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## Taxpayer Choices in Future Tax Shifts

By Vito Tanzi

If one should interview the Italians on their preferences for spaghetti as compared to hamburgers, the answer that he would get is rather obvious: Italians would have nothing to do with hamburgers and would most surely prefer to continue eating spaghetti. Now, as every expert on nutrition will tell you, the protein content of spaghetti is very low. That of hamburgers, on the other hand, is very high. Consequently, the Italians would be much better off, the nutritionists believe, if they changed from spaghetti to hamburgers.

Tax experts find themselves very much in the position of the nutritionists while the taxpayers are very much in the position of the Italians. The experts keep prescribing taxes that are "good" for the taxpayers; the taxpayers keep preferring taxes that they like. The pattern of tax structure change for the various countries reflects these two often conflicting influences and it is probably no accident that the countries where economic science is more developed (the Anglo-Saxon countries) are also those where the tax systems are more biased toward "good" taxes.

As long as the level of taxation is relatively low it may be possible for the experts to have their logical arguments carry the day. But as the level of taxation rises, the conflict between their recommendations and the taxpayers' preferences become more acute, and taxpayers' resistance hardens. In due time the structure of taxation is likely to come to reflect more and more the taxpayers' preferences. The moral is then simple: when tax burdens become high, taxpayers' preferences become more important. After all, as Schmolders has written, "pub-

lic preferences follow not logical but psychological laws."

Since this paper is supposed to deal with urban problems, I shall not discuss in detail the fascinating and greatly under-researched subject of taxpayers' psychology. Rather I shall draw a few conclusions from that limited literature to anticipate changes that I believe are likely to take place in the financing of central and local governments as they try to increase their tax burdens. I shall also briefly point to some aspects of taxation that have been practically ignored in the public finance literature.

### ***This Issue in Brief***

As the level of taxation rises, says Dr. Tanzi, conflicts arise between the kind of taxes prescribed by experts and those taxes taxpayers themselves prefer.

In a recent poll asking which tax was the least fair or the worst, 45 percent named the property tax. Answering another poll asking what tax was preferred if the Federal government had to raise taxes "substantially," a similar percentage voted for a value added tax; 30 percent for raising the individual income tax.

Answering a like question on ways of raising state taxes, 46 percent voted for a sales tax, 25 percent for an income tax and 14 percent for a state property tax.

"There is little doubt," says Dr. Tanzi, "that, given the choice, the majority would prefer indirect over direct taxes, regardless of the opinion of the tax experts. . ."

More than a century ago John Stuart Mill wondered whether "direct or indirect taxes are the most eligible." After observing "the unpopularity of direct taxation" and contrasting it "with the easy manner in which the public consent to let themselves be fleeced in the prices of commodities," he reached the conclusion that "An Englishman dislikes, not so much the [tax] payment, as the act of paying." He called this preference for indirect taxes an "infirmity of the popular mind." His final assessment, however, was that "if our present revenue of about seventy millions were all raised by direct taxes, an extreme dissatisfaction would certainly arise at having to pay so much." The implication, thus, was that indirect taxes are necessary evils since they make possible the raising of needed revenue.

Hugh Dalton, another Englishman who, in addition to having written one of the classic texts in public finance, had also the distinction of having held the office of Chancellor of the Exchequer, sided with the "plain man" in the conviction "that the best tax is that which is least felt, that is to say which causes the least inconvenience and *conscious* sacrifice to those who pay it." Dalton quotes approvingly an ingenious Cambridge formula "that the rich should pay more taxation than they think, while the poor should think they pay more than they do."

It was an Italian, Amilcare Puviani, however, who seems to have made the most important contribution to the subject of the subjective burden of taxation or of "fiscal illusion." Some of the more important advice that he gave to the authorities to minimize taxpayers' resistance by creating a fiscal illusion makes very interesting reading. Here are a few samples: rely on taxes that are included, or "wrapped up" to use Dalton's expression, in the prices of the products since, in this case, the taxpayer is likely not to be aware of the tax that he is

paying and not to feel the sacrifice. He would, therefore, argue against the American practice of separating the tax from the price in local sales taxes. Do not remove or change the tax laws too often since the taxpayers become particularly insensitive to taxes which have been levied for a long time. Take advantage of shifts in public opinion which decrease the taxpayers' resistance to new or additional taxes. Avoid relying on just one or two taxes since the greater the number of taxes, the lower the taxpayers' resistance. Collect the levy when it is least painful to the taxpayer.

### **Indirect Taxes Account For Major Part of 521 Legislative Actions**

With this introduction let us now turn our attention to the problems that the states and the local governments of the United States are having in raising the revenues that they need.

At the state level general sales taxes account now for more than 30 percent of state revenues and the trend has been definitely upward. In the words of the Advisory Commission on Intergovernmental Relations (ACIR): "Since World War II, state tax policymakers have tended to adopt a direct consumer tax policy in order to reconcile their need for additional tax revenue with their desire to minimize the damage which tax increase action might have on the tax environment." The ACIR reports also that of 521 legislative actions — increasing rates or enacting new rates — by states between January 1, 1959 and December 15, 1971, indirect taxes — that is general sales, motor fuel, cigarette and alcoholic beverage — accounted for 375 while the direct taxes for only 146.

In the 1967-71 period seven states introduced an individual income tax and eight a corporation tax. By the end of 1971, 45 states had general sales taxes, 50 had gasoline and cigarette taxes, 49 had death and automobile registration taxes, 40 had individual income taxes and 45 had corporation income taxes. Finally, 33 had taxes on distilled spirits and 14 on gifts.

At the local level there was a fall in reliance on the property tax and a greater dependency on other sources including sales taxes, income taxes, charges and miscellaneous, and transfers from states and from the Federal government.

There is some evidence that the states and the local governments are paying more attention to the psychology of the taxpayers even though the legislators have probably never heard of Puviani.

First of all there is a clear indication that these governments are beginning to rely more on taxes



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that are "wrapped up" in the prices of the products. However, there is still the habit of separating the tax from the price in the belief, as Dalton put it, "that mankind can only learn through suffering, and that political responsibility can only be brought home to us through conscious payment of the price of greatness — or of folly as the case may be."

There is also some evidence that, in good Puviani fashion, they are taking advantage of shifts of opinion. A clear example of this occurred after the Surgeon General of the United States reported a link between the incidence of cancer and cigarette smoking. Quoting again the Advisory Commission on Intergovernmental Relations:

"... cigarette tax rate increases were enacted largely without fear of an accompanying adverse voter reaction. State cigarette tax rates could be, and were, catapulted to higher levels. In 1959 only two states imposed cigarette taxes of as much as 8 cents per pack. By 1967, 27 states had cigarette taxes of 8 cents or more per pack..."

Third, there is the already reported trend toward diversification of the sources of revenue.

Over the last decade there have been several studies which, using survey techniques, have tried to find out what the taxpayers preferences were for alternative forms of taxation. The most recent of these was based on a poll made last May by the Opinion Research Corporation for ACIR.

When asked which of the major tax sources utilized presently by the three levels of government was the least fair or the worst, 45 percent identified the local property tax, 19 percent the Federal income tax, 13 percent the state income tax and another 13 percent the state sales tax; 10 percent had no opinion. There was some variation among the respondents but all groups were in agreement as far as the property tax was concerned. When asked which of these taxes was the fairest an almost equal percentage chose the Federal income tax (36 percent) as the state sales tax (33 percent). The state income tax was chosen by only 11 percent and the local property tax by only 7 percent. There is thus little doubt that at the state and local level the taxpayer preference is by far for sales taxes. State income taxes and especially local property taxes are simply not very popular.

The property tax is probably the only tax for which the taxpayer is well-informed about the precise amount that he pays. Only the person who pays the tax as part of his rent is not aware about the payment. If the taxpayer spreads the tax payments throughout the year by including the tax in

the monthly payment that he makes to the bank holding the mortgage, he should resent the tax a little less. If he holds no mortgage, he should resent the tax more because he will pay it in a lump sum. If his income fluctuates and he has no mortgage, he is very likely to dislike the tax even more since he will pay it regardless of the level of income in a particular year.

These expectations were borne out by the poll. Those who were 60 years or older, and can thus be assumed to include a higher percentage of those who have paid their mortgages, and the farmers, who probably carry less mortgages than the others and in addition have fluctuating incomes, gave the property tax the worst rating. The renters on the other hand rated this tax much more favorably than the others even though, as Professor Dick Netzer has argued, they may carry a heavier burden than those who live in the house they own.

### **Answers to ACIR Poll Favored VAT Over Increased Income Tax**

The ACIR poll asked also a question about the possibility of replacing part of the revenue from the local property taxes with a value added tax and with an increase in individual income taxes. The answers to these questions are also interesting. In spite of the fact that, as Puviani maintained and as Dubergé found in his survey, taxpayers are wary of new taxes, and in spite of the considerable publicity over the years about the inherent fairness of an income tax, more than twice as many respondents (32 percent) favored the value added tax as compared with an increase in income tax (14 percent). Interestingly enough a full 44 percent did not want any of these two actions. Obviously, they did not quite believe that the introduction of a new tax, or an increase in an existing one, would lead to a decrease in property taxes. Their experience told them that such things never happen in the real world.

Another question asked by the ACIR poll was: suppose the Federal government must raise taxes *substantially*, which of these do you choose: collect a value added tax, raise individual income tax rates, broaden the base of the income tax. The answers to this question were: 34 percent for a VAT; 10 percent for raising the individual income tax rates; and 40 percent for broadening the base of the income tax. Since the last alternative is hardly a realistic one, the interesting choice is between the first two. Furthermore, when the interviewed were asked to choose the second best way of raising substantial revenues, they chose the value added tax above the other options.

Finally, the question was asked: "suppose your state government must raise taxes substantially, which of these do you think would be the best way of doing it: state income tax, state sales tax or state property tax?" The answers to these questions were: state sales tax, 46 percent; state income tax, 25 percent; state property tax, 14 percent; other and don't know, accounted for 15 percent.

**Must Pay More Attention to Administrative, Compliance Costs**

There is little doubt that, given the choice, the majority of the taxpayers would prefer indirect taxes over direct taxes regardless of the opinion of the tax experts on the topic. In particular with respect to the state and local governments of the United States, they would prefer sales taxes to income taxes and income taxes to property taxes. There is little doubt too that as the level of taxation rises, these preferences will manifest themselves in an always clearer fashion. Thus if one had to make a bet on the future development of the state and local tax structure one would be wise to put his money on an increasing role for indirect taxes.

Why is it that people have these preferences? The answer about the psychology of the taxpayers emphasized by Mill, Dalton, Schmolders, Dubérgé and some others is only part of the answer. I simply cannot believe that all there is to it is that taxpayers "dislike, not so much the payment, as the act of paying." There is surely more to it.

First of all, I believe that we have to pay much more attention to administrative and especially compliance costs than we have done up to now since these costs may be very different from tax to tax. To give some very quick examples. In a recent study for Montana it was found that the share of administrative and compliance costs in total revenue was 29.0 for individual income taxes, 9.5 for property

taxes, and only 1.7 and 2.7 for beer and cigarette taxes. B. Strumpel also found very high compliance costs for income taxes in Germany.

One related problem is that the compliance costs are not only high but very different from individual to individual. This raises an issue of horizontal equity. It is bad enough to have to pay high taxes; it is worse to have to spend a lot of time and money to pay the tax. A real cost of compliance for the direct taxes (income, property, etc.) is the price of purchasing equity in the appeals system when there is disagreement between the taxpayer and the tax authorities. Audit and appellate conferences and litigation take a lot of time and money. Appeals procedures that are costly will make the taxpayers feel cheated. As it always happens, the rich will be represented by trained lawyers, the average taxpayer will have to do it himself. In most cases he will feel frustrated and helpless.

Still another problem is the uncertainty connected with the payment of a direct tax. For the property tax it is the uncertainty of the assessment. Is the assessment right? Is it the same as for comparable houses? For the income tax, it is the great number of grey areas for which one never knows whether to take a chance or not. If he takes a chance, he may spend the next three years with the anxiety of being audited. If he doesn't, he may spend them feeling like a fool. The tremendous success of tax practitioners in the U.S. has been attributed to their practice of solving doubtful issues in favor of the taxpayer.

In conclusion I would expect over the future years a shift away from the property tax and from the state income taxes toward more reliance on indirect forms of taxation. We are likely to become less concerned with equity on the revenue side and more concerned on the expenditure side.

