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Fiscal Illusion: How Big Government Makes Tax Look Small

Sinclair Davidson

Perspectives on Tax Reform (15)

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CIS Policy Monograph 81

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2007

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Davidson, Sinclair.
Fiscal Illusion: How Big Government Makes Tax Look Small / author, Sinclair Davidson

1st ed.
ISBN 9781864321968 (pbk.)

1. Economic development. 2. Taxation. 3. Government spending policy.
4. Expenditures, Public. 5. Fiscal policy.
I. Centre for Independent Studies (Australia)
II. Title. (Series: CIS policy monographs; no. 81).

338.9

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Foreword

This Policy Monograph is the latest in the Perspectives in Tax Reform series from the Centre for Independent Studies.

Rather than focusing on any particular tax or level of government, Sinclair Davidson in this paper canvasses an issue that cuts across all taxes and all levels of government: fiscal illusion and how it contributes to the growth of the state. Fiscal illusion is the political art of crafting tax and expenditure policies ways that make taxpayers think government costs them less than it actually does relative to the benefits they receive from government spending. This illusion increases the politically sustainable size of the tax burden and, with it, the level of government spending.

Davidson identifies many of the techniques that governments use to promote fiscal illusion, including opportunistic tax levies designed to take advantage of community sympathy for various causes. Another example is the imposition of taxes on business, which are not transparent to households even though they are passed on in higher prices or lower wages.

Recent Australian experience of taxation is mixed. Davidson welcomes some changes that have reduced fiscal illusion, such as the replacement of the hidden and highly selective wholesale sales tax and an assortment of hidden, narrowly based state taxes with the broader and more transparent Goods and Services Tax (GST). On the other hand, Davidson argues that the chronic underestimation of government revenue in recent years has contributed to fiscal illusion by making the prospective tax take appear smaller than it turns out to be.

Countering fiscal illusion is more difficult than identifying it, and is a topic beyond the scope of this paper. But exposing the policies and practices that create fiscal illusion, as Davidson has done, is a good first step.

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Executive Summary

- Despite political rhetoric calling for small government, the Australian government has continued to grow. One mechanism whereby government can increase in size is through fiscal illusion. In essence, the issue becomes one of designing a tax system that minimises taxpayer resistance to any given level of taxation. The higher the elasticity of taxable income, or behavioural response to taxation, the lower the revenue a tax will (generally) raise.
- Fiscal illusion gives governments the opportunity to distort their citizens' fiscal consciousness; in particular, it allows them to create the impression that taxes are not as onerous as they appear. In this way, big government can raise more tax revenue than it otherwise could. There are a number of different techniques government can employ to create fiscal illusion. For example, greater complexity within the tax system generates uncertainty about the true tax burden. The extensive use of hypothecated or earmarked taxes also adds to fiscal illusion.[1] The Australian tax system is extremely complicated, and relies increasingly on hypothecated taxes. The Medicare levy is a particular example of this. The complexity of the tax system is such that only 43% of Australians understand how the graduated progressive tax system works.
- An important mechanism for dampening tax reform expectations is the persistent underestimation of government revenue. Since 1996, the Treasury has consistently underestimated revenue, leading to larger surpluses than have been budgeted for. These 'unexpected' revenues have allowed government to accumulate large sums of money that are now being 'parked' in various funds. These funds will be used to subsidise future government spending. This tactic represents a lost opportunity for government to pursue fundamental tax reform.
- The Inspector-General of Taxation (IGT) can play an important role in reducing fiscal illusion. A lot of taxation information is made available to the public by a variety of government agencies. Each year, the IGT should be required to produce a single, authoritative report on tax system complexity.
- The Charter of Budget Honesty requires the Treasurer to produce an economic and fiscal outlook report at each budget. There is no requirement, however, that the information contained within those reports be honest. It is quite clear that Treasury has been systematically underestimating future government revenue. The Treasury revenue forecasting process needs to be audited. Unfortunately, it is not clear who would be in a position to undertake such an audit.

An earlier version of this paper was presented at the 2007 CIS Consilium Conference. I would like to thank Robert Carling and Alex Robson for their comments on a previous version of this paper.

Introduction

In his 1990 John Bonython lecture, James Buchanan pointed to the death of socialism, but argued that 'Leviathan lives on.'[2] In that lecture, Buchanan indicated a lack of an agreed principle as to how the economy should be organised. Leviathan, which can be characterised as a 'special-interest, rent-seeking, churning state,' finds fertile ground for growth in this type of environment.[3] In the almost two decades since then, Leviathan has not just survived, but has thrived. There are a number of possible explanations for growth in government. In the first instance, it may well be that voters demand big government, and politicians are simply responding to that demand.

The difficulty with this explanation is that voters would appear to be demanding big government with small government rhetoric. In the case of Australia (until the Labor victory in the November 2007 federal election) and the US, for example, the government has come from the party that is rhetorically associated with 'small government.' If voters wanted big government they could, in the first instance, elect the opposition party.[4] It is possible, but unlikely, that Leviathan survives without any electoral support: that politicians are willing to supply big government and are able to do so despite there being no voter demand for it. This second explanation is not plausible over more than one electoral cycle. Government that systematically ignores voter demands will suffer electoral damage.

Voters are unsure about what big government costs, so they demand more government than they otherwise would.

A third explanation, which this paper will explore, relates to fiscal illusion. Leviathan promotes itself by creating an illusion on the demand side. Voters are unsure about what big government costs, so they demand more government than they otherwise would. Further, Leviathan is aided and abetted by those institutions of society that benefit from large government. In previous work I have referred to these as the *revenue lobby* (while Peter Saunders has written of the *welfare lobby*). The revenue lobby consists of those elements within the ATO, the Treasury, and public service departments, and their allies in politics, academia, and the media who continually argue for higher levels of taxation and welfare expenditure.

The consequences of taxation and fiscal illusion

Jean-Baptiste Colbert famously articulated the idea of fiscal illusion with the cynical observation that 'The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the least possible amount of hissing.' In modern terms we would describe the 'hissing' as being a behavioural response to taxation. It is well-known that individuals respond to taxation. For example, some individuals may substitute leisure for labour when tax rates rise, or invest less and consume more, and so on.[5] Ideally, taxes would excite no behavioural response, but raise revenue nonetheless. The hypothetical tax that achieved this would be called a 'neutral tax'; it would require that a (living) goose be plucked with no hissing. Of course, this is impossible. All forms of taxation give rise to behavioural responses, and the stronger those responses, the greater the social cost of taxation.[6] Even poll taxes, often described by economists as being behaviourally neutral, cause hissing, albeit not of the type economists usually consider.[7] As George Stigler argued, taxes should 'not imperil the political support for the regime,' but 'must yield revenue.'[8]

Joel Slemrod writes that 'a progressive tax distribution requires higher marginal tax rates, which dampen the incentive to work and do anything else that engenders financial success, and encourages privately rewarding but socially inefficient activities that reduce taxable income.'[9] The same principle applies to all taxation. The diversion of economic activity as a consequence of taxation incurs costs. These do not only include the work–leisure trade-off, but all the costs associated with raising tax revenue, including value-reducing activities such as tax avoidance and tax evasion. In technical terms, the behavioural response to taxation is called the elasticity of taxable income.[10] The issue of importance is how large this behavioural response is. If it is small, then high taxes have smaller social costs, while a higher behavioural response implies higher social costs from taxation.

Of course, the question of what is 'big' or 'small' is a value judgement. Slemrod recognises this, and argues that 'the benefits of a more equal distribution of well-being' are 'a value judgement.'[11] To provide some context, however, if the (Australian) response elasticity were greater than 1.22, a decrease in the top marginal personal income tax rate would lead to an increase in personal income tax revenue.[12] The equivalent figure for the US is 1.86 (assuming a top marginal tax rate of 35%). Empirical estimates for the US elasticity of taxable income vary greatly. Martin Feldstein, for example, has estimated a figure in the range 1.1–3.05, while Jonathan Gruber and Emmanuel Saez find a figure of 0.4.[13] The important point to note, however, is that even if the (Australian) behavioural response were less than 1.22, determining whether it is too big or too small is still a value judgment. We should not assume that maximising tax revenue is a legitimate function of government.

Slemrod argues that tax authorities have some control over the social costs of taxation through their ability to influence the behavioural response to taxation. When introducing a new tax or modifying an existing one, the authorities have to choose a suite of policies. They also have to provide a justification for the tax and introduce (or modify) anti-avoidance and anti-evasion policies and the like. By making tax bases as broad and comprehensive as possible, tax authorities are aiming for a lower behavioural response, which allows them to easily increase rates in future. Geoffrey Brennan and James Buchanan recognise this in *The Power to Tax*, arguing that citizens would ideally constrain government in the choice of tax base. Otherwise, 'all persons would be totally vulnerable to the fiscal authority, with all potential economic value subject to overt confiscation in the taxing process.'[14]

The tax authorities therefore have an incentive to minimise the behavioural response to taxation, subject to some cost constraint.[15] That constraint could be political, financial, or legal. The behavioural response is determined by individual choice, which is outside direct government control, but also by the authorities' anti-avoidance technology, 'and the amount of tax coordination and harmonization.'[16] Australia has been a very active participant in efforts to harmonise and coordinate international tax information sharing and anti-avoidance activity.

Another mechanism for reducing tax response behaviour is to engage in behaviour that fosters fiscal illusion. The Italian economist Amilcare Puviani has developed the tax illusion literature in detail, but unfortunately, his work has not been translated into English, so the anglophone world has to rely on secondary sources for an understanding of the phenomenon.[17] Puviani considers how a tax system would be designed if the political authorities wished to minimise taxpayer resistance to any given level of tax revenue. As Buchanan indicates, 'political agents find it in their interest to modify the fiscal consciousness of citizens.'[18] In particular, '[t]ax impositions will be made to seem less onerous than might otherwise be the case.'[19] Fiscal illusion is said to occur when economic decision-makers incorrectly perceive the opportunities and costs they face. Within their understanding, these decision-makers' behaviour may be rational, but can still be at odds with reality.

If Leviathan can create the illusion that the tax burden is lower than it actually is, the state can grow beyond the size that voters want it to.

It is possible to create a fiscal illusion on the revenue and expenditure sides of fiscal policy. For example, on the revenue side, government attempts to dampen perceptions of high taxation, while on the expenditure side it wants to enhance perceptions of the value of taxation. In general, the literature on fiscal illusion has concentrated on the tax burden. If Leviathan can create the illusion that the tax burden is lower than it actually is, the state can grow beyond the size that voters want it to. Buchanan describes a series of mechanisms, based on Puviani's writings, that can be employed to create fiscal illusion.

In the first instance, complexity in the tax system is a source of fiscal illusion. The graduated progressive income tax fits exactly into this category. Adding exemptions, deductions, and mild (if not severe) inflation complete the illusion. Then indirect taxes such as excise, various levies, and the Goods and Services Tax (GST) also contribute to fiscal illusion. The burden of public debt and its relationship to the present and future tax burden also fits into the first category.

The second form of fiscal illusion can be described as 'taxing winners' or, at least, windfalls. For example, taxes on inheritances, transfers, and gifts are (often) willingly paid. Australia has few such taxes. The third form of fiscal illusion is fees and charges on memorable and pleasant events such as wedding licences, driving licences, pet licences, fishing licences, and gambling taxes. These two categories are very similar, and the taxpayer gets to share their good fortune (and their financial fortune) with the tax collector.

A fourth form of fiscal illusion can be described as opportunistic taxation. Here Leviathan takes advantage of changes in community attitude to levy a tax. For example, the Ansett levy, the sugar levy, the milk levy, the super surcharge levy, the gun buy-back levy, and the Timor levy were all opportunistically imposed to cater to a specific attitude in the community. The Timor levy was not collected when it turned out that community attitudes did not support the imposition of the tax. Such levies are often introduced very quickly on a narrow base with a specific objective, yet remain in place for long periods of time.

Remarkably, the majority of Australians do not understand how the graduated progressive income tax works.

The fifth form of fiscal illusion can be described as a 'dread consequence' tax. Without such taxes, the consequences for social life would be disastrous. For example, without the Medicare levy people might die in the gutter. Of course, there is little evidence of wholesale death in Australian gutters prior to the imposition of the Medicare levy, yet it is impossible to argue against it. This is a particularly good example of fiscal illusion. Community attitudes towards it are very positive, yet it also disguises the total cost of public health. The levy itself does not generate sufficient revenue to sustain the Medicare program. Approximately 75% of Medicare funding comes from general revenue. At present, global warming is providing a similar rationale for a massively expanded state. In the first instance, there is a campaign to increase petrol taxes to benefit the environment and to reduce traffic congestion.[20] Finally, the imposition of taxes with unknown or uncertain economic incidence adds to fiscal illusion. The company income tax is a classic example of this.

It is clear that many mechanisms exist to create fiscal illusion. This is even before the campaign of misinformation—including arguments that the 'rich' don't pay their fair share and the like—that sustains Leviathan is taken into account.

Voter ignorance

Andrew Norton has undertaken an extensive analysis of public attitudes towards taxation, arguing that individuals may support higher taxes in the belief that they themselves will not actually pay the tax.[21] Many voters are woefully ignorant about how the Australian tax system works. In the 2004 Australian Election Survey,[22] only 43% of respondents knew that low-income earners pay a smaller proportion of their income in tax than higher earners do. Of the remainder, 30% thought low-income earners pay a greater proportion of their income in tax, and 8% thought they pay the same proportion.[23] Remarkably, the majority of Australians do not understand how the graduated progressive income tax works.[24]

Table 1: Ignorance of the tax system

Response	Respondents (%)
A bigger proportion of their earnings	30.3
The same proportion	7.9
A smaller proportion	43.4
Don't know	18.4

Source. Australian Election Survey 2004[25]

G.20. Obviously, a person on a low income will pay less total money in income tax than someone on a high income. But do you think that a person on a low income pays: (1) A bigger proportion of their earnings in income tax than someone on a high income; (2) The same proportion; or (3) A smaller proportion of their earnings in income tax; (4) Don't know.

Voters' level of knowledge or ignorance did not appear to dictate their attitudes towards the tax-cut/welfare-cut trade-off. Nor did it dictate whether they thought tax policy was important at the 2004 election. People who thought low-income earners pay more in income tax, however, were more likely to identify with the ALP,[26] more likely to think taxes had risen a lot since 2001, and more likely to strongly favour spending on social services. They tended to describe themselves as 'working class,' and had lower incomes.

Of course, the whole notion of fiscal illusion relies, to some extent, on voters being rationally ignorant.[27] This does not mean, however, that voters make irrational choices. Arthur Lupia and Mathew McCubbins have explained how 'the democratic dilemma' is resolved so that rationally ignorant voters do make rational decisions.[28] This suggests a limit to Leviathan's ability to engage in activities that create fiscal illusion. Leviathan needs to continually reinforce the arguments and perceptions that sustain the illusion. Some voters will seek out and publicise objective information that contradicts it, and this in turn will raise the costs of maintaining it. Sustaining the illusion incurs information costs, search costs, and communication costs. These are not trivial: while information about taxation is readily available, the communication costs are very high.

We should all be aware of how much tax we pay and how much tax others pay.

It is not just voters who can be rationally ignorant. The former prime minister of New Zealand, Mike Moore, made a remarkable confession in the *Australian Financial Review*: he has been advised, apparently repeatedly, to leave New Zealand as a tax refugee.[29] Moore writes, 'I once talked to some senior NZ politicians about this and their eyes glazed over, as mine did when I was in politics, thinking, "stop complaining, you must be earning it to pay [the top tax rate]".'

Tax system complexity

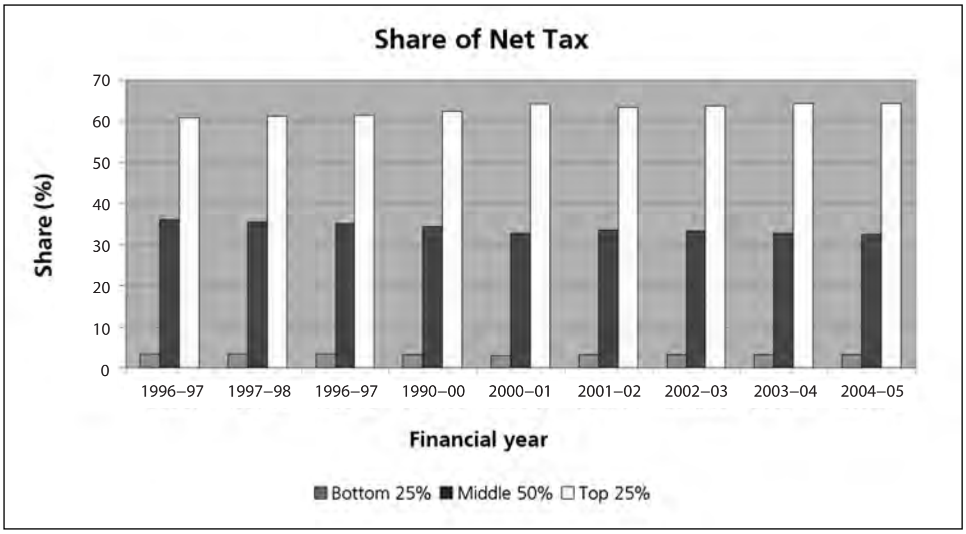
Having a complex tax system is the first step towards fiscal illusion. The complexity of the Australian tax code is such that, in 2005, the code itself totalled an estimated 8,800 pages.[30] In 2006, the federal government announced that it hoped to eliminate 2,135 pages of 'inoperable' material from the tax act. In 1936, the *Income Tax Act* was 126 pages long; by 1996 the tax act was 3,500 pages long.[31] Since 1996, the tax code has more than doubled in size. Gary Banks estimates that at that rate on growth, 'by the end of this century the paper version of the *Tax Act* would amount to 830 million pages. It would take over 3 million years of continuous reading to assimilate and weigh the equivalent of around 20 aircraft carriers.'[32]

Adam Smith's second maxim of taxation is that tax 'ought to be certain, and not arbitrary.'[33] Smith took the view that certainty is an important consideration; in fact, 'a very considerable degree of inequality … is not near so great an evil as a very small degree of uncertainty.' In Smith's view, uncertainty of taxation 'encourages the insolence and favours the corruption of an order of men [tax collectors] who are naturally unpopular, even where they are neither insolent nor corrupt.' Not only should taxation be certain for the individual taxpayer, it should be certain for all observers too. In other words, we should all be aware of how much tax we pay and how much tax others pay. One of the problems of the Australian tax system is that there is a lack of trust in it—many people seem to take the view that everybody else is not paying their 'fair share' of tax.

The notion that some people are not paying their 'fair share' of income tax is, of course, entirely true. Figure 1 shows the relative net income tax shares of the bottom 25% of taxpayers, the middle 50% of taxpayers, and the top 25% of taxpayers.

As can be seen, the net income tax share of the top 25% of taxpayers has increased from 60.8% in 1996–1997 to 64.3% in 2004–2005. At the same time, the net income tax share of the bottom 25% has fallen from 3.4% to 3.2%, while the middle 50%'s net income tax share has fallen from 36% to 32.5%. According to the 2004 Australian Election Survey, 57.8% percent of respondents thought that tax had increased between the 2001 and 2004 elections. Where income tax is concerned, that statement is only true for the top 25% of taxpayers.

Figure 1: Who pays personal income tax?



Source: Derived from ATO tax statistics

The company tax burden is even more unevenly distributed. Table 2 shows the proportion of firms with a tax liability of greater than $1 million and the proportion of net corporate tax those firms pay. In 2004–2005, 0.38% of firms paid 72.59% of all net corporate income tax. There is a lot of cynicism surrounding company tax, with some individuals claiming that large companies are able to avoid paying their 'fair share' of tax. Yet that is not the case: smaller companies tend to pay little corporate tax, while larger companies shoulder (almost) the entire burden.

Table 2: Who pays net corporate income tax?

Financial year	Proportion of firms (%)	Proportion of net corporate tax paid (%)
1996–1997	0.30	64.45
1997–1998	0.32	67.45
1998–1999	0.34	65.95
1999–2000	0.38	66.87
2000–2001	0.33	70.99
2001–2002	0.35	69.79
2002–2003	0.37	70.54
2003–2004	0.39	70.20
2004–2005	0.38	72.59

Source: Derived from ATO tax statistics

The curious case of Australia

Australia has a big government, and relies on fiscal illusion much as many other economies do. There is, however, a curious anomaly in the Australian environment. In the past eleven years, the Howard government reduced its use of some forms of fiscal illusion while increasing its use of others. For example, it eliminated federal public net debt and replaced the highly complex wholesale sales tax with the much less complex and more transparent GST. It also attempted to eliminate or reduce many state taxes, levies, and charges that create fiscal illusion.

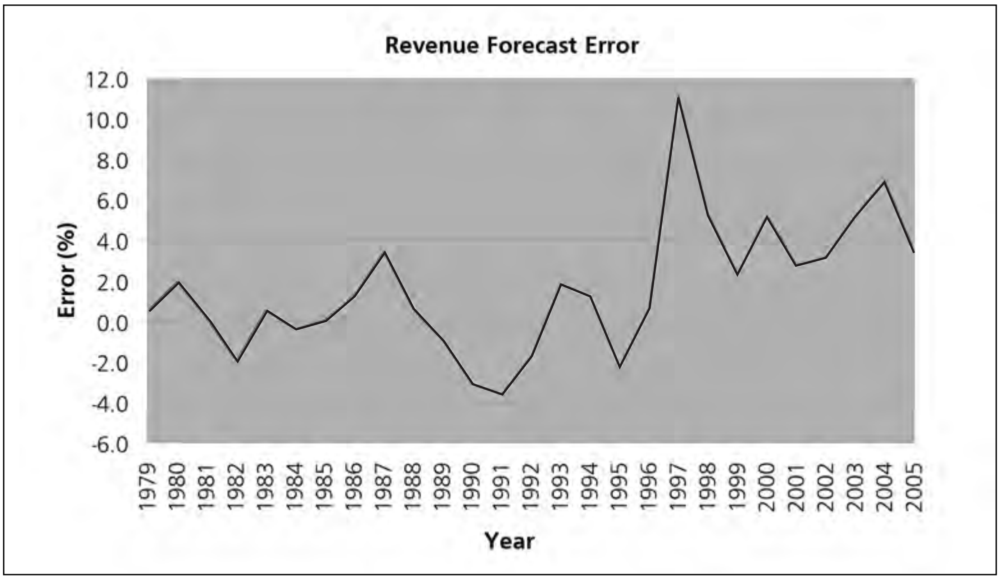
Yet the same government employed opportunistic taxation with gusto, refused to cut spending, and ran a budget surplus. In contrast to Ronald Reagan's argument that government will always spend all the money it can, the Howard government was strongly committed to running a surplus and did *not* spend all it could. It also did not reduce taxes as much as it could have, establishing the Future Fund and the Higher Education Endowment Fund to 'park' budget surpluses.[34] There was, however, no suggestion that these funds would reduce future tax burdens. Rather, they were created to subsidise future government spending. Most of the economic literature in this area predicts that Leviathan will grow as much as it can and will likely run budget deficits. The public choice literature on budget surpluses is under-developed. That same literature suggests that budget surpluses occur when rent-seekers reduce their lobbying behaviour.[35] It is not clear that this argument is appropriate in the Australian environment.

In his 2007 budget speech, then-Treasurer Peter Costello made the following comment:

> Our tax system exists to fund the decent services in health, education, aged care, and other services that Australians legitimately expect and are entitled to receive. If after we provide for those services, invest for the future, and balance our Budget, we can reduce the tax burden, we should do so. [36]

Costello often made this or similar comments, and they seem to express a sensible and responsible claimed fiscal policy. Robert Carling has described the Howard government's fiscal strategy as keeping the budget in balance, on average, and the forward estimates in surplus.[37] As Costello's comment indicates, cutting taxes followed from the primary strategy. Alex Robson has argued that an important part of Australian fiscal illusion is 'unexpected' revenue.[38] Australians have come to expect that budget surpluses will always turn out to be larger than initial estimates. Figure 2 calculates the revenue forecast error as a proportion of the original budget estimate of government revenue.

Figure 2: How big is the budget surplus?



Source: Relevant Commonwealth budget papers

An unbiased forecast should, on average, be correct. Unexpected events always confound forecasts, but over time these errors should be random and not reveal a pattern. Since 1996, however, the forecast errors have been large and positive. Robson argues that this is all part of a deliberate strategy to avoid tax cuts.[39] Former Secretary of the Australian Treasury John Stone, has been scathing in his comments, referring to the forecast errors as a 'persistently woeful record' that 'can no longer be regarded as just bad luck.'[40] It seems that the Howard government deliberately ran larger surpluses than it announced each year. This strategy was facilitated by the Treasury underestimating government revenue. Yet the government did not spend all the money raised, and nor did it cut taxes as much as it could have. John Stone argues that had the government used the 'unexpected' surpluses to cut tax, the top marginal personal income tax rate could have been cut to 30% and the capital gains tax could have been abolished.[41]

Policy responses to fiscal illusion

The Inspector-General of Taxation (IGT) acts as an advisor to the federal government, in the interests of taxpayers. This high level position was created as a consequence of a 2001 election campaign promise. In particular, the IGT has the brief of making recommendations for the improvement of the tax system. The IGT cannot, however, review tax policy. The IGT has already expressed concern about the complexity and administration of Australia's tax laws.[42] Providing information that counters the effects of fiscal illusion would be within the IGT remit. A lot of information is placed into the public domain by the Australian Bureau of Statistics, the ATO, and the Commonwealth Treasury. A single, authoritative report into tax system complexity would reduce fiscal illusion substantially. In other words, part of the IGT work plan should be a comprehensive strategy for taxpayer fiscal education.

The Charter of Budget Honesty requires the Treasurer to produce an economic and fiscal outlook report at each budget.[43] The charter is very prescriptive about what the report should include, and even sets out the principles of 'sound fiscal management.' These are, among other things, to 'pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden.' There is nothing unusual about anything in the charter; it all seems quite reasonable. What is missing, however, is any requirement that the information in the report be accurate. In other words, there is no requirement that the budget itself is 'honest.' This is a major oversight. It is possible, but unlikely, that bad luck has confounded revenue estimation since the Howard government was elected. Stock market analysts with such a poor forecast accuracy record would attract the attention of financial market regulators. It is clear that the Treasury revenue forecasting process needs to be audited, and quality control processes need to be adopted, but it is not clear who would be in a position to undertake such an audit.

The Howard government did very little to reform and simplify the income tax system.

Robert Carling has previously addressed the issue of earmarked taxes.[44] As he argues, taxpayers may choose to accept earmarked taxes, yet should have access to transparent information. Governments levying hypothecated/earmarked taxes should have to report and publicise, each year, the number of such levies, the revenue raised by those levies, and the total expenditure they support (they should publicise, for example, that the Medicare levy only raises about 25% of the cost of Medicare).

Conclusion

Fiscal illusion sustains growth in government revenue and spending. The Howard government was one of the highest-taxing and -spending governments in Australian history. The tax system is complex and unfair, with a small proportion of individuals and even smaller proportion of companies paying the lion's share of both personal net income tax and net company tax. The Howard government did very little to reform and simplify the income tax system. Yet, at the same time, it took steps to reduce fiscal illusion by eliminating public debt and simplifying indirect taxes.

The Australian Leviathan is thriving, yet is also attracting some criticism. Its arguments against reducing taxation become shriller each year. It is clearly becoming harder for government to find areas where it can spend money effectively. Rather than returning surplus funds to taxpayers, the government is choosing to invest in equity portfolios on the stock market through special purpose funds. There are limits to how far this strategy can go.

Endnotes

1 Hypothecated taxes are those where the revenue is dedicated to a purpose related to the activity taxed. An example would be a petrol excise whose revenue is used to build and maintain roads. Tax hypothecation is also known as *earmarking*.

2 James M. Buchanan, *Socialism is Dead but Leviathan Lives On*, CIS Occasional Paper 30 (Sydney: The Centre for Independent Studies [CIS], 1990). Reproduced in *The Collected Works of James M. Buchanan*, vol. 1 (Indianapolis: Liberty Fund, 1999).

3 As above, 186.

4 To some extent, this may have occurred. In Australia, the 'big government' party (Labor) holds government in all states, while in the US the 'big government' party (the Democratic Party) holds both the House and Senate.

5 See Sinclair Davidson, *Are There Any Good Arguments against Cutting Income Taxes?* CIS Policy Monograph 69 (Sydney: CIS, 2005).

6 See Murray Rothbard, 'The Myth of Neutral Taxation,' *The Cato Journal* 1 (1981), 519–564.

7 Poll taxes and land tax are said not to distort economic decision-making. This may well be true in a textbook setting, but introducing poll taxes has proven to be political suicide.

8 George Stigler, 'Smith's Travels on the Ship of State,' in *The Economist as Preacher, and Other Essays* (Chicago: University of Chicago Press, 1971), 142.

9 Joel Slemrod, 'My Beautiful Tax Reform,' in Alan Auerbach and Kevin Hassett (eds), *Toward Fundamental Tax Reform* (Washington: AEI Press, 2005), 138.

10 For an accessible review of the large literature in this area, see Joel Slemrod, 'The Consequences of Taxation,' in Ellen Paul, Fred Miller, and Jeffrey Paul (eds), *Taxation, Economic Prosperity, and Distributive Justice* (Cambridge: Cambridge University Press, 2006).

11 Slemrod, as above.

12 In other words, elasticity corresponds to the turning point of the (Australian) Laffer Curve. See Davidson, *Are There Any Good Arguments* for a discussion of the Laffer Curve and evidence supporting this theory. The turning point is calculated as $(1 - t)/t$, where t is the top marginal income tax rate in Australia (45%, excluding the Medicare levy). Also see Slemrod, 'My Beautiful Tax Reform,' 79.

13 Jonathan Gruber and Emmanuel Saez, 'The Elasticity of Taxable Income: Evidence and Implications,' *Journal of Public Economics* 84 (2002), 1–32, especially table 1, 5.

14 Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, vol. 2 of *The Collected Works of James M. Buchanan* (Indianapolis: Liberty Fund, 1999), 44–45.

15 There is, however, an exception to the rule. When governments are trying to collect revenue, they want to minimise the tax response, but on other occasions, when engaging in social engineering, they may want to maximise the response.

16 Slemrod, 'My Beautiful Tax Reform,' 87.

17 James M. Buchanan summarises Puviani in his 1967 book *Public Finance in Democratic Process*, vol. 4 of *The Collected Works of James M. Buchanan* (Liberty Fund: Indianapolis, 1999).

18 James M. Buchanan, 'Tax Reform as Political Choice,' in *Debt and Taxes*, vol. 14 of *The Collected Works of James M. Buchanan* (Liberty Fund: Indianapolis, 2001).

19 As above, 52.

20 See Robert Carling, *Tax Earmarking: Is it Good Practice?* CIS Policy Monograph 75 (Sydney: CIS, 2007) for discussion of tax hypothecation.

21 Andrew Norton, *Will You Still Vote for Me in the Morning? Why Politicians Aren't Rushing to Increase Taxes*, CIS Policy Monograph 65 (Sydney: CIS, 2004).

22 The AES data (2004–2005) is available from the Australian Social Science Data Archive, http://assda.anu.edu.au/. Those who carried out the original collection and analysis of the data bear no responsibility for my analysis and interpretation of it.

23 Some within the revenue lobby argue that the Australian tax system is proportional. This is incorrect: in Australia, income tax and the total tax burden in is progressive. See Sinclair Davidson, 'Taxation with Misrepresentation: Australia's Revenue Lobby in Denial,' *Policy* 20:4 (Summer 2004–05), 31–37.

24 It is possible that some respondents were confused by the interaction of the tax system and the welfare system: low-income earners do face high effective marginal tax rates.

25 AES 2004–05.

26 The converse was true too. Nearly 56% of voters favouring the Coalition on tax policy knew low-income earners pay a lower proportion of their income in income tax.

27 For a full discussion, see Roger D. Congleton, 'Rational Ignorance, Rational Voter Expectations, and Public Policy: A Discrete Informational Foundation for Fiscal Illusion,' *Public Choice* 107 (2001), 35–64.

28 Arthur Lupia and Mathew McCubbins, *The Democratic Dilemma: Can Citizens Learn What They Need to Know?* (Cambridge: Cambridge University Press, 1998); Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton: Princeton University Press, 2007), argues that four sources of voter bias lead to poor policy preferences.

29 Mike Moore, 'This Cup Does Not Runneth Over,' *Australian Financial Review* (24 May 2007), 63.

30 Fleur Anderson and Duncan Hughes, 'Costello Overhauls Tax Laws,' *Australian Financial Review* (25 November 2005), 1.

31 *The Australian*, 'Tinkering at the Edges,' (25 November 2005), 1.

32 Quoted in Fiona Buffini, 'Getting Rid of Clutter Not Easy in a Minefield', *Australian Financial Review* (25 November 2005), 53.

33 Adam Smith had four maxims of taxation. See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, (1776; repr. Chicago: University of Chicago Press, 1976), 350–352.

34 See Stephen Kirchner, 'Future Fund or Future Eater: The Opportunity Cost of Commonwealth Revenue Hoarding,' *Policy* 22:3 (Spring 2006), 28–31.

35 Russell S. Sobel, 'Can Public Choice Theory Explain the U.S. Budget Surpluses of the 1990s?' *Journal of Public Finance and Public Choice* 23 (2004), 169–181.

36 Peter Costello, 'Budget Speech 2007–08' (8 May 2007), http://www.budget.gov.au/2007-08/speech/html/Speech.htm.

37 Robert Carling, 'Put Budget Surplus to Good Use,' *Australian Financial Review* (17 September 2007), 71.

38 Alex Robson, personal communication.

39 Alex Robson, 'Peanuts via Costello Makes Us All Proper Charlies,' *Canberra Times* (5 September 2007), 11.

40 John Stone, 'Mr Costello's Repeated Budget Failure,' *National Observer* 73 (Winter 2007), 13–24.

41 As above, 23.

42 John Garnaut, 'Tax Watchdog Has Million-step Plan to Fix the System,' *Sydney Morning Herald* (10 February 2004).

43 Commonwealth of Australia, *Charter of Budget Honesty Act 1998*, http://scaleplus.law.gov.au/html/pasteact/2/3115/top.htm.

44 Robert Carling, *Tax Earmarking*.

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CIS Policy Monograph • PM81 • ISSN: 0158 1260 • ISBN: 978 1 86432 196 8 • AU$9.95
Published December 2007 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

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