Taxpayers Beware!

James Cox, Principal Adviser to the NSW Government Pricing Tribunal, reviews ***The Case for Earmarked Taxes: Government Spending and Public Choice*** *by Ranjit S. Teja and Barry Bracewell-Milnes (Institute of Economic Affairs, London, 1991) and* ***Charging for Government: User charges and earmarked taxes in principle and practice*** *edited by Richard E. Wagner (Routledge, London and New York, 1991).*

Referring to the situation in the United States, Gary Anderson notes (*Charging for Government*, p.13) that 'the employment of "non-tax revenue enhancement" has become popular with politicians of both major political parties as a potential cure for the federal deficit, which sometimes refers to the goal of somehow spending more while taxing less. The notion that revenue can be increased without raising taxes is therefore very attractive. On the other hand, the idea of earmarking specific tax revenues to "worthy" causes has widespread appeal. A Gallup Poll taken in May 1989 found that more than 80 per cent of respondents in California believed that the revenue from Proposition 99 tax increases on cigarettes should be earmarked to health care'.

Australia, too, has been creative in inventing user charges and earmarked taxes, like the Medicare levy and fees for university students. Impecunious State governments have advanced, in some cases, to an even higher level of creativity. The New South Wales government, for example, is financing some of the costs of improved environmental standards for the Sydney Water Board through a levy on the Board's customers, has introduced a tax on petrol to finance better roads, and is financing improvements to public transport through a levy on parking spaces.

The books under review argue that taxpayers should not be overjoyed by these developments. In only a few cases are earmarked taxes and user fees likely in practice to be much of an improvement on general-fund financing.

The Case for Earmarked Taxes includes self-continued pieces by Ranjit Teja and Barry Bracewell-Milnes. Teja, an economist with the International Monetary Fund, is particularly concerned with the part that earmarking might play in poorer countries where the general level of inefficiency may be high. For example, earmarking may protect important social and economic activities from encroachment by the military and may 'force a bureaucracy into activities which it has few incentives to pursue, such as expenditure on operations and maintenance' (p.35). Earmarking is an alternative to user charges that may be easier to implement. And it may have made acceptable to populations a higher level of taxation than would otherwise have been practical.

Teja complements his arguments with a report on earmarking in Colombia. His overall verdict is favourable, but he notes that earmarking needs substantial reform. Some 'earmarked revenues were excessive, as in the case of earmarked coffee taxes that subsidise domestic coffee consumption. . . Another example involved the earmarking of 10 per cent of revenues for the judiciary' (p.34).

Bracewell-Milnes notes that earmarking is one of the alternatives to general-fund financing through the pooling of revenues. Other alternatives include user charges, lotteries, the sale of licenses and tax relief for favoured activities. The traditional provision of public services by monopolies free at the point of consumption leads to overprovision and inefficiencies, and centralises and politicises decisions.

By comparison with general-revenue funding, earmarked taxes (and indeed user charges) reduce demand (through the price mechanism) and increase supply (by removing constraints on funding). Taxpayer discontent may be lessened by the replacement of compulsory payments by earmarked taxes or other payments that have at least a partly voluntary character. And earmarked taxes may help to draw people's attention to the costs of providing government services.

It would be hard to argue that earmarked taxes are to be preferred on economic grounds to user charges or, indeed, privatisation, if these other options are practical. Bracewell-Milnes argues that earmarking is a useful first step in areas of government activity that are hard to reform. Thus, earmarked levies for health or social security could be a prelude to more radical change.

All this amounts, once again, to a favourable assessment of earmarking. Bracewell-Milnes adds an interesting chapter on earmarking in British fiscal practice that tells a different story. Under the Development and Roads Improvement Funds Act 1909, revenues from motor-spirit duties and carriage licences were paid into the Road Improvement Fund. This was described by the government of the day as 'an extraordinary example of voluntary taxation' (p.59). Nevertheless 'governments raided the Road Improvement Fund in 1915 and the Road Fund in 1929, 1935 and 1936, and ended the hypothecation of vehicle excise duties in 1937' (p.58). In the case of social security, the link between contributions and benefits that was recommended by Beveridge in his wartime report has been progressively weakened. This was largely done to pay higher benefits to existing pensioners than would otherwise have been possible. The history of earmarking for social security and roads expenditure in Australia is equally unedifying.

Bracewell-Milnes is especially keen on tax expenditures. Tax reliefs devolve expenditure decisions from the government to the taxpayer. They may be good value from the government's point of view since they may conscript private dollars for public purposes. Yet tax expenditures, like direct

expenditures, can easily be used in the distributional war of all against all. Because the effects are hard to gauge, they may be particularly dangerous weapons in that war.

The authors in *Charging for Government* take a darker view of their subject. They approaches their subjects from the standpoint of public-choice theory and there is considerable overlap between the contributions. They tend to argue that user charges for government-provided services and, to a lesser extent, earmarked taxes appear at first sight to be similar to the prices that would be established in competitive markets. Many naive economists have indeed been misled by the resemblance. But the efficiency advantages claimed for user charges and earmarked taxes may not result in practice, for several reasons. First, politicians may not have strong incentives to price services efficiently: undercharging in general and cross-subsidies to politically influential groups may help to win elections. Second, in the absence of competitive markets, governments may not have enough information to price services at marginal cost. Third, many government-imposed charges (e.g. licence fees) are for compulsory rather than voluntary transactions and are more like taxes than prices. Fourth, the introduction of new charges may reduce the demand for a service, but there is no guarantee that government agencies will respond by reducing supply. They may instead seek alternative sources of funds to enable the activity to continue at its previous level. Similarly, there is no guarantee that the introduction of user charges would enable tax rates to be reduced; for example, the government might use the revenue to reward politically favoured groups. Fifth, earmarking might encourage rent-seeking: those who benefit from expenditure financed by earmarked taxes have an interest in increasing the amount of revenue raised through those taxes. Sixth, as we have seen, governments may raid the funds raised through earmarked taxes and use them for other purposes. To add insult to injury, they might then require the victims to pay once again for their favoured expenditure.

One strong conclusion emerges from the discussion. In the words of Nobel laureate James Buchanan, 'we can reach more robust conclusions concerning the possible earmarking of tax revenues for outlay programs that are not complementary with the generation of tax bases. Such non-complementary dedication of tax revenues does not, and cannot, serve efficiency enhancing purposes, and should be constitutionally prohibited, in any and all models of the fiscal process' (pp.161–2). For example, it may improve the level of economic efficiency to use revenue from motor-vehicle and petrol taxation to improve roads. Those who pay will receive benefits more or less in relation to the amount they pay. The same is not true of the use of vehicle and petrol taxation to improve public transport.

The contributors to *Charging for Government* particularly dislike the argument that an excise tax on cigarettes can be justified by the demands that smokers place on the health system. Dwight Lee points out that even non-smokers die eventually and there is no reason to suppose that smoking has any effect on the amount of health care that people receive over their lifetime. Lee concludes, 'There is no connection between the amount of health care an individual consumes and the amount he will pay through the cigarette tax "user charge". But it is for this very reason that the user charge justification for the cigarette tax is so popular with those associated with the medical bureaucracy. It is a charge which can be used to increase their budgets without doing anything to reduce the demands which are used to justify budget increases'(pp.72–3).

Some contributors discuss the possible use of constitutional rules to ensure that earmarked taxes are of the efficiency-enhancing variety. They recall that the Swedish economist, Knut Wicksell, proposed a century ago that individual public-expenditure items and the associated financing measures should be voted on, one by one, by taxpayers. Only expenditure items for which there was unanimous agreement would proceed. This is a very stringent requirement but one could be confident, were it to be adopted, that the benefits of the resulting public expenditure (if any) would exceed the costs to taxpayers.

In summary, governments could use user charges and earmarking to improve the allocation of resources, reduce the size of the public sector, and bring home the cost of government-provided services to taxpayers. Equally, however, user charges and earmarking could be used to finance an expansion of the public sector, to reward politically powerful groups, and to confuse the general public about the cost of government-provided services. Let the taxpayer beware!

Empowering the Guardians

***Alan Moran**, Research Director of the Tasman Institute, reviews **Responsive Regulation: Transcending the Deregulation Debate** by Ian Ayres and John Braithwaite (Oxford University Press, Melbourne, 1992).*

Advocates of a greater role for government have been encouraged by the accession to power of US President Clinton, which seemingly interrupts an almost unbroken run of world-wide electoral disappointments. However, to outsiders, those on the Left appeared continuously to adapt by successfully promoting new fields of intervention. The stated purpose of many of these was to improve the way that business meets market needs.

The demonstrated failures of government intervention have, however, delivered some cruel