Paying for Public Spending: Is There a Role for Earmarked Taxes?

MARGARET WILKINSON

I. INTRODUCTION

Tax earmarking, or hypothecation, refers to the assigning of receipts either from a single tax base, or as a proportion from a wider pool of revenue, to a specific end use; it contrasts with general fund financing of expenditure from consolidated receipts. The idea has been seized on both by those who want to defend the public sector who think it would make taxation popular and by those who want to cut public spending who expect the opposite effect.

Earmarking may be applied in a strong or substantive sense, or in a weak or nominal sense. In the strong case, revenue determines expenditure, or at least revenue must match expenditure, and there may be associated referendums on the amount of spending and the tax rate. In the weak case, earmarking is purely formal — undertaken to make the system more transparent and to inform the taxpayer of the cost of a service. Earmarking may also be wide, covering a whole spending programme, or narrow, for a specific project within a programme. The principal example of earmarking (nominal) in the UK today is National Insurance contributions (NICs) which go to the National Insurance Fund out of which contributory benefits are paid.

This paper considers the range of support for earmarked taxes, examines the issues, and asks if there is a role for such taxes in the British system.

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II. BACKGROUND TO THE DEBATE

1. Support for Earmarking

The idea of earmarking has made considerable progress among politicians. In their 1992 election campaign, the Liberal Democrats proposed 1p on income tax specifically to be devoted to spending on education; in Being Honest about Taxation (1994), they discuss wider proposals. A Labour Party policy document, Health 2000 (1994), proposed consideration of a hypothecated NHS tax, though the document preferred ‘an integrated approach and a broad revenue base’. Earlier, Leon Brittain (1988) had proposed that employees’ National Insurance contributions should be earmarked for NHS spending.

Supporters of earmarking who are on the Left or in the Centre see it as a means of encouraging people to pay for better services (such as health and education). Those on the libertarian Right see it as demonstrating to voters the cost of state services and advancing opting out and privatisation. A third view is that, whatever its outcome, earmarking would make for informed choices and more democracy. Finally, there are the sceptical who think that there should not be any greater role for earmarking than there is at present.

2. Attitudes to Public Spending and Taxation

Appendices to British Social Attitudes: The 8th Report (Jowell, Brook, Taylor and Prior, 1991) show what people tell interviewers and write in self-completion questionnaires about public spending and taxation. In most areas of expenditure, people want more spending. Even though the rubric warns ‘Remember if you say “much more”, it might require a tax increase to pay for it’, 90 per cent for health and around 80 per cent for education and pensions want ‘more’ or ‘much more’ spending. ‘The environment’ and police/law enforcement are also viewed favourably. Respondents are neutral on unemployment benefits, and only defence spending and the arts are seen as areas to be cut (Jowell et al., 1991, Appendix III, responses to Q. 2. 11 L). However, they do not expect to pay higher taxes; Tables 1 and 2 show how the conflict is reconciled. Table 1 shows what people think about levels of taxation on different incomes, and Table 2 shows in which income group they place themselves.

Table 1 shows that 50 per cent of respondents thought that those in the high income group paid too little in taxes and, by implication, could pay more and fund desirable social expenditure. However, they found tax levels on those with middle and low incomes were about right or too high, and 96 per cent of respondents placed themselves in these income groups (Table 2). Thus people think that those with ‘high incomes’ should pay more tax — but hardly anyone thinks that he or she has a high income. Most people think that they are paying
TABLE 1
British Views on Taxation, 1990: Responses to ‘How would you describe levels of
taxation for those on high, middle and low incomes?’

<table>
<thead>
<tr>
<th>Response</th>
<th>High incomes</th>
<th>Middle incomes</th>
<th>Low incomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Much too high</td>
<td>3.5</td>
<td>2.7</td>
<td>26.6</td>
</tr>
<tr>
<td>Too high</td>
<td>9.5</td>
<td>24.8</td>
<td>49.5</td>
</tr>
<tr>
<td>About right</td>
<td>34.7</td>
<td>64.0</td>
<td>19.2</td>
</tr>
<tr>
<td>Too low</td>
<td>40.8</td>
<td>6.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Much too low</td>
<td>8.9</td>
<td>0.1</td>
<td>0.7</td>
</tr>
<tr>
<td>DK/NA</td>
<td>2.7</td>
<td>2.3</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Jowell et al., 1991, Appendix III, answers to Q. 19 of the interview questionnaire.

TABLE 2
British Views on Taxation, 1990: Responses to ‘Among which income group would
you place yourself?’

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>High income</td>
<td>2.8</td>
</tr>
<tr>
<td>Middle income</td>
<td>53.4</td>
</tr>
<tr>
<td>Low income</td>
<td>42.6</td>
</tr>
<tr>
<td>DK/NA</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Jowell et al., 1991, Appendix III, answers to Q. 20(a) of the interview questionnaire.

the right amount or too much in taxes. Given this situation, some politicians
think that earmarking could make taxes less unpopular.

III. THE THEORETICAL BASIS OF THE DEBATE

1. Traditional Public Finance

The traditional approach describes the allocative and distributive failures of the
market, and the normative role of government in correcting those failures. Tax
revenues from several sources are put into a single pot, a general fund, from
which public services are provided. Equity in raising taxes is judged by ability to
pay rather than by the benefit criterion on which earmarking is based. In the
orthodox account, the government is shown to act as an omniscient and
benevolent institution which improves on the market outcome and achieves an
efficient allocation of resources. Traditional theory employs the device of a
‘social welfare function’ which guides an independent decision-taking budgetary authority. Critics of this account argue that in this approach, ‘the government’ is a black box into which voter preferences are fed and from which outcomes, which are claimed to be welfare-maximising, emerge.

Traditional theorists take a pragmatic view of earmarking (see, for example, Musgrave and Musgrave (1989) and Rivlin (1989)), or ignore it entirely (for example, Kay and King (1990)), or are sceptical (Dilnot, 1993). Musgrave and Musgrave admit that earmarking introduces rigidities into the budgetary procedure, but support strong earmarking where particular taxes are like charges on the consumer; they cite US gasoline taxes. In the most recent edition of their classic text, they allow that formal, information-giving earmarking may also have a part to play in the fiscal system. Rivlin finds earmarking reduces resistance to paying taxes; she points to the fact that there was no backlash to the 1983 US federal gasoline tax increase which ‘paid to fix roads’, nor to the repeated increases in US payroll taxes which fund social security. In Britain, Hills of the Welfare State Programme at the London School of Economics supports earmarking as a measure to promote greater democracy (Hills, 1993, p. 59).

However, most traditional thinking on taxation rejects a large role for earmarked taxes. The OECD definition of a tax appears to rule it out: ‘the term taxes is confined to compulsory, unrequited payments to general government’ (OECD, 1988, p. 37) (my italics). Orthodox public finance theorists argue that public spending should be determined by policy decisions, not by the amount of revenue raised by an earmarked tax. They point out that earmarking reduces the flexibility of the fiscal system: the yield of a tax and the revenue necessary for a service may at the start coincide, but over time, excess revenues may accumulate under some heads while there are deficiencies elsewhere. Writers from the Institute for Fiscal Studies show that NICs, Britain’s principal earmarked tax, do not determine the amount of spending on the programmes they pay for (Dilnot, 1993, p. 64). They point out that in the early 1980s, when high unemployment cut NICs revenue, the NIC rate was raised; in the boom of the late 1980s, as receipts rose, the subsidy to the National Insurance Fund from general taxation was cut; and in the recession of the 1990s, the subsidy was increased. In their view, ‘any further hypothecated taxes would principally be an exercise in deceiving voters that their tax payments controlled government spending in a way which they simply will not’ (p. 64). However, they comment that more hypothecation might make it possible to raise more revenue, but remark that this would be on the basis of deluding taxpayers rather than increasing their choices over tax and spending decisions.
2. Public Choice

The theoretical base that libertarians refer to is the public choice school, which grew up in the 1950s and 1960s. The social welfare function has no place in the public choice model where the state is not ‘an independent choosing agent’, but ‘exists only as a means through which individuals combine to accomplish collective or jointly desired objectives’ (Buchanan, 1963, p. 456).

The public choice school contends that market failure is not corrected at zero cost. As well as market failure, there is government failure which arises through the self-interested behaviour of politicians and bureaucrats. The growth of the public sector is not a response to the demands of citizens, but a burden imposed by a powerful government bureaucracy (Niskanen, 1971). To restrain public spending, mechanisms to give more power to the citizen are necessary. Earmarked taxation is one of these mechanisms.

Buchanan’s seminal paper on earmarked taxation (Buchanan, 1963) argued that financing public services from a general fund allowed the citizen to vote only on the aggregate level of public services, whereas earmarking allowed the voter/taxpayer/beneficiary ‘to participate separately, either directly or through his representative, in the several public expenditure decisions which may arise’ (p. 458). Thus voters could make ‘private’ choices on each public service by comparing their costs with their benefits.

Buchanan assumed the simple decision-making rule of the median voter and single-peaked preferences so that the median individual’s behaviour mirrors the majority’s. He then showed, using a simple two-public-good model, that general fund financing would reduce welfare. ‘Forcing him to purchase the two services in a bundle will move the individual to some less preferred position on his utility surface’ (p. 462). If separate voting on services led to 60 cents of every tax dollar paying for the police and 40 cents for fire services, but general funding led to a 50:50 ratio, then ‘since, under independent quantity adjustment, he could always, should he desire, select quantities of fire and police services indicated by the second solution, the fact that he does not do so in the first solution suggests that such a combination must be less preferred than the initial combination chosen’ (pp. 462–3). One of the two services would be over-expanded and the other contracted when compared with the optimal solution. The general fund would not provide the welfare-maximising (Pareto-efficient) quantities.

The goods used in the model — police and fire services — are ones from which every member of the community potentially benefits. Buchanan noted that a public service like education which provides ‘differentially higher benefits for particular subgroups in the community (in this case families with children) will tend to be more demand elastic than services that are more “general” in benefit incidence’ (p. 466). A rise in tax price would lead to greater reduction in quantity demanded than for a general service. He therefore remarked that
services that benefit particular groups would benefit from a ‘tie-in arrangement’, i.e. general financing.

Buchanan concluded by noting that his formal model was ‘remote from real-world political experience’, but defended it on the grounds that ‘“some theory is better than nothing”’. He then admitted that ‘A more complete and more complex treatment may lead to normative conclusions that would be somewhat more in conformity with ruling opinion’ (p. 469). In particular, the inclusion of decision-making costs in the segregated revenues model might make it “inefficient” relative to consolidated revenue schemes’, but if this were the case, the cost savings ‘must be demonstrated to outweigh the distortions upon which the model of individual fiscal choice focuses attention’ (p. 469).

Earmarking represents a return to the benefit approach to equity in taxation. However, paying in line with benefits received does not mean that each taxpayer pays the same amount of tax. Buchanan’s earmarked tax was not a poll tax: ‘the low income citizen ... is required by the tax structure to pay a differentially low tax price for units of collective good and ... the high income citizen ... is required to pay a differentially high tax price for the same good’ (p. 468). (Thus the British Community Charge, which required the same payment irrespective of income, went further than Buchanan’s interpretation of the benefit approach would have recommended.)

Some of the libertarian Right today appear to go further than Buchanan and take little account of the various caveats to which he drew attention. For them, the attractive quality of the earmarked tax is that it informs taxpayers of the costs of public services and dispels any fiscal illusion. They intend it to reduce public expenditure; it is a half-way house, particularly for private/mixed goods like education and health care, to user charges and privatisation. They emphasise earmarking’s potential for shifting the balance of power away from the state towards the individual. Bracewell-Milnes (1991), for example, demonstrates their agenda: ‘The purpose is to increase the power of the taxpayer or consumer over the money he pays; this increased power leads ultimately to the right to opt out and pay for services privately, whether through insurance or directly’ (p. 45).

3. An Unorthodox Approach

In their pamphlet, Reconnecting Taxation (1993), Mulgan and Murray argue that the upward pressure on spending on labour-intensive public services led to tax revolts throughout the world. The attempts of the Right in the 1980s to solve the crisis through cuts in both spending and taxes did not succeed. They contend that fundamental shifts in the nature of the economy and of society, which is now a ‘sophisticated, consumerist culture’, have made the old system unsustainable: the payment of taxes into a central pool out of which the state

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2 Previously an adviser to Gordon Brown, Labour Party Shadow Chancellor.
determines spending is too centralised, opaque and unresponsive. They base their arguments on ‘a tradition which works from the ground up’, which is suspicious of the state, and which ‘can be found in Jeffersonian liberalism, Catholic social thinking and in more recent years in feminist and green approaches to government’ (p. 18). They propose an alternative agenda, an important part of which is ‘to reconnect taxes and services, and to share sovereignty between elected representatives and citizens’ (p. 45). This reconnection will happen by hypothecating funds wherever possible. They propose ‘citizen choice’, rather than ‘top-down decision-making’, and subsidiarity — the devolution of tax-raising authority to regional and local level. The examples they offer are similar to those of other Centre and Left supporters of earmarking and include a ballot on a series of options for the health budget which would give information on the annual cost of each option to the average taxpayer, and regional or city-level voting on public transport tax and spending.

IV. IS THERE A ROLE FOR (MORE) EARMARKING IN THE BRITISH SYSTEM?

It is clear that earmarking cannot achieve all that its advocates desire. Some supporters expect it to be a constraint on spending, while others think that it will make taxes popular and permit spending to continue. Bracewell-Milnes thinks that earmarking will ‘help to control the rise in aggregate government spending’ (Bracewell-Milnes, 1991, p. 81), whereas Rivlin predicts the opposite effect: ‘There is one apparent exception to [the proposition that a tax increase is political suicide]: taxes earmarked for specific purposes can be raised’ (Rivlin, 1989, p. 113). Another conflict centres on democracy: some think that earmarking would increase democracy by devolving economic power to the taxpayer; others think that it would merely delude voters. Hills thinks that earmarking could mean that ‘democratic choices could be more clearly expressed’ (Hills, 1993, p. 59), whereas Dilnot argues that if further earmarking led to a greater willingness to pay, ‘it would be on the basis of misleading taxpayers rather than expanding democracy’ (Dilnot, 1993, p. 65).

In order to evaluate these claims, we must define the different types of earmarking, and relate earmarking to taxes and spending.

1. Types of Earmarking

In the case of strong earmarking, the amount of revenue from the tax determines the amount of spending on the service, and there may be referendums on programmes and the taxes to pay for them. With weak, information-giving earmarking, tax revenue may be designated for a particular service, but it does not determine the amount spent, and transfers to and from general funds are possible. There is also wide earmarking, where revenue is designated for a whole
spending function, and narrow earmarking, which provides funds for a specific expenditure within a programme. Table 3 shows possible combinations.

**TABLE 3**

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wide</strong></td>
<td>(1)</td>
<td>(3)</td>
</tr>
<tr>
<td><strong>Narrow</strong></td>
<td>(2)</td>
<td>(4)</td>
</tr>
</tbody>
</table>

(1) **Strong, wide earmarking.** With this, a whole spending programme, for example education, would be matched by its own tax. Supply would be matched to demand by changes in spending and/or revenue. Higher spending would require a larger tax revenue; saving on expenditure would mean less tax to pay, not more resources for other programmes.

(2) **Strong, narrow earmarking.** An example of this is the financing of roads by the gasoline tax in the US. The effect should be to match supply and demand by the tax price of roads.

(3) **Weak, wide earmarking.** The British system of NICs is an example of nominal earmarking for a whole spending function (contributory benefits).

(4) **Weak, narrow earmarking.** ‘Narrow’ would normally define a particular part of a programme—for example, an extra 1p on the income tax rate for nursery education—with the tax raising revenue but not determining the amount spent.

Many of those who recommend earmarking, wide or narrow, appear, though not always explicitly, to refer to strong earmarking (Buchanan, 1963; Bracewell—Milnes, 1991; Hills, 1993; Mulgan and Murray, 1993; Teja, 1991).

2. **Appropriate Taxes**

Table 4 shows UK tax receipts for 1992. Revenues are shown according to their impact or statutory incidence, but taxpayers attempt to shift their burden onto others and the chain of adjustment from statutory to economic incidence (where the true burden lies) can be extremely complex. The assumptions that are usually made (see, for example, Pechman (1985, p. 32)) are that personal income and social security taxpayers are not able to shift their burden, that personal taxes on capital or property are not shifted and that expenditure taxes are borne by consumers. Companies may shift some of their NICs backwards onto workers in lower wages, and some of their corporation tax forward onto consumers in higher prices; the burden that is not shifted is borne by shareholders. We conclude that ultimately all taxes are borne by individuals, but only some of them are transparent, with the burden clear to those who pay.

Only taxes that are transparent should be earmarked. This is because the earmarking principle is based on the benefit approach and people take decisions by voting, or less directly through their representatives, on the tax price they wish to pay for public goods. The Right is explicit on this; the Centre and Left refer to giving information and to enhancing democracy. Only transparent taxes
TABLE 4
Tax Revenues, UK, 1992

<table>
<thead>
<tr>
<th>£ billion</th>
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</thead>
<tbody>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>57.7</td>
</tr>
<tr>
<td>15.5</td>
</tr>
<tr>
<td>8.0</td>
</tr>
<tr>
<td>15.7</td>
</tr>
<tr>
<td>22.0</td>
</tr>
<tr>
<td>13.8</td>
</tr>
<tr>
<td>41.1</td>
</tr>
<tr>
<td>26.0</td>
</tr>
</tbody>
</table>

can give the information that the taxpayer/voter/citizen needs; hence an earmarked tax should not be shifted or, if shifting takes place, this should be evident to those who bear the burden. Where it is not clear who pays, earmarking should not be applied. For example, it might be thought desirable to earmark part of employers’ NICs to pay for job training; however, as this tax is partially shifted (onto workers, with the rest borne by owners/shareholders), it is not clear who bears the burden and so there is no theoretical rationale for earmarking. Income tax, employees’ NICs and taxes on domestic property are transparent, and VAT may be included with them because, though it is shifted (from producers to consumers), consumers know that they are paying. The share of transparent taxes approaches 60 per cent of total revenue, and as its advocates propose earmarking for only some spending programmes, this relatively high proportion would set no constraint on its feasibility.

3. Spending Categories

Programme-wide strong earmarking requires people to reveal their preferences for public spending by voting or (somehow) through their elected representatives. The different categories of government expenditure must be analysed to see whether this process would efficiently match supply with demand, or whether distortions would arise and make earmarking inappropriate. Public spending results from the market’s complete failure to provide some

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3 This argument applies both to strong (expenditure-determining) and to weak (information-giving) earmarking.
goods and partial failure in the provision of others, and from its inability to provide everyone in the community with an income. The appropriateness of earmarking for income redistribution is discussed below where contributory and non-contributory social security are distinguished from each other. First we look at the public spending on goods and services which arises from the market’s allocative failure.

The goods people want lie on a spectrum from pure public goods to pure private goods. However, for simplicity they may be classified into three groups: private, public and mixed. Private goods are excludable and rival in consumption and, assuming certain conditions are met, the market supplies them efficiently. Public goods lack one or both of private goods’ characteristics and the market fails entirely — there is no provision. At the national level, military defence, at the regional level, the London flood barrage, and at the local level, clean streets are examples of public goods where both exclusion and rivalness in consumption are absent. The government should aim to provide, or pay private firms to provide, pure public goods in line with people’s (unrevealed) preferences. Mixed goods, like private goods, are rival in consumption and exclusion is feasible, so the market can work. However, like public goods, they also provide non-rival, non-excludable external benefits for which preferences are not revealed, so that there is partial market failure. Health care, education, public transport, refuse collection and fire services are all mixed goods but the balance of private and external benefits varies between them. Governments should provide, or subsidise the provision of, mixed goods in line with private/internal plus external benefits.

In the light of these characteristics, strong earmarking would appear, in theory, to be appropriate for pure public goods but not for mixed goods. This is because public goods are all externality and taxpayers/voters would have to reveal their preferences if there were to be any provision at all. Those who want,
say, defence spending, would have to reveal this in their voting; and tax and spending would be in line with the median voter’s preferences. However, for mixed goods, which also provide internal benefits, the case is different. Some voters can opt out and provide for themselves and their families through the market; others gain no direct benefits (e.g. they expect good health, or have no children). Because mixed goods yield internal benefits, some quantity would always be provided by the market, and this is likely to obscure the existence of external benefits so that voting might be in line with the expected internal benefits of direct consumers only. The ‘proxy charge for private benefits’ argument would lead us to expect this; however, if it happened, the result would be provision below the efficient level, which requires taking account of externalities. This conclusion is supported by Buchanan’s view that services that provide differentially higher benefits to subgroups in the community receive lower spending under earmarking than under general financing.

Finally, perhaps because externalities are too small to justify the public provision of some mixed goods, another, overlapping, category — merit goods — is often distinguished. In the provision of these, individual preferences are overridden by a paternalistic government which decides what amounts people ought to consume. Health care and education come into this, as well as into the mixed, category. These goods may be classified, like cash benefits, as part of the government’s distribution function; they are given in kind, however, because voters prefer to make ‘gifts which are earmarked’ rather than cash.

Table 5 shows totals for the large spending programmes for the UK in 1992.

Defence (which costs over 40 per cent of income tax or 60 per cent of VAT receipts) and law and order (20 per cent of income tax or nearly 60 per cent of Community Charge plus non-domestic rates) are usually accepted as pure public goods, which were the category used by Buchanan in his model, though he considered local-level provision. If we assume that voters are not ignorant of the benefits of defence and police etc. services (for defence, mainly intangible — their feelings of security — and for the police, tangible — crime reduction — and intangible), then earmarking would match supply with demand and, assuming away decision-making costs etc., maximise welfare. Jowell et al. (1991, Appendix III) found police services were viewed favourably by voters, but that defence was eighth out of eight spending areas in popularity, below the relatively unpopular culture and the arts. Even when people thought that others would pay, only 9 per cent wanted more spending on the military and defence and almost 50 per cent (more than 50 per cent of those with an opinion) wanted less spending. Strong earmarking might not reduce (and might even increase) spending on police, courts and prisons, but it would probably reduce defence spending.

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7 Altruism (voting for internal benefits for other people), however, might lead to greater provision than this.
Health (60 per cent of income tax or 85 per cent of VAT) and education (56 per cent of income tax or one-and-a-half times Community Charge plus non-domestic rate receipts) come first and third in taxpayers’ priorities (Jowell et al., 1991, Appendix III). These are the areas for which both defenders and opponents of public spending advocate earmarking. However, as was argued above, earmarking would not be appropriate here as preference revelation is likely to be distorted, and in particular preferences for external benefits, which may or may not be perceived, are unlikely to be revealed.

Market failure in income distribution is dealt with by means of contributory and non-contributory social security. Contributory benefits come from the National Insurance Fund, which is a pay-as-you-go scheme with current contributions paying for current benefits, though beneficiaries regard their past ‘insurance’ contributions as having paid for their current benefits. NICs are the nearest there is to an earmarked tax in the UK system, with the earmarking being purely formal and cushioned by subsidies from general taxation. Strong earmarking to change current spending would not appear to be politically feasible: it is unlikely that governments would drop their commitments to beneficiaries and future beneficiaries in favour of referendums by taxpayers.

Non-contributory benefits (nearly 70 per cent of income tax or nearly 100 per cent of VAT), the largest component of which is income support for the unemployed, are different from most other public services. The tax that provides resources for them is not a payment for a service for most taxpayers, but a contribution to support others, and the benefit approach fails. Jowell et al. (1991, Appendix III) found that unemployment benefits (a proxy for income support) came sixth in popularity out of eight spending areas. Earmarking should not be applied; if it were, then the majority could, if it wished, limit the incomes of the poorest in society. (If the merit good/redistribution in kind rationale is applied to health care (and possibly also to education) then similar arguments apply for these services as for non-insured benefits and the benefit approach again fails.)

4. Specific Taxes for Specific Programmes?

As in the strong, wide case, the argument put forward for strong, narrow earmarking is an efficiency one — that it is a proxy for a charge that matches private benefits. To illustrate the issue, two transport proposals are considered: how to pay for roads and a tax for London’s underground.

Excluding VAT on cars and petrol, taxes paid by road users (£14.9 billion) amount to three times the direct cost of roads (£5 billion). However, the total costs of road use, including external costs — congestion, pollution and so on — are likely to be much higher than the direct costs. Motor vehicle duties are not a good proxy for the costs road users impose: every car-owner pays exactly the

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same amount irrespective of how much and where they travel. Petrol duty does better, but some drivers, for example in congested cities, impose far more indirect costs than travellers on other roads. With much of the cost of road use being external and with cost varying according to place and time of day, road pricing, which is now technically feasible, could be made to match costs more closely (to be more efficient) than earmarked taxes in getting drivers to pay for the social (internal and external) costs of road use.\footnote{Potentially congested roads become private goods with the price consisting of two components: a price to cover direct road costs plus an environmental tax to cover estimated external costs.}

Finally, at a low level in the public spending hierarchy, though there may be no analytical case to be made, it may be expedient to use earmarking. For example: London Transport’s investment plans are opposed by the Treasury and London’s transport suffers. The costs of a better public transport system, and in particular the modernisation of the underground system, are very high, but so are the potential benefits. London First, a business-led group, in an unpublished paper, proposed the earmarking of part of London’s business rates (which are due to fall) for transport investment. According to the Financial Times, the Treasury rejected its proposal, in part because it dislikes earmarking.\footnote{Financial Times, 14 March 1994. (There was no formal Treasury rejection of the plan, merely an informal negative reaction.)} However, improving London’s public transport infrastructure is likely to be efficient, with benefits outweighing costs. The argument for substantive earmarking as a proxy charge for private benefits is too narrow here; it is probable that a cost–benefit analysis would show social benefits far outweighing costs. Mulgan and Murray’s naïve bottom-up decision-making, with Londoners voting on whether to pay more tax for the underground network, would not be desirable: voters would vote on the basis of their internal benefits, on a narrow and short-term view of costs and benefits, whereas here, as with most public projects, a wide and long-term view is needed. Supporting earmarking to fund the modernisation of the underground is not based on the proxy charge argument\footnote{In any case, with the London First proposal, property owners, not underground users, would pay — the burden of business rates is capitalised into (lower) property prices.} but on expediency — earmarking might get some resources for a desirable project. Higher up the spending hierarchy, expediency is a more difficult principle to support.

V. CONCLUSIONS

First we must evaluate the potential effects of earmarking, and second we must judge whether any of the claims for it are justified.

Taking each category of Table 3 in turn:

(1) \textit{Programme-wide, strong earmarking, accompanied by voting on service and tax level.} If decision-making costs, problems of alternative decision-
making rules and consumer ignorance are ignored, then it may be argued that for a service that potentially benefits everyone (which is all externality, so that externalities cannot be ignored), for example national defence, there is a theoretical case for earmarking. In practice, however, it is unlikely that any party would risk the experiment. None of earmarking’s supporters use defence or law and order in their examples; education and health care are more usually advanced. However, in the case of those services where there are internal benefits which accrue to subgroups, strong earmarking accompanied by voting on their budgets and taxes to pay for them might threaten provision. It is difficult to predict the outcome of programme-wide earmarking unaccompanied by referendums. Expenditure would be more likely to determine the tax rate than in the voting case.

(2) Narrow, strong earmarking. This is the category that receives most support, even from the traditional public finance approach. The argument is that where a particular tax may be applied to a particular expenditure, it can be an efficient link between supply and demand, as price is for a private good; gasoline taxes to pay for the direct costs of roads are usually cited. However, new technology, which makes roads excludable and road pricing (to cover all costs) feasible, has made this example obsolescent, and others are hard to find.

(3) Weak, wide earmarking. National Insurance contributions fall under this head, and on the basis that an old tax is a good tax, it is probably expedient that NICs should continue. Some recent proposals to extend earmarking probably also fall into this category. The argument here is not economic efficiency, matching supply with demand; rather, it is based on the view that if people know that their money is going to, say, the NHS, they will willingly pay the tax. It is a matter of faith and expediency (and the faith may be misplaced).

(4) Weak, narrow earmarking. An example is the proposed 1p on income tax to pay for nursery education. No principle can be appealed to in support of this category; as with the NHS tax in (3), it is a matter of expediency.

We turn now to assess the claims for earmarking. The first is that it matches supply of public goods with demand and so is efficient. Second, there are the rival claims: that earmarking gets taxes more willingly paid, or alternatively that it reduces spending and could lead to privatisation. The third claim is that it promotes democracy.

Public choice supporters use simple economic models to show earmarking is Pareto-efficient. However, such models assume away the imperfections and distortions of the real world which make second-best solutions preferable. Libertarian campaigners ignore the qualifications (simplifying assumptions,
problems of decision-making rules, decision-making costs) that Buchanan pointed out could invalidate his model’s conclusions in favour of earmarking. The only evidence we have for Britain on hypothecation and willingness to pay is that employees’ NICs appear to be a popular tax. However, with NICs there is a very clear quid pro quo for each individual taxpayer — an accumulating contributions record which will result in a retirement pension and, potentially, other contributory benefits. For other services, the link between the individual taxpayer and the service is not so clear, and as most voters think that they are already paying enough tax (Tables 1 and 2), referendums might lead to results which pleased the Right, who want to reduce state provision, rather than those who want to protect spending.

Finally, we are left with the question of whether earmarking would promote democracy or merely delude voters. Strong or weak earmarking without referendums might make decision-makers more accountable, but could become mere window-dressing. Even with referendums, taking part in decision-making on taxes and spending on, say, the NHS, while all other decisions were taken by the executive, would not be a great advance for democracy. It could be that if the vote were for higher taxes and more spending for health, the government might make offsetting decisions elsewhere; or if less spending were voted for, it might feel able to spend more in another area. Over the economic cycle, revenues would rise and fall, and strict adherence to earmarking would require procyclical spending or tax changes; for example, recession would require spending cuts or tax rate increases. Alternatively, contributions to, or subsidies from, general revenues would be required which would weaken the earmarking principle. However, scepticism that earmarking would not greatly promote democracy is not a rejection of the public choice ‘black box’ criticism of the traditional approach: many difficulties also attach to analyses using the social welfare function.

Though tax hypothecation might have an expedient role to play in getting a specific project or part of a programme undertaken, it is not a solution to the large-scale and very difficult problems that governments face in making decisions on taxes and public spending. The problems that arise in providing services within resource constraints and in meeting the expectations of voters cannot be solved by earmarking, with or without referendums. Governments must weigh the alternatives, and determine priorities with full knowledge of the complexities that are involved, and then be accountable to the electorate for them.

REFERENCES


