DT: 336.22; 336.02; 336.22.01
Keywords: public choice – size of government – fiscal illusion – tax incidence – social security – payroll tax

Visibility of Taxes and the Size of Government

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Positive theories of the size of government (for example, Peltzman (1980), Meltzer and Richard (1981)) generally assume that taxpayers have perfect information about the taxes they pay, their incidence and their deadweight costs. Yet the opposite idea, that taxpayers are not correctly informed about taxes, has also enjoyed considerable support, notably among libertarian thinkers. Governments are sometimes accused of reducing the „visibility" of taxes so that they could pluck more money from taxpayers who are less prone to oppose taxes that are „hidden" from them. This proposition has often been popularized by Milton Friedman: „Which taxes should be abolished? The least visible... You need taxation, but taxation should be visible so that people know what they are paying. Otherwise you give everyone the impression he is getting something for nothing."[1] For example, income tax withholding presumably hides the income tax from workers, compared to the old way of collecting income tax in a single payment at the end of the year.

The „fiscal illusion" literature (Wagner (1976), Clotfelter (1976), Pommerehne and Schneider (1978)) has tested the visibility hypothesis empirically, typically by regressing the size of local or state governments on indirect measures of tax visibility, such as a Herfindahl index of tax sources. The results have varied from finding a strong negative relationship between visibility and government spending to finding the exact opposite. One possible reason may be that the measures of visibility are rather imperfect proxies and reflect other relevant factors, such as the efficiency of the tax system or power of particular interest group.

In this paper I provide a new, cleaner test of the visibility hypothesis. I use the split of the payroll tax between employers and employees as a measure of visibility. This brings several advantages: how the payroll tax is divided between employer and employee has no effect on the efficiency of the payroll tax, and no effect on the division of real tax burden between employer and employee. It is a mere accounting device. However, higher employer's share might reduce the workers' awareness perception of the tax. In most countries, it was set at the time when the Social Security program was introduced, and has not changed since then. The employer's share of the payroll tax varies substantially among countries, ranging from zero in the Netherlands to one in Pakistan. Most countries are somewhere between the two extremes, but typically the tax is split fifty-fifty or is tilted more heavily on the employer.

I obtain data on the split of the payroll tax from „Social Security Systems around the World", and data on country characteristics and government finances from GFS and ILO. In the sample of 89 countries, covering the 1985–1999 period, I regress the ratio of pension spending to GDP on the employer's share of the payroll tax and several control variables. Surprisingly, I find that the effect of the split goes *against* the visibility hypothesis – the payroll tax is lower in countries where employers pay a larger fraction of it. The coefficient is significant but small. It implies that if a typical country increased the employer's share from 50 % to 60 %, the pension spending as a share of GDP would drop by 0.2 percentage points. In other regression spe-

[1] Milton Friedman in Prague (1997)

cifications, the effect of the employer's share often becomes insignificant, but nowhere do I find a significant positive relationship between employer's share and payroll taxes. This casts serious doubts on the visibility hypothesis.

In the second part of the paper, I try to reconcile the data with theory and present the first (to my best knowledge) formal model of size of government in which taxpayers are misinformed about taxes. The traditional visibility argument tacitly assumes that there is only one taxpayer group, and in such a case the argument is undisputable. But it ignores one of the central issues in public finance, tax incidence. If tax incidence is brought into the analysis, the visibility argument becomes less straightforward. If there are two taxpayers who bear the tax burden, the government can get bigger if the tax becomes less visible to both taxpayers. This may be unrealistic in practice. For example, shifting the payroll tax from the workers to employers can indeed make the tax less visible to the workers, but it can as well make it more visible to the employers. I model this idea in the framework of Becker and Mulligan (1998). One tax is imposed on two taxpayer groups, who have some initial misinformation about the tax incidence. The total tax revenue is determined in political competition between the two taxpayer groups and one group of subsidy recipients. Each taxpayer group spends resources on political pressure based on its own perception of the tax burden. Under certain assumptions, I show that only one taxpayer group will be active. When the tax becomes more visible (i.e., when the taxpayers' misinformation about tax incidence gets closer to the truth), I show that the government will get smaller only if the perception of the active taxpayer group gets stronger so that the active group increases its opposition against the tax. If the active group's initial perception of the tax burden was too „pessimistic", that group will reduce its opposition when the tax becomes more visible, and the government will get bigger.

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SUMMARY

JEL Classification: H1, H22, H55
Keywords: public choice – size of government – fiscal illusion – tax incidence – social security — payroll tax

Tax Visibility and Government Size

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The paper studies the popular hypothesis that "hiding" taxes from taxpayers, such as by nominally dividing the payroll tax between employees and employers, leads to higher taxes. To test the hypothesis, I analyzed payroll taxes and pension spending in a sample of 89 countries and found that countries where employers nominally pay a higher share of the payroll tax tend to have lower taxes and smaller pension programs, contrary to the visibility hypothesis. In an effort to rationalize these counterintuitive results, I derive an interest group model of the size of government where taxpayers have biased information about taxes and their incidence. The model shows that the government may get larger when taxpayers are better informed if making a tax more visible to one taxpayer group makes it less visible to another group, which I argue is plausible in some real-world applications.