the discount face value of alternative tax payments on which place the debt was missioned [6]. Therefore, this fundamental equivalence between government securities and taxes does not cause any changes in tax payers' behavior. That kind of "asset illusion" can be expanded towards private debt and public debt [7].

The fourth institution, that Puviani includes in his first, is financing public goods and services through *inflation, i.e. emission of money*. This form of funding is very difficult for the individual, because he or she would not be able to determine the own part in service costs funded and supplied by the government. This effect of inflation is similar with the indirect taxation under full employment.

The final way through which the governing group, the one who controls fiscal measures, may generate illusion expressed with unclear participation of the subject in the total government expenditures is the *false hope.* This has for intention to persuade the individual to think that the various expenditure programs are with temporary status and short term, but when they are started the intention is to keep them in life. In this way the tax payer will be exposed to significantly higher expenses then originally expected. When the program initiates, then is relatively easy to present the argument "sunk costs" to the tax payer in order to secure extension for the program [a sunk cost is a sum paid in the past that is no longer relevant to decisions about the future. Even though economists argue that sunk costs are no longer relevant to future rational decision making, in everyday life, people often take previous expenditures, say, on repairing a car or house into their future decisions regarding those properties].

- Not knowing the real costs for pubic goods and services it is not basic option for presenting fiscal illusion, although is one of the crucial. The second category includes those institutions designed for connecting the obligation with some issue or time frame, which the tax payer thinks it's valuable. Puviani idea is based on recognition that the temporary circumstance may affect isolated individual decisions and consequently individual view can vary significantly under such conditions. Impulsive buying is also crucial phenomenon in marketing, but it's role in making ordinary consumer choice is reduced due to recurrence of marketing activities. The individual does not "buy" voluntarily government services and with no impulse.

  Estate, inheritance and gift taxes fit just fine in this context. It is assumed that some rich uncle dies and leaves his inheritance from million dollars to his nephew, who did not anticipate the heritage. It is obvious that in the moment of announcement, the tax collection from this heritage would not be felt in the same way as it would be for paying regular tax after five years from the acquisition of the wealth.

  The same implies for transfer taxes. Probably every exchange embodies net gain for both sides in the transaction. Therefore, tax payment in the moment of finalizing transaction in presence of net gain tends to be less sensitive for tax payers in comparison with similar tax paid in deferent time.
- Third mean for presenting fiscal illusion is *collection of explicit fees* for services offered in valuable or satisfied circumstances. He involved fees for marriage license, hunting license, entertainment license, fees for graduation, etc. Licenses for business, charged

in the beginning of the operation, can be explained through optimistic attitudes of all potential managers.

- The dominant class will exploit the advantage in changes of public opinion for social matters and use those changes for establishing new taxes. If in the community prevails certain stand, then the circumstances for such tax collection will be based on that feeling. The tax burden will look smaller in comparison with different situation. According to Buchanan, Puviani surfaces his provocative hypothesis when suggested that taxes, aimed for redistribution of income, were happily accepted from the rich groups when they were threatened with demonstrations from the poor class. On the other side, there is some legitimacy in his argument that certain taxes are explicitly imposed in order to secure consensus from some groups for other social changes.
  For example, corporate tax is often implemented and justified before business groups as political gift for working class in order to secure political support for other issues. It seems that he did not make difference between "explanations" how some taxes appeared under political pressure and "explanation" for individual tax responses.
- According to Puviani, the governing class in order to obtain general tax acceptance made threats to political entity with direct consequences in case of not approving tax collection. These "scary strategies" intended alternatives of some tax suggestions to be presented in worse light then they are. It seems that the degree in which this tactic will be effective will create fiscal illusion from the governing class, which could influence individual behavior. In modern fiscal environment, such tactics are more detected on the consumer side then tax side, because bureaucracy and citizenship may initiate catastrophic consequences if certain spending programs are not supported and kept.
- If the individual total tax burden is fragmented in order to be able to face multiple small payments then several large ones, then it will create illusionary effects. If, for example, all taxes paid by the subject are concentrated in personal income, the individual will be more then aware for the sacrifice he makes for supporting government services. Therefore, fiscal systems in monopolistic states intend to be more complex and relatively less leaned on generally implemented taxes.
- The last important tool for creating illusion on the tax size is implementing of taxes where the individual would not know who the last tax payer will be or where the tax incidence is not aware. This illusion relates to the first one discussed previously. It is obvious that this uncertainty in tax institutions is a result of unknown tax incidence, which affects the fiscal choice.

Fiscal illusions in public expenditure. The essential analysis was extended on the consumers side of fiscal budget, besides the less applying conditions. The most important one was the government tendencies to conceal the truth and the real composition of the budget programs from the public eye.
In the past, the possibilities for creating illusions on this manner were strongly stressed out because of the absence of systematic accounting and adequate budget technics. Even in contemporary budget systems, the complex budget makes it impossible to have detailed inspection.
However, in best case scenario, the citizen stays with poor knowledge regarding allocation of public money. This elementary ignorance helps the governments to easily manipulate with budget positions through adding larger sum of money for programs that are most popular in public.
Puviani's hypothesis offer a new essential perspective of fiscal structure that can be useful even in case of implementation in modern government constitution. He worked on the assumption that the fiscal system was organized by the governing class – elite in the political society. In the modern extension of his ideas, Fasiani initiated debate for fiscal illusion in his study called "Public finance in monopolistic state".
However, it is assumed that the political structure is democratic and fiscal decisions are made by all members of political group through voting process regardless of his form – direct or indirect. Those political assumptions should not imply that Puviani analysis is worthless.

According to Fasiani, all traces of elite model are rarely exempted, which means that the analysis of Puviani is relevant according to his terms [8].
Buchanan considers that even in full democratic system, the fiscal institutions, regardless of motivation behind their original organizations, can be analyzed and sorted by their tendencies to generate fiscal illusions.
Here it is analyzed the positive approach, who does not involve why political institutions act as they behave, but it observes them such as they are and then analyzes their effects. For such kind of approach, the form of political constitution it is irrelevant.

3. Fiscal illusions in contemporary regimes

All institutions, according to Puviani, were explained upon the illogical motivation of governing class to exploit the dominee class. Afterwards, it is concluded that his contribution was something more then explicit norms of fiscal organization. Then was developed tax principle for aggregate sacrifice (Edgewort and Pigou). This principle was recognized as like Puviani fiscal illusion. What is for the aim of fiscal illusion if not for minimizing the aggregate sacrifice of tax payer through minimizing the resistance of the tax payer? He was political realist who did not made scam through assumption that government is despotic and benevolent. Contrary of that, Edgeworth-Pigou principle can be applied simply in autocratic environment where the despot is completely charitable and powerful. That is obviously insignificant for the democratic structure where the despot is not interested in the tax payer's reaction, that implies a lot of power in his domain. Edgeworth-Pigou or Puviani observed the tax side independent from expenditure side, which implies for nondemocratic framework. In democratic system, not even the "smallest aggregate sacrifice" or the "minimization of the burden through illusion" is suitable as a norm for fiscal organization. However, the norm should be allowing the individuals, through the structure of institutions for collective decision, to bye public goods and services on a manner so their choices could not disturb the production of goods and services on the private market so they could remain neutral and undisrupted as possible.
The governing class of Puviani is attempting to promote optimistic illusions, i.e. the tax payer thinks that he pays less and in return receives more, then through alternative institutional arrangements. However, if all considerations for motivation are left aside and only the institutions are considered, then there will be no assumption that current fiscal illusions will be always optimistic, i.e. the appearance of pessimistic illusions is also possible.
Income deductions for tax payment. After the World War II, in USA a large portion of personal income tax was collected through tax on wages and fees. The employer acts like tax collector, and the employee does not receive directly the proportion of his wage or fee, which is kept for tax purposes. These reforms in tax system of USA were exclusively supported by the argument for increase of tax payer benefits.
Income deductions for tax payment would surely fit in the first category of Puviani institutions, which intend to present the opportunistic cost for supporting public services from tax payer as unclear. The person which does not have control over income before payment, could not sense the real cost for public services on a manner that is comparable with the original act of overpayment. Therefore, this illusion has influence on individual behavior on the same way as indirect tax.
Before the introduction of tax payment through income deductions and paying upon earnings, the individual was forced to pay the whole sum of yearly tax obligation in one moment. This approach probably generated pessimistic illusion and contributed in presenting government expenses in overdosed amount.
From conceptual aspect, the ideal institutional agreement may be the one which allows the individuals to pay for government goods and services on a way which they consider as most suitable for achieving long-term finance of consumption. The absence of logical feeling for transfer, the absence of every monthly or quarterly account is just the thing that causes income deduction to be questioned and tends towards illusion [9].

Progressive rates of income tax. The pessimistic illusion can be generated on the same manner as the optimistic one, especially when the system organization it's not conducted without specific design for illusion. It seems that the progression has the tendency to create excessive feeling of tax burden upon the tax payer. The effect here derives from disagreement between average and marginal tax rate and preserved tendency of people to think alike marginal rates conditions. If this illusion is present, then the press would discuss about the tax structure and the politicians would have tax debates.
From some reason, the marginal tax rate presents relevant tax rate for analyzing individual choices. With the acclimatization on private sector behavior, the individual taxable income would depend from the marginal tax rates. However, in the efforts to select adequate amount of public goods, the individual must think with accordance of average tax rates, while in meantime the necessities of total income vary.
Namely, if public goods and services are disposable according to some schedule for negative quantitative discounts, which is the case in increasable marginal price, then he can think and respond wrongful guided by progressive tax structure.
However, the implication from the hypothesis here is that the individual could strive to select larger quantity of public services under the model of proportional income taxation then under the progressive model, although his/her tax obligation is identical.
Social insurance taxes. It is obvious for all individuals that without detailed analysis and knowledge of the system, the effects of promoting institutions in the area of insurance, which imply insurance independence and integration, would have for purpose to conceal the real flows of costs and benefits from participants. The facts are that the system as independent account of trust fund extracted from regular budget procedures, it's not heathy from insurance point of view in the process of implementing private financial standards and that the plan will depend from continues will of the treasury to finance the current demands towards the system. Those individuals who contribute to the system, finance relatively small portion of received benefits, and the rest of funds must be obtained from current taxes charged from the potential users.
While the current collaborator accepts regular increases of his own taxes, as those calculated on his employer, under the assumption that those will be accumulated for support of pension benefits, so more he will be less resistant on such increases if he knew that those tax increases were necessary for current payouts of beneficiary's. It works with illusion like that of Puviani. If the future demands against the system are correctly discontinued together with the future taxes that will be imposed on them, then the participant in the system would recognize that in net value the costs would significantly surpass the benefits calculated in face value. The fact that there is no disbursed resistance against entering the system, it supports the hypothesis that illusion is present and effective, even for the employee who is capable to recognize the bankruptcy of the insurance system.
However, if he predicts that for the time of his retirement other potential participants can be attracted by illusionary insurance demands, then he will not be rationally motivated to reject the plan. On that manner, the system secures long-term assets through which can be made income transfers for older people with the help of productive population, which can be explained or rationalized to many tax payers based on cooperative plans for retirement protection [10].
Taxation of corporation income. Taxes imposed on corporate income have tendency to create large insecurity for the ultimate tax payer, which is enough to be considered by the last category od Puviani.
Taxation of capital gains. The treatment of capital gains under the income tax is closely connected with the problem of medium. One reason for continued favorized treatment of profit is the absence of effective average fees in the regular income tax. According to model of Puviani, it is obvious that taxes should be more imposed on profit, then on regular income.

4. Conclusions

The fiscal illusion has shown us through this paper that can make serious distortions in the process of public decision, based on the fiscal variables that are publicly available to the voter. Precisely that sort of government approach in publicly concealing the real situation with the fiscal variables had been the initial problem of getting valuable information from the individual voters in order to make the proper fiscal decision. For example, paying taxes or demanding higher amount of public expenses for things that are essential for them. This illusion is disbursed in the segment of public revenues, and in the segment of public expenditure. This kind of distortion can create false picture for the state of the economy, which also would mean false perception from the public about their costs and benefits from the government. This form of government illusion may be dangerous, because it would stimulate the government to make or prolong the process of making bad decisions (about the public debt, tax rates, public expenditures, etc.)

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