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The Challenge of Transparency in Taxation

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Fiscal illusion may not be a household term, but it is nothing new. Coined by Amilcare Puviani in 1903, *fiscal illusion* theorizes that the ruling class intentionally misleads the public by exaggerating the benefits of public services and obscuring the total tax burden.[1] The theory was developed and popularized by economist James Buchanan in the 1960s as a way to better understand tax policies and outcomes. While fiscal illusion involves a *systematic misunderstanding* of both expenditure and revenue policy, scholarly analysis has focused primarily on the revenue side through the examination of tax policies. This policy brief focuses on tax policy and its relationship with transparency as a means of possibly counteracting the effects of fiscal illusion.

While the federal government has taken the lead in implementing efforts toward greater transparency—for example, by creating the easy-to-access website Recovery.gov to enable visitors to track the spending of stimulus money[2]—state and local governments are following suit by providing more online information about how they spend taxes.[3] Proponents of increased transparency in the public sector, including elected officials and citizens, believe that transparency is an important tool for holding governments accountable and reducing corruption. In a period when trust in government has hit a record low (24 percent in 2014 and a record low of 19 percent in 2013),[4] increased transparency is viewed as a way of promoting trust and cooperation between government and its citizens.

Despite almost universal support for transparency, there is no clear way of efficiently and effectively achieving this goal. Many such efforts involve posting more information and data online, but data dumping by itself does little to increase transparency. For example, does making 10,000 pages of expenditure and revenue information available online further transparency when the

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pure volume of information makes it next to impossible for researchers to understand, much less find, what they are looking for? In response to concerns about data dumping, academics and nonprofits have attempted to categorize how open and accessible state websites really are. As of 2013, 43 states have created websites dedicated to fiscal transparency. In many of those cases, however, the fiscal data the states present are not easily accessible or digestible by either nonexperts or scholars—thus the websites are not successful at reaching the majority of the public.[5] Exceptions include the states of Kentucky, Arizona, and New York, which not only present fiscal information on their websites but also provide video tutorials of how to navigate their sites.

Other common methods to increase transparency involve expanding citizen knowledge and participation in the budgetary process. This is done through information sharing in the form of budget briefs and participatory budgeting, whereby citizens choose how and where to spend a portion of their budgets (as is currently done in San Francisco, Vallejo [California], St. Louis, Chicago, New York, and Boston). Participatory budgeting allows citizen groups to create proposals and then vote on them directly, thereby taking control of a portion of government expenditures.[6]

To date, most efforts toward greater transparency in the public sector have targeted the expenditure side of public spending while ignoring the revenue side. For example, in 2013, Michigan began to provide comprehensive line-item budget expenditure reports with expenditures characterized as core services, support services, or work projects.[7] Given polling statistics showing that 76 percent of Americans believe government spends too much, this trend may not be surprising.[8] Despite the lack of attention given to the revenue side, 72 percent of Americans report that the federal government needs to either completely overhaul its tax system or make major changes to it.[9] Perhaps one reason for the emphasis on expenditures rather than revenues is that in many states, revenues are already subject to referendum and tax and expenditure limits and are therefore considered so restricted that states and local governments are less inclined to engage citizens in conversations about tax policy. Or it may be that concerns about accountability are primarily about how the money is being used—not how it is collected.

The lack of public discourse about revenue transparency does not mean that public revenues are at all transparent. This brief discusses revenue transparency with particular attention to what makes revenue instruments transparent, what the obstacles to transparency are, and some options for increasing transparency.

TRANSPARENCY AND THE FISCAL ILLUSION

Transparency in government can be understood as government providing data and information on its operations, management, and policies—that is, clear information on what it is doing and how. Advocates of transparency come from across the political spectrum, from normal citizens, and from numerous nonprofits.[10]

Broadly speaking, a government's revenues are transparent when people can understand their total tax burden, including fees and license costs. Fiscal illusion research is very concerned with the lack of transparency in government financing. Most research on this topic revolves around the tax burden and finds that fiscal illusion causes citizens to perceive their tax burden to be lower than it actually is. This misperception leads citizens to believe that government services cost less than they do, thereby creating demand for government services to be beyond what is socially optimal. This is troubling because there is also evidence that when citizens understand the true cost of government, their policy preferences change. For example, one study finds that the transparency of the local tax burden has a strong impact on citizen demand for redistributive policies: 90 percent of citizens supported a policy when the tax was opaque versus only 10 percent when the same tax burden was transparent.[11]

OBSTACLES TO TRANSPARENT REVENUES

There are many obstacles to making government revenues transparent. Some have to do with the nature of the revenue instrument while others are the result of policy choices or tax administration. An underlying reason is the high cost to citizens of getting complete information on their total tax burden.[12] These costs, scholars have argued, lead citizens to choose to be "rationally ignorant" regarding their tax burden, which then allows governments to rely on deceptive or illusionary revenue instruments.[13]

The difficulty of acquiring this information is due to several factors. First, many taxes or fees are paid throughout the year, so citizens who want to capture their full tax burden must carefully monitor each tax payment.

Sales taxes are collected on the purchase of most commercial items (not all items, though; for example, many states do not collect sales taxes on food, and in some states food is taxed at the local but not the state level). This means that many Americans pay sales taxes multiple times a day, so to know their total tax burden they would have to keep track of every receipt and be mindful of the sales tax rates in their jurisdictions.[14] This temporal spacing is most apparent in the sales tax, but other common examples are excise taxes (such as for gasoline or tobacco), tolls, park fees, and utility fees.

A second obstacle is the revenue complexity in the American system, in large part because there are a lot of taxes and fees that citizens pay. Fiscal illusion literature has shown that the tax system becomes more opaque as the number of revenue instruments grows. This problem is exacerbated by a reliance on taxes that are less visible and are spread out over time.[15] This becomes especially problematic when citizens must pay the same tax in multiple jurisdictions and to various levels of government. Because citizens may pay federal, state, and even municipal income taxes, they need to understand how their burden is spread over multiple governments.[16]

An additional obstacle is that some tax instruments are inherently less transparent than others. For example, the impact of sales taxes is attenuated by virtue of frequent payment, whereas property taxes, when not paid through escrow accounts, are more transparent because they are made known to taxpayers much less often, typically once a year. Many researchers of fiscal illusion theory point to the very transparency of property taxes as the primary reason why they are so unpopular. Similarly, income taxes *should* be transparent, but income tax withholding has made them more opaque.[17] Taxpayers are not confronted with their tax bill and may not keep track of how that burden accrues over the course of the year.

Why would government make its revenues less transparent? The fiscal illusion literature would say policymakers make them less transparent to make them more politically palatable. Another explanation is that as policymakers implement changes to ease administration, a loss of transparency is simply a side effect.

STRATEGIES TO INCREASE TRANSPARENCY

What can be done to increase transparency on the revenue side? There are numerous strategies, but many are not feasible. For example, revenue systems would be more transparent if revenue instruments were used only by one level of government, not by overlapping jurisdictions. The more levels of government that share a tax base, the more difficult it is for taxpayers to track where their tax money is going, which in turn makes it difficult to hold the appropriate level of government accountable.[18] Another strategy would be to limit the number of revenue streams used at each level of government. If states were financed exclusively by income taxes, citizens could calculate their tax burdens more easily.[19] Under the current system, the citizen has to combine income tax burdens with sales taxes, excise taxes, fees, and so on.

There are more feasible ways in which governments could increase transparency. First, they could choose (if legally able) to rely on more transparent taxes. For local governments this could mean relying more heavily on property taxes and less heavily on sales taxes.[20] Increasing property taxes would most likely be met with a good deal of opposition from the public. The literature provides evidence that more visible and transparent tax structures lead to increased rationality of policy outcomes, so facing the political backlash may be worth it.[21] Furthermore, there is evidence that citizens are more willing to pay higher taxes (and trust elected officials) when fiscal institutions are more transparent.[22]

Other ways that government can increase revenue transparency are less structural in nature. Through increased citizen education and engagement, citizens can come to understand the ramifications of different revenue policies, including what their respective tax burdens actually are.[23] Governments could provide taxpayers with "receipts" for different tax instruments, which breaks down how much of a citizen's taxes goes to each government program.[24] In November 2014, a bipartisan effort in Oklahoma, the Taxpayer Transparency Act, led to the creation of a taxpayer receipt.[25] It is intended to foster understanding of how taxes support state government and to enable citizens to hold their elected officials more accountable—ultimately leading to superior outcomes. However, citizens must first know their tax burdens to input them into the tax receipt form and receive a breakdown of what their taxes are paying for.

One of the few other states to adopt a taxpayer receipt is Utah.[26] The Utah system requires citizens to input their income tax burden on a receipt form, but it also allows citizens to estimate their own sales tax burden or provides an estimate based on a citizen's income. While this system is imperfect—for example, it does not take into consideration family size or the individual taxpayer's preferences or behaviors—it does provide a reasonable estimate of the taxpayer's *state* sales tax burden, thereby increasing transparency of sales tax revenue. To make this process even more transparent, Utah could link to the receipt once income taxes are filed to use taxpayers' personal information to populate the receipt, compare this information to the average burden in the state, and include estimates of all other taxes and fees.

Beyond creating a taxpayer receipt, few states and local governments are making an effort to increase revenue transparency. One exception is momentum toward shining a light on tax expenditures—that is, government spending through the tax code using various forms of tax breaks. While this approach does not directly help citizens understand their true tax burden, tax expenditures are not only a form of public spending; they also affect many aspects of tax policy and equity. For example, Massachusetts now publishes its tax expenditures budget, allowing taxpayers to view all tax expenditures and the magnitude of each. The budget focuses on expenditures from three categories of taxes: personal income tax, corporate income tax, and sales tax.[27] Vermont passed a law in 2013 mandating that the government must evaluate and provide justification for all tax expenditures.[28] While these efforts make substantial progress in making government more transparent, both governments and citizens need to do more to fight fiscal illusion as it applies to tax burdens.

Citizen outreach and education is difficult and costly. Governments have to use scarce resources to find ways to get citizens to engage. However, such efforts would be worthwhile if governments could inform citizens as to the scope of government activities, the reason government provides services and their benefits, and how much those services cost and how they are financed. Such knowledge, were it accessible, would allow citizens to make better-informed decisions about their desired level of taxes and services.

ENDNOTES

1. Many economists who study fiscal illusion still agree with Puviani. For an overview of some of these issues see Whitney B. Afonso, "Fiscal Illusion in State and Local Finances: A Hindrance to Transparency," *State and Local Government Review* 46, no. 3 (2014): 219–228; Paulo Reis Mourao, "Towards a Puviani's Fiscal Illusion Index," *Hacienda Pública Española* 187 (2008): 49–86; Richard Wagner, "From the Politics of Illusion to the High Cost of Regulation," *Of Public Interest* 3, no. 8 (2001), www.limitedgovernment.org/publications/opi_columns/OPI3-8.htm.

2. It should be noted that there are those who argue that the current White House is actually quite opaque. For example, see Josh Gerstein, "President Obama's Muddy Transparency Record," *Politico*, March 5, 2012, www.politico.com/news/stories/0312/73606.html; J. B. Wogan, "Obama's Transparency Record: Lots of Data, Not as Much Sunlight," *PolitiFact.com, Tampa Bay Times*, July 16, 2012, www.politifact.com/truth-o-meter/article/2012/jul/16/obama-report-card-transparency-sunlight; and Paul D. Thacker, "Where the Sun Don't Shine," *Slate*, March 12, 2013, www.slate.com/articles/news_and_politics/politics/2013/03/barack_obama_promised_transparency_the_white_house_is_as_opaque_secretive.html.

3. For more on state transparency efforts, see Benjamin Davis, Phineas Baxandall, and Ryan Pierannunzi, "Following the Money 2012: How the 50 States Rate in Providing Online Access to Government Spending Data" (Washington, DC: US PIRG Education Fund, 2012), http://www.uspirg.org/reports/usp/following-money-2012. For examples of these efforts, see, for Texas, "Texas Transparency," Texas Comptroller of Public Accounts' transparency website, www.texastransparency.org; and for Asheville, North Carolina, "Asheville Budget Explorer," http://www.avlbudget.org/showme.

4. Pew Research Center, "Public Trust in Government: 1958–2014," November 13, 2014, http://www.people-press.org/2014/11/13/public-trust-in-government/.

5. Examples of criteria used to evaluate these websites are level of information, historical data, tax expenditures, budget, and revenue forecasts. Websites are considered more accessible when they include learning aids or explanatory materials, such as glossaries of key terms, frequently asked questions, and video tutorials to help navigate the site. See James E. Alt and Robert C. Lowry, "Transparency and Accountability: Empirical Results for US States," *Journal of Theoretical Politics* 22, no. 4 (2010): 379–406; Joel B. Thornton and Elaine Thornton, "Assessing State Government Financial Transparency Websites," *Reference Services Review* 41, no. 2 (2013): 366–387; Jonathan B. Justice and John G. McNutt, "Social Capital, E-Government, and Fiscal Transparency in the States," *Public Integrity* 16, no. 1 (2013): 5–24.

6. These citizen proposals are first vetted by the jurisdiction, however. In most of these cities, participatory budgeting is available only in a certain district or ward. Vallejo, CA, is the only city of the six that conducts participatory budgeting citywide.

7. Mich. Pub. Act 536 of 2012, Comp. Laws § 18.1373 (2015).

8. Emily Ekins, "81 Percent of Independents, 59 Percent of Democrats

Say the Federal Government Spends Too Much," *Reason*, September 12, 2013, http://www.reason.com/poll/2013/09/12/84-percent-of-independents-62-percent-of.

9. Carroll Doherty, "Public Wants Tax Reform. But What Kind of Reform?" Pew Research Center, May 22, 2013, www.pewresearch.org/fact-tank/2013/05/22/public-wants-tax-reform-but-what-kind-of-reform.

10. For example, see "Promoting Transparent, Effective and Accountable Government," Ford Foundation, http://www.fordfoundation.org/issues/democratic-and-accountable-government/promoting-transparent-effective-and-accountable-government; "Local Policy," Sunlight Foundation, http://www.sunlightfoundation.com/policy/local.

11. Rupert Sausgruber and Jean-Robert Tyran, "Testing the Mill Hypothesis of Fiscal Illusion," Public Choice 122, nos. 1–2 (2005): 39–68; see also Tino Sanandaji and Björn Wallace, "Fiscal Illusion and Fiscal Obfuscation: An Empirical Study of Tax Perception in Sweden" (IFN Working Paper No. 837, Stockholm: Research Institute of Industrial Economics, 2010), http://www.ifn.se/wfiles/wp/wp837.pdf; Rupert Sausgruber and Jean-Robert Tyran, "Are We Taxing Ourselves? How Deliberation and Experience Shape Voting on Taxes," *Journal of Public Economics* 95, no. 1 (2011): 164–176.

12. To a lesser extent, in many jurisdictions there is also a high cost to citizens of getting total revenue collections and expenditure information. This situation occurs most frequently in small, local jurisdictions where the budget may not be online and may not be readily available, complete, or clear.

13. Anthony Downs, *An Economic Theory of Democracy* (Boston: Addison-Wesley, 1957).

14. Tax salience is another concern regarding sales taxes. Research has shown that, because the cost of the tax is not presented with the cost of the good, people do not adequately factor in the additional cost that the tax adds and consequently do not correctly modify their expenditures.

15. Visibility is understood as how clear the total burden of a given tax is.

16. This issue can be even greater for individuals who work in more than one state or live and work in different states and are thus required to pay income taxes in multiple states and are aware of how their burden in one state interacts with their burden in another.

17. They are less transparent also because of the complexity of the income tax code; the numerous deductions and tax expenditures make income taxes difficult to understand and navigate.

18. Barry R. Weingast, "Second Generation Fiscal Federalism: The Implications of Fiscal Incentives," *Journal of Urban Economics* 65, no. 3 (2009): 279–293; Lorenzo Boetti, Massimiliano Piacenza, and Gilberto Turati, "Decentralization and Local Governments' Performance: How Does Fiscal Autonomy Affect Spending Efficiency?" *FinanzArchiv* 68, no. 3 (2012): 269–302; Paolo Liberati and Agnese Sacchi, "Tax Decentralization and Local Government Size," *Public Choice* 157, nos. 1–2 (2013): 183–205.

19. These strategies are being discussed exclusively from the perspective of transparency. There are reasons why governments may not want to do this—for example, the advised behavior of revenue diversification.

20. This is becoming less and less feasible, however, and local governments are becoming increasingly dependent on sales taxes. Also, property taxes continue to make up the bulk of own-source revenue.

21. Sausgruber and Tyran, "Testing the Mill Hypothesis of Fiscal Illusion."

22. James E. Alt, David Dreyer Lassen, and David Skilling. "Fiscal Transparency, Gubernatorial Approval, and the Scale of Government: Evidence from the States," *State Politics & Policy Quarterly* 2, no. 3 (2002): 230–250.

23. See Seth B. Payton and Sheila S. Kennedy, "Fiscal Magic: Outsourcing and the Taxing Power," *State and Local Government Review* 45, no. 3 (2013): 189–195.

24. Alternate ways that such receipts could be constructed include creating a profile of an average taxpayer in a particular income tax bracket and estimating and reporting the estimated taxes paid by this person. This would enable the citizen to see the scope of taxes (and fees) as well as get an estimate of his or her overall tax burden. This kind of receipt could also report how that money is being used. For an overview of taxpayer receipts and information on creating one, see Whitney Afonso, "Would You Like a Receipt with That? An Information-Sharing Tool for Enhancing Citizen Engagement," *Public Management Bulletin* no. 8, February 2014, http://sogpubs.unc.edu/electronicversions/pdfs/pmb08.pdf.

25. Taxpayer Transparency Act of 2014, 62 OK Stat. § 62-46 (2014).

26. "Utah Taxpayer Receipt," Transparent.Utah.gov, Utah Public Finance, http://utah.gov/taxpayer-receipt.

27. See "Tax Expenditure Budget," Governor's Budget FY 2012, Commonwealth of Massachusetts, http://www.mass.gov/bb/h1/fy12h1/tax_12/hall.htm.

28. See "Tax Expenditure Reports," Vermont Department of Taxes, http://www.state.vt.us/tax/expenditurereports.shtml.