



Preferences for funding particular government services from different taxes

Simon Kemp *

Psychology Department, University of Canterbury, Christchurch, New Zealand

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Abstract

Five studies investigated New Zealanders' preferences for funding particular government-provided services from different types of tax: flat and progressive income tax and flat consumption tax. Respondents preferred progressive to flat income tax when the service was relatively cheap, and when it was perceived that rich people benefited more from the service. They preferred to fund more expensive services and those perceived as more valuable or vital from income rather than consumption tax, regardless of whether the income tax was flat or progressive. The relative funding preferences for income and consumption tax were correlated with the perceived relative predictability of revenue from the two taxes and the perceived likelihood that the government might change them, but not to respondents' ideas of how much revenue is obtained from them.

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1. Introduction

This paper investigates people's preferences for funding different services from different kinds of tax. Taxes are sometimes tagged for particular purposes. For example, in New

* Tel.: +64 3 3642968; fax: +64 3 3642181.

E-mail address: Simon.Kemp@canterbury.ac.nz

Zealand, taxes levied on petrol are largely earmarked for building new roads. Many countries maintain a separate fund for pensions for older people obtained from levies on people's salaries. On the other hand, often many government services are funded from a common pool into which a number of different taxes may be paid. Currently, in New Zealand, almost all tax is paid into the Consolidated Fund and almost all services are financed from this fund.

Taxes may differ in their apparent appropriateness for different kinds of service. It is easier to connect a petrol tax with the provision of roads than with the provision of old age pensions, for example. In this paper, two general dimensions on which taxes vary are considered. Firstly, individuals may pay tax on the goods and services they consume or on their income. Secondly, taxes paid by individuals can be distinguished by the extent to which those who earn (or spend) more pay more tax. Taxes may be progressive (higher earners pay a higher proportion of their income as tax), flat (everyone pays the same proportion of their income as tax), or regressive (higher earners pay a lower proportion of their income as tax). The studies reported below concentrate on how funding preferences for different services vary with whether the tax is a flat income tax, a progressive income tax or a flat consumption tax. A fourth category, progressive consumption tax, was not investigated. Such taxes may be levied by taxing luxuries or, as suggested by Frank (1999), by a progressive tax on income that exempts saving. However, the former case is complicated by the issue of defining a luxury (e.g., Kemp, 1998). Also, it is unclear that a progressive income tax that exempts saving would actually be *perceived* as a consumption tax.

If people do have preferences for funding different types of service from different types of tax, then knowing these preferences could be important in devising a tax system which people perceive as fairer or more appropriate, and thus happier to cooperate with. (See, e.g., Falkinger, 1995; Lewis, 1982, for discussion of psychological components of taxation and tax evasion.) However, it is not clear what preferences people might have or, indeed, whether they should have them at all.

McCaffery and Baron (2003, p. 230) stated that a “rational actor should care only about the total amount of tax she pays”. However, when people “are asked to judge the fairness of one tax, they tend to think as if this tax were the only one”. These researchers obtained empirical evidence for such thinking, which they termed disaggregation bias. There is an obvious connection between such disaggregation bias and the phenomenon of mental accounting (e.g., Thaler, 1985, 1999), and one might similarly ask what difference it would make if some services are provided from one kind of tax rather than another.

Note here a difference between the provision of government and private services. Consider for a moment what would happen if the prices of the privately-supplied goods and services that you buy were changed but that the total amount you paid for your usual basket of goods and services was unchanged. Clearly, there would be no difference if you kept on consuming and purchasing the same mix of goods and services. However, in theory – and most likely in reality as well – you could respond to changes in specific prices by changing your behaviour to consume and purchase less of the previously cheap but not so desirable items and more of the previously expensive and more desirable items.

It is not clear, however, that major behavioural changes would result if, for example, a government went from, say, funding both defence and education from both income and consumption tax to funding defence wholly from income tax and education wholly from

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