

FISCAL ILLUSION IN CLASSICAL ECONOMIC LITERATURE
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I. INTRODUCTION

Fiscal illusion refers to the ability of certain fiscal institutions to alter the perceived costs and benefits of the public sector. Buchanan [2, 1960, pp 59-66; 3, 1967, Chapter 10] is the first modern economist to write directly on the concept of fiscal illusion. He traces the concept's origins back through the writings of Mauro Fasiani in the 1940s to those of another Italian, Amilcare Puviani, at the turn of the century. However, fiscal illusion is not a concept first borne by Continental minds. Classical economists of the late 18th and early 19th Centuries incorporated fiscal illusion into their analysis of public finance. This paper will provide the reader with evidence of fiscal illusion in classical economic writings. Readers who are unfamiliar with the concept of fiscal illusion may find the paper enlightening since each major illusion-generating institution is discussed.

The next section will discuss the relationship between taxation and fiscal illusion. The benefits of public services and fiscal illusion will then be analyzed. The fourth section will explore public debt and how Classical economists believed this method of finance hid the cost of government.

II. TAXATION

Indirect taxation is an excellent example of an institution which generates fiscal illusion. An excise tax nominally paid for by a producer is just one example of indirect taxation. J.B. Say noted fiscal illusion generated by excise taxes in his analysis of tax incidence:

[The seller] frequently does no more than advance the tax either wholly or partially; . . . so that a great many persons are paying portions of the tax, at a time when they least suspect it, either in the shape of the advanced price of commodities, or of personal loss, which they can feel but cannot account for [12, 1844, p. 471].

Adam Smith [13, 1971, p. 355] observed that greater fiscal illusion is generated when the tax is collected gradually and in small amounts. In his discussion of the excise tax on salt, Smith observed "that nobody could feel very sensibly even a pretty heavy tax upon it."

John Stuart Mill [7, 1936, p. 865] also recognized the illusion accompanying indirect taxation. He believed the burden of direct taxation was the only burden the taxpayers were sure they bore. The direct taxation made citizens aware of the costs of public services. This awareness would act as a

control to limit public expenditures which Mill felt was absent with indirect taxation.

Thomas Cooper was the foremost American economist during the first half of the 19th century. He noted [5, 1971, p. 260] that public officials resorted to indirect taxation so as to hide the costs of government and he considered such financing to be "taxes on ignorance."

Piercy Ravenstone [10, 1966, pp. 21-22], a Ricardian Socialist, believed that the incidence of taxation was deliberately obscured in order to gain political acceptance. The incidence theory that taxes fell ultimately on "property" was nothing more than a rationalization intended to generate illusions.

Thus it was recognized by Classical writers that indirect taxes as well as taxes collected often and in small amounts, fostered fiscal illusion. These taxes lowered the resistance of the public to the financing of public expenditures.

III. EXPENDITURES

Taxpayer-voters may not be fully aware of the benefits of public services. Such benefits may be indirect and quite difficult to evaluate. Mill thought there was a systematic undervaluation of the public benefits of public services. He believed that indirect taxation was justified since the illusion on the tax side would offset the underestimation of the benefits of government services:

. . . If our present revenue of about seventy [1862] millions were all raised by direct taxes, an extreme dissatisfaction would certainly arise at having to pay so much; . . . so great an aversion to taxation may not be an unqualified good. . . [The financing of public services has] again and again been prevented by the reluctance which existed to apply to Parliament for an increased grant of public money. . . . [7, 1936, 855-66].

John R. McCulloch was also aware of the ability of indirect taxation to distort the perceived burden of taxation. He believed that taxpayer-voters would underestimate the benefits of government services and justified hiding the amount of taxation via indirect taxation because of the failure of taxpayer-voters to fully appreciate public service benefits.

The burden of direct taxation is palpable and obvious. . . . And the benefits derived from government, though of the highest importance, being neither so very obvious nor striking as to be readily felt and appreciated by the bulk of the people, there is in the great majority of cases a strong disinclination to the payment of direct taxes. For this reason governments have generally had recourse to those that are indirect. [6, 1968, p. 147]

Public officials can control or manipulate to some degree the stock of information held by voters. Classical economists realized the unique positions of bureaucrats allowed them to affect the perceptions (i.e., generate illusions) of voters. Henry Parnell noted this ability of government officials when he wrote concerning the practicality of trimming the government budget:

It is almost impossible for persons, not themselves in office, to have sufficient knowledge of details to be able to expose the fallacies on which the pleas for expense are enforced; and the absence of such an exposure produces often a belief that the expense is necessary [9, 1968, p. 99].

Classical economists were fully cognizant that citizens were not fully informed concerning the benefits of the public sector. Some justified indirect taxation on the grounds that fiscal illusion on the tax side may balance the illusion on the benefit side. Our Classical precursors were also aware that information concerning public service benefits could be manipulated by public officials.

IV. PUBLIC DEBT

A major strand of modern public finance literature concerns itself with public debt. Buchanan's early work [1, 1958] on the burden of the public debt set off a now famous and quite furious debate which lasted most of a decade. As E.G. West [15, 1975] pointed out, this debate was primarily the result of economists using "burden" to discuss two different concepts.

At the aggregate level there is no burden of internally held debt. Money is merely passing from one hand to another. Other than the Ricardo-Pigou effect of reduced capital formation, no burden is placed on future generations because the debt revenues take resources out of current private consumption and investment.

However, at the individual level, taxpayers can currently avoid the financial burden of public expenditures by having the government borrow in the capital market. At a future date, future generations of taxpayers would bear a burden when this debt was retired. Even though in the aggregate the lenders and taxpayers are the same people, at the individual level their functions can be separated.

Classical economists were well aware of both the aggregate and individual burdens of the public debt. One such classical economist was Count Destutt Tracy, whose Treatise on Political Economy had its translation edited by Thomas Jefferson in 1817. Tracy [14, 1970, p. 241] demonstrated the Ricardo-Pigou effect and acknowledged that resources obtained by public debt were utilized in the period borrowed. He also summarized the argument

Buchanan presented one hundred and forty years later concerning the burden of the debt.

Modern economists accept the basic Ricardian equivalence theorem that equated a once and for all tax with the issuance of debt. However, classical economists, including David Ricardo himself, did not believe that individuals would consider the two alternatives quite equivalent. After explaining his equivalence theory, Ricardo went on to offer an important qualification which was based on fiscal illusion:

From what I have said, it must not be inferred that I consider the system of borrowing as the best calculated to defray the extraordinary expenses of the state. It is a system which tends to make us less thrifty--to blind us to our situation [11, 1973, pp. 162-63].

The propensity of public debt to generate fiscal illusion was almost universally accepted by classical economists. One can scarcely find a scholar of that period who was not opposed to the excessive use of debt because of its ability to "blind" taxpayers. After explaining the Ricardo Equivalence Theorem, Thomas Chalmers wrote:

Notwithstanding, however, loans are more popular than taxes The people do not feel that governments are [sic] taking the money out of their pockets by borrowing, though this is virtually done, and at the time too, in the shape of higher prices, if not in the shape of higher taxes. They think that a loan only entails a distant calamity, although the full weight of it is felt in a present calamity. But this is not perceived, and blindness reconciles them to a sore infatuation [4, 1968, p. 495].

But Adam Smith had previously instructed everyone on this subject and in the strongest and clearest terms. Discussing the means of raising a large amount of revenue to support a war, he wrote:

They [government] are unwilling for fear of offending the people, who, by so great and so sudden an increase of taxes, would soon be disgusted with the war; and they are unable from not well knowing what taxes would be sufficient to produce the revenue wanted. The facility of borrowing delivers them from the embarrassment which this fear and inability would otherwise occasion [13, 1971, p. 402].

Smith believed that government fools the people by not directly taxing them. Sovereigns create public debt because its effects are felt only indirectly. The expense of the war is only directly felt when the public debt is to be paid off.

J.B. Say [12, 1844, p. 483] also noticed that nations feel "stronger" because of the

national debt or rather because of their ability to so easily raise revenues. They were more likely to attempt gigantic and wasteful projects and more likely to wage war. Tracy [14, 1970, p. 245] echoed a similar conclusion and also noted that nations often placed themselves in positions deemed necessary to cause an increase in public debt. Without the debt creation potential they would be less prone to allow themselves to be put in such positions.

Henry Parnell [9, 1968, p. 103] observed that ". . . the [Napoleonic] war destroyed all previously established systems of control and economy [in government]." This was due to the government's ". . . facility of getting money by loans." He noted that all the extraordinary expenses that arose during the war were having their effect felt by other taxpayers only after the war was over. Parnell was probably not the first nor the last writer to notice that temporary expenditures have a tendency to become permanent when he wrote, ". . . though the war is over the spirit of profusion survives."

Classical economists were aware that public debt removed some political limitations on expenditures and that authorities may over-extend the public sector with public debt. The expected result would be a default on the debt.

Adam Smith [13, 1971, p. 42] was well aware of the tendency of sovereigns to increase the debt in order to avoid directly taxing their subjects. He was also aware of how these sovereigns could avoid a "bankruptcy" or a default on the public debt. They could also fool their subjects and creditors by resorting to an earlier form of money creation: raising of the denomination of the coin.

This money creation and its accompanying inflation is actually a very indirect method of taxation. This type of taxation makes it very difficult indeed for an individual to identify his share of the burden of the costs of government goods and services. In fact, an individual may not be at all certain how government is to blame for his decreasing real income.

V. CONCLUSION

Fiscal illusion refers to the ability of certain fiscal institutions to alter the perceived costs and benefits of the public sector. The concept is generally thought to have been only an area studied by modern economists. Hopefully, this paper has dispelled that notion. Classical writers were aware of such illusion-producing devices as indirect, confusing and complex taxation. The ability of the government to exploit fiscal illusion concerning the benefits of government programs was also observed. Mill and McCulloch observed that consumers often undervalued the services of government--another form of illusion.

Public debt and its ability to beget illusion on the part of taxpayers was noted by most classical economists. Taxpayers would feel liberated from the burden of expenditures financed by public debt. Also noted was the tendency of government to overexpand its outlays due to the debt's facility in raising revenue. Money creation was seen as a method of avoiding default on the public debt. The resultant inflation was viewed as an indirect form of taxation which generated fiscal illusion.

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