On the origins and main consequences of fiscal illusion. a short tribute to a big Economist: James Buchanan

Vicini, Andrea

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The Fiscal Illusion is a old phenomenon with a new consideration. Historically speaking the first theorist of this concept is the Italian economist **Amilcare Puviani (1854-1907)**. As is widely recognized by many economists the contributions on Public Finance are developed basically in Italy during the XIX Century. However, all these separated concepts were been structured and systematized only during the XX Century. These concepts are became object of study by the Public Choice and in particular by **James Buchanan**, which is the architect of a coherent framework (or as defined euphemistically by himself a **Research Program in political economy**[1]) which integrate all the development of macroeconomics theory, with the studies on the public finance, with particular reference on the Italian school which produced original ideas[2].
Although there is not a general consent on the definition of **Fiscal Illusion** because often in economy the original definition was substitute by the main effects, (as explicative example considers the correct definition of inflation as point out by Mises) in his general formulation, the **Fiscal Illusion** suggests that when government revenues not completely transparent or are not fully **perceived by taxpayers**, then the cost of government is seen to be **less expensive than it actually is**.

Since some or all taxpayers benefit from government expenditures from these unobserved or hidden revenues, the public's appetite for government expenditures increases, thus providing politicians incentive to expand the size of government[3].
In this proposition are contained numerous economics unintuitive mechanisms, which must be examined, more in detail. Buchanan (1967) provides a formulation of Puviani's theory, in his essays and contribute to a reconsideration of the original concept which produce a substantial new literature on Fiscal Illusion, most of it mainly empirical and related to the public governance[4]. The essence of the empirical work on Fiscal Illusion consists of econometric studies based upon some kind of model of public spending[5].
From a epistemological point of view, Puviani’s work although formulated in the beginning of the XX century, adopts theoretical concepts not available by the theory during the time of formalization but only many years after, such as: the hypothesis of asymmetric information, the concept of rationality which became a fundamental assumption for the behavioral economics and the others new fields of economy. This presence of concepts not adequately acquired from the mainstream, has

1 Cfr.: J. M. Buchanan – *Politics without Romance* – Policy • Vol. 19 No. 3 • Spring 2003. p. 1-6.
2 Cfr.: R. E. Wagner – *Public Choice and the Diffusion of Classic Italian Public Finance* – Il Pensiero Economico Italiano 11, 2003. p. 271-282.
3 Cfr.: J. M. Buchanan – *Public Finance in Democratic Process* – Vol. 4, Chapter 10. Liberty Fund, 1966. p.100-111.
4 Cfr.: P. Reis Mourao – *Towards a Puviani’s Fiscal Illusion Index* – Revista de Economía Pública, 187- (4/2008), p. 49-86.
5 Cfr.: W. E Oates – *On the Nature and Measurement of Fiscal Illusion: A Survey* – In G. Brennan et al., eds., Taxation and Fiscal Federalism: Essays in Honor of Russell Mathews (Sydney: Australian National University Press, 1988). p. 65-81.

generated many difficulties which affect on the acceptance among economists, because the notions of rationality make claims about illusion that seem to border on being assertions of irrationality[6].
In his essay Puviani analyze different cases of Fiscal Illusion, the specific situation are described and enriched by Buchanan, with the opportune reflections. In general terms we can affirm that the illusions are created through taxes and through public spending programs or mix of both.
First of all the total revenues needs for produce the public services, and any individualized share in this total may be obscured to the taxpayers, this situation produce an evident **Fiscal Illusion**.
Although the cases described in Puviani 's analysis are interesting, many economists are convinced that his model appear not close to current institutional setting, in particular the general hypothesis of continuous research of Fiscal Illusion by the government is not always verified[7].
As stressed by Buchanan in clear sense *"Puviani looked at the whole fiscal process through a "different window" from that which has been used by English-language critics. The institutions were to be explained, in his vision, by the unconscious motivation of the ruling class to exploit the ruled. Upon closer examination, however, we see that Puviani did little more than make explicit some of the norms for fiscal organization that were also widely accepted by the* utilitarians"[8].
Respect to the role of the economics we can say that Puviani assumes a neutral position regards the government, similar to the Public Choice. The essence of the Phenomenon is related with the concept of correct information and consequent behavior. If the chooser does not possess adequate information about alternatives and if he is uncertain, he conceptualizes the **alternatives imperfectly**. If he is affected by an illusion, he conceptualizes the alternatives falsely. It is evident from the assertion mentioned that in this scenario the role of expectations is important, it is needs remember that a illusions may be both optimistic and pessimistic.
The cases study of Fiscal Illusion are very large, a complete description is not possible in this paper, (in that case it is needs a specific essay); however the different institutional setting joint with the level of fantasy of the politicians play a relevant role in every country. However it is possible explains some general principles which are the essential elements presents in a Fiscal Illusion:

- A constraining fiscal policy is in general obtained with a reduction of the public spending or with a raise of the taxation. In both cases the costs are immediate, while the benefits are often perceived in the future.
- Another situation is generated between benefits concentrated, i.e. directed to specific group or social category, and costs diffused, shared between numerous taxpayers. In other words, the concentration of the benefits (public spending or fiscal advantage) in a restricted group produce a strong reaction, because a common interest is concentrated and organized. On the contrary the presence of costs diffused make difficult organize a real resistance, because the individual cost of resistance could cost more than the single tax requested.
- Another situation is originated by the contrast between visible benefits, which are perceived by the direct interested and invisible costs which are not perceived by the taxpayers. The visibility produce consent for the politicians proponent, whereas the frequent invisibility of the costs neutralize the opposition. This scenario explains because the increase of the public spending conduct systematically to a deficit, the cost is future diffused and so invisible, whereas the benefit is immediate concentrated and directly perceivable.
- The progressive taxation is another source of Fiscal Illusion, because in presence of a increase of nominal salary, the marginal ratio is directed in great part to the fiscal agency, with a effect on the real salary reduced respect to the nominal terms.

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6 Cfr.: R. E. Wagner – *Public Choice and the Diffusion of Classic Italian Public Finance* – Il Pensiero Economico Italiano 11, 2003. p. 271-282.
7 Cfr.: B. Dollery, A. Worthington - *The Empirical Analysis of Fiscal Illusion* - Journal of Economic Surveys 10(3): (1996). pp. 261-297.
8 Cfr.: J. M. Buchanan - *Public Finance in Democratic Process* – Vol. 4, Chapter 10. Liberty Fund, 1966. p.100-111.

The attention directed to the Fiscal Illusion is increased even with the contribution of empirical investigation as expressed before. One part of the economics literature concentrates the attention on the mechanisms of measurement. Furthermore, the increase of public debt in many countries moved the attention on others factors respect to the traditional element considered by the mainstream economics, which are not enough for a exhaustive explanations.
An interesting investigation in this field, was conducted by Paulo Reis Mourao[9]. The author builds an index for Fiscal Illusion for attempt to provide a clear benchmark, in his article after the identification of the theoretical framework Reis Mourao recall the attention on the vast literature produced regard the **Fiscal Illusion**, and then builds a quantitavive models which adopts a range of **twenty-six variables**, taking into account their use in the literature, analytical soundness, measurability, country coverage, relevance to the phenomenon being measured, and relationship to each other, to develop a robust index. The data is related to 68 countries, including developing and developed countries. The countries were selected using the specific filter, who have chosen only those democracies with comparable requisite. The period covered in his investigation is from 1960 to 2006. From the analisys emerge a decrease in the values of the Fiscal Illusion index for all countries between 1960 and 2006 which reveals that there has been a generalized reduction in Fiscal Illusion over time. Therefore, we can infer that **democratic maturity** improves **good governance practices**, consequently reducing **Fiscal Illusion levels.** However, how is evident, this reduction was not equal across countries. The most significant improvements occurred in countries like Belgium, Italy, Portugal, or Spain, with a significant decrease of more than fifty percent. Although the numbers of variable and the correlation between them generally can conduct to mis-interpretation and consequently not correct conclusions, some general considerations can be stressed.
In this study the countries were grouped according to two dimensions: age of democracy (old/new democracies) and degree of development of the country (developed/developing). The **old democracies** include the established democracies 32 countries were considered as “old” democracies and the other 36 as “new”[10].
However, it is important to point out that in 2006, the geopolitical scenario was completely changed respect to the past, the **new democracies** or developing countries had a level of Fiscal Illusion equivalent to the one characterizing **old democracies** or developed countries in 1960. This fact suggests that new democracies or developing countries, on average, are exhibiting the **Fiscal Illusion** dimensions that the developed world had forty years ago.
Moreover, from the time series observed, emerge some lines of tendency, the **Fiscal Illusion** level of the new democracies/developing countries remained stable until 1984-1985, years that signal the beginning of a period of diminishing values. After a period of a more significant decrease (1984-1995), the level of Fiscal Illusion stabilized until the last temporal observation.
This reveals that in spite of the national and international economic, social, and political convulsions, there are institutions in each country and in each group of countries that maintain the fiscal and political practices leading to a “natural” value of **Fiscal Illusion**, which can be adopted in my view as a indicator of **democratization of the public policy.**

A different point of view is expressed by Wallace Oates in his article he considers the limits of the empirical literature on the **Fiscal Illusion**[11]. His reservation on the results produced by the econometric findings are concentrated on the endogeneity of the illusion variables and alternative explanations of the results. A part the classical objections directed toward the econometric studies, it is needs remember that statistical correlation don't demonstrate the existence of nexus of casualty.

9 Cfr.: P. Reis Mourao - *Towards a Puviani's Fiscal Illusion Index* - Revista de Economía Pública, 187- (4/2008), p. 49-86.
10 Cfr.: P. Reis Mourao - *Towards a Puviani's Fiscal Illusion Index* - Revista de Economía Pública, 187- (4/2008), p. 49-86.
11 Cfr.: W. E Oates - *On the Nature and Measurement of Fiscal Illusion: A Survey* - In G. Brennan et al., eds., Taxation and Fiscal Federalism: Essays in Honour of Russell Mathews (Sydney: Australian National University Press, 1988). p. 65-82.

The Second observation formulated by Oates considers the subjectivity of the fiscal illusion. The authors is convinced that because the phenomenon is strictly related with individual and psychological behavior, it is not possible a "categorization", thus appear improper all the considerations which consider the individuals as a aggregate. This last point seems particularly weak to me, because even the marketing analysis which considers the potential consumers are built on a accurate "profilation" of the individuals.
In conclusion we can affirm that the continuous developments of economics literature on the transparency of the government, and the electoral behavior, shows that despite being an old idea, Fiscal Illusion is a phenomenon that persists in **democratic countries**, conditioning their economies, mainly the **public policy**[12].
In my view, the contribution of James Buchanan remain a milestones in the analysis of the policy maker's behavior. His area of study is a bridge between the political science and the public finance, this character of interdisciplinary influenced me to the approach of the macroeconomics questions.

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12 Cfr.: P. Reis Mourao, L. Gonçalves Vega - *Elections, Fiscal Policy and Fiscal Illusion* - NIPE WP 18/ 2010.