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What is tax salience?

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Brief: Tax Salience

Tax salience is a relatively new field of economic research, which emphasises that the way in which taxes are displayed can affect how they influence the economy. In particular, it emphasises that people are more likely to change their behaviour in response to highly visible and highly salient taxes. As tax salience implies that people respond to factors other than net tax liability, such as the way that taxes are displayed and the tax payment mechanism, it can be seen as an application of behavioural economics to the field of taxation.

An example of tax salience

The best known example of tax salience comes from a paper by [Raj Chetty, Adam Looney and Kory Kroft](#) that looks at sales taxes in the United States. Importantly, sales taxes are not displayed at the shelf, and are only added to the shelf price at the register.

The paper finds that as a result of low tax visibility, people don't fully incorporate sales taxes when making purchasing decisions. In other words, if the sales tax increased, there would be a smaller response in demand than would occur with an equivalent increase in price.

It is also important to note that people are not unaware or confused about the sales taxes that they have to pay. When asked about which items are subject to sales taxes, the vast majority of people were able to correctly identify which items were subject to tax and the approximate tax rate. Rather, as a result of not showing the taxes at the shelf, people don't fully incorporate them into purchasing decisions.

A concept with a wide variety of applications

The concept of tax salience has been shown to be important in a wide range of areas, such as:

- People don't take into account [ongoing ownership taxes](#) (registration) when purchasing cars.
- [E-tolls](#) are less salient than having to pay road tolls in a toll booth, and as a result tolls are generally raised to higher levels after E-tolls are introduced.
- [Income taxes and value-added taxes/GST](#) are similar taxes in a lifetime setting, but an income tax is found to have a stronger impact on work incentives in an experimental setting.

- Having [electricity bills](#) paid by automatically debiting from a bank account decreases the salience of these charges, and is shown to have a positive effect on peoples demand for electricity
- [Income tax withholding](#) and auto-filling tax returns reducing the salience of the income tax and increasing the effectiveness of the income tax system.

These examples all share the common characteristic that taxes are less than fully salient, meaning that consumers respond less to a change in taxes than they would to an equivalent change in prices. However, there is evidence that in some situations taxes can be more salient than an equivalent price rise (meaning that consumers respond more to a tax than they would to an equivalent price rise).

For instance, [Li et al.](#) look at responses to gasoline taxes in the United States and find that consumers respond around three times as much to a tax increase as they do to an equivalent price increase. They attribute this response, at least in part, to a high level of salience caused by the significant media coverage that typically precedes an increase in the gasoline tax.

Policy implications

Some taxes are designed to encourage certain behaviour, such as to decrease cigarette consumption, or limit the amount of pollution. However for most taxes, a tax is considered to be efficient if it can collect revenue while leaving production and consumption decisions relatively unchanged.

If reducing the salience of a tax can reduce the amount that people respond to that tax, it can increase the efficiency of tax collection. It is clear that there is a limit to how far this type of policy could be pursued. Tax system clarity is valued in its own right (and it would be wrong to completely deceive people about the tax they are liable to pay). Moreover, issues such as [income effects, externalities and equity considerations](#) can complicate the overall welfare effect of changes in tax salience.

Nevertheless, the examples given above in the areas of withholding income tax from each payslip (rather than collecting it all at the end of the year) and E-tolls have both reduced the salience of the tax system, and are generally (but not [universally](#)) considered successful policy improvements. It is also suggestive that highly salient taxes, such as council rates, are amongst the most politically controversial taxes.

On the other hand, if a policy is designed to change people's behaviour, it is important that the tax be highly salient. For instance, a tax on fuel may encourage people to buy more fuel efficient cars, but will only work if people incorporate that tax at the time they are buying the car. The research above suggests that this decision is influenced both by the size and the salience of the tax, and that measures to increase salience may increase the desired response to the tax.

Welfare analysis when taxes are not salient

An important contribution of research in this area is to extend traditional

welfare analysis into a situation where individuals aren't behaving 'optimally'. This is an important advance, as traditional welfare measures (such as consumer surplus, and compensating variation) use observed demand as a measure of a consumer's valuation of a good. If we think that people are not responding to a tax fully, it is no longer possible to use an observed response as the valuation of the good.

There are a variety of approaches to this problem, as well as a variety of complications that can arise in their application. As such, interested readers are directed to section 5 of the [Chetty, Looney and Kroft](#) paper and to this [video](#) (from about minute 20 onwards).

Further reading:

[Salience and Taxation: Theory and Evidence, by Raj Chetty, Adam Looney and Kory Kroft](#)

[E-Z TAX: Tax salience and tax rates, by Amy Finkelstein](#)

[Three essays on Tax Salience, by David Gamage & Darien Shanske](#)

[The simple economics of salience and taxation, by Raj Chetty](#)