

# **Tax Earmarking**

## Is It Good Practice?

Robert Carling

---

*Perspectives on Tax Reform (12)*

# **Tax Earmarking** Is It Good Practice?

Robert Carling

*Perspectives on Tax Reform (12)*

CIS Policy Monograph 75



**2007**

# Contents

Foreword.....	vii
Executive Summary.....	ix
Introduction.....	1
1 What is earmarking?.....	1
2 Why earmark at all?.....	2
3 The benefit principle of taxation .....	2
4 Theories of fiscal choice .....	3
5 Modern criteria of tax design: Efficiency, equity, simplicity .....	4
6 Summary: Is there a role for tax earmarking? .....	5
7 Earmarking in Australia .....	6
8 Evaluation of Australian practice .....	8
9 A case study—What to do with the Medicare Levy .....	9
10 Conclusion—Taxpayers beware! .....	10
Endnotes .....	11

**The Centre for Independent Studies Perspectives on Tax Reform series:**

1. Geoffrey de Q. Walker, *The Tax Wilderness: How to Restore the Rule of Law* (March 2004)
2. Terry Dwyer, *The Taxation of Shared Family Incomes* (March 2004)
3. Peter Saunders and Barry Maley, *Tax Reform to Make Work Pay* (March 2004)
4. Sinclair Davidson, *Who Pays the Lion's Share of Personal Income Tax?* (June 2004)
5. Andrew Norton, *Will You Still Vote for Me in the Morning? Why Politicians Aren't Rushing to Increase Taxes* (July 2004)
6. Lauchlan Chipman, *The Very Idea of a Flat Tax* (November 2004)
7. Peter Burn, *How Highly Taxed Are We? The Level and Composition of Taxation in Australia compared with OECD averages* (November 2004)
8. Alex Robson, *The Costs of Taxation* (May 2005)
9. Sinclair Davidson, *Are There Any Good Arguments Against Cutting Income Taxes?* (August 2005).
10. John Humphreys, *Reform 30/30: Rebuilding Australia's Tax and Welfare Systems* (November 2005)
11. Robert Carling, *State taxation and fiscal federalism: A blueprint for further reform* (September 2006)

All papers can be downloaded free at [www.cis.org.au](http://www.cis.org.au), or hard copies can be ordered at a price of \$9.95 from the Centre for Independent Studies, PO Box 92, St Leonards, NSW 1590, Australia. The first ten papers in the series have been completely revised and updated and republished, together with a new introduction, in Peter Saunders (ed), *Taxploitation: The case for income tax reform*, available for purchase from the CIS bookshop.

## Foreword

This Policy Monograph is a further instalment in The Centre for Independent Studies' long running participation in the tax policy debate.

The first ten monographs in the Perspectives on tax Reform series were consolidated in the book titled *Taxploitation: The Case for Income Tax Reform* published by the CIS in 2006. Those papers focused on personal income tax and its interaction with the social security and welfare system. The Eleventh, published in November 2006, canvassed issues in state taxation and fiscal federalism.

This Monograph critically analyses the use of earmarked (or 'hypothecated') taxes in Australia. Further papers in this series will continue to broaden the coverage to issues such as company income tax and other aspects of capital taxation.

The Centre's work on tax policy in the past was guided by Peter Saunders, who has now passed the baton to me so that he can concentrate on social policy.

**Robert Carling**

Senior Fellow  
The Centre for Independent Studies

## Executive Summary

Governments in Australia rely overwhelmingly on general revenue to finance their expenditure, but there is a trend towards heavier use of earmarked taxes at all levels of government. In broad terms, an earmarked tax is one that identifies a specific use for the revenue that it generates. The practice is also known as ‘hypothecation’.

The best known example in Australia is the Medicare levy, but more recently it has been joined by the gun buy-back levy, the Ansett levy, the milk levy, emergency services levies and infrastructure levies among many others at federal, state and local levels of government. Although such taxes still represent a small proportion of total tax revenue, their expansion represents a new trend in tax policy, which on the whole is unwelcome because of the particular forms that earmarking has taken.

Earmarking can be beneficial, but the conditions for this are quite strong and are rarely met in practice. The earmarked tax (which may be a separate tax or a fixed proportion of a broad tax) needs to be kept separate from other revenue, be applied exclusively to the expenditure programme for which it is identified, and fully fund (but not over-fund) that programme rather than being mixed with general revenue.

If these conditions are met, the benefit of earmarking is that it can lead to better fiscal choices being made by informing taxpayers of the true cost of expenditure programmes. In this way it can result in an allocation of resources and an overall level of taxation more in line with the public’s preferences than is the case under general funding. Advocates of smaller government see this leading to lower overall levels of government expenditure and taxation. But advocates of higher spending also see the potential for earmarking to facilitate increased overall taxation.

Be that as it may, it is difficult in practice to satisfy the strong conditions for earmarking to produce the benefits expected of it: it would be difficult to identify enough tax instruments; the cyclical character of revenue would create problems; and many expenditure programmes are intended to be redistributive rather than to be of direct benefit to the taxpayers paying for them. In addition, the sharing of responsibilities between the federal and state governments for some areas of expenditure means that no one level of government can be held accountable through an earmarked tax for the totality of spending in those areas.

This is not to say that earmarking cannot be of use at the peripheries of government budgets, when a separate tax can serve a ‘user pays’ or ‘beneficiary pays’ role in enhancing resource allocation. Examples in Australia include the long-standing wool tax, aviation fuel excise and the aircraft noise levy.

Tax earmarking in its strong form, with the revenue segregated for a specific purpose and determining the amount of expenditure for that purpose, is generally unpopular with government because it imposes rigidities on their budgets. Earmarking favours particular categories of expenditure by giving them monopoly access to specific revenue sources and makes it more difficult to reallocate resources at the discretion of executive government. If applied widely, it would also make it more difficult to budget for surpluses or deficits.

These objections have not, however, prevented governments from using ‘soft’ forms of earmarking where it has been convenient to do so. There is a tendency to cherry-pick the more popular services for earmarked funding. Typically the earmarked tax only partly funds its intended purpose and merely serves to top up general revenue applied to the same purpose. In other cases the earmarked tax over-funds its targeted expenditure programme. As another example of misuse, a purportedly ‘beneficiary pays’ tax may in fact fall on taxpayers other than the beneficiaries.

Soft earmarking is more political opportunism than sound fiscal policy. Governments tend to use it when they see it as a way of increasing the tax burden with less taxpayer complaint than an increase in general taxation would generate, but in effect soft earmarking *is the same as an increase in general taxation*. The following points set out some specific objections to soft earmarking:

- If the earmarked tax only partly funds a programme, it deludes taxpayers as to the true cost of what they are paying for.
- Cherry-picking the most popular programmes for earmarking while leaving the bulk of programmes to be funded from general revenue is a recipe for a bigger public sector because it panders to the public popularity of the earmarked services while leaving the less popular programmes in place and funded from general revenue.
- Earmarking a tax increase is a way for governments to avoid the hard work involved in searching for savings in existing expenditures to make way for new priorities. It facilitates incremental budgeting, which is one of the systemic ways in which big government gets bigger.
- Mixing earmarked with general funding makes the earmarking meaningless. Money being fungible, such mixing neither constrains expenditure on the earmarked purpose nor puts a floor under it, for the simple reason that the general funding component is elastic up or down at the discretion of government.

Many uses of earmarking in Australia exhibit these flaws. The Medicare levy provides a good example. It is politically sustainable only because of the public popularity of Medicare. In fact, it has been increased three times since its introduction in 1984—the only increase in statutory personal income tax rates in those 23 years. The levy covers only around one-quarter of the cost of Medicare, thereby giving misleading cost information to taxpayers. Spending on Medicare is not determined by the proceeds of the levy but by government policy decisions on the allocation of general revenue. Reform of the Medicare levy should be a part of future personal income tax reform.

There are some examples of good tax earmarking in Australia, but more generally governments have misused the concept to the detriment of fiscal policy. Taxpayers should be alert to such misuse and wary of further extensions of the earmarking practice in Australia.

## Introduction

Earmarked taxes are an exception to the rule that governments rely mainly on general tax revenue to finance their expenditures. But Australian governments are using earmarking more. The Medicare levy on personal income tax has existed for many years, but more recently it has been joined by the gun buy-back levy, the Ansett levy and the sugar levy, among others. These are all Federal imposts, but state and local governments are also active in this field, with fire service levies on property or insurance premiums and ‘environment’ and ‘infrastructure’ levies on council rates, among others. It is quite possible that governments at all levels will venture further in this direction in future, particularly if their budgets tighten. It is not stretching the imagination too far to contemplate a ‘Save the Murray-Darling levy’ or an ‘Education levy’.

Although such taxes still represent a small proportion of total tax revenue, their expansion represents a new trend in Australian tax policy. Should we welcome this trend or not? Is it likely to lead to a higher or lower overall tax burden? Will it lead to an allocation of government resources that better reflects what the public wants? Will it forge a stronger link between spending and taxing decisions? Or is it just that governments have found a clever new way to increase the tax burden with less taxpayer complaint?

### 1. What is earmarking?

Tax earmarking—or what is sometimes called ‘hypothecation’—means different things to different people. In its purest form it means that all revenue from a particular tax is kept separate from general revenue, can only be used for a specific government expenditure programme and fully funds that programme.

Another version of pure earmarking sets aside a fixed portion of a particular tax for a specific expenditure programme and fully funds that programme. For example, ‘x’ percentage points of personal income tax could be earmarked to fully fund defence expenditure.

Pure earmarking imposes hard budget constraints on government in that the earmarked revenue determines expenditure on the chosen programme, which may be higher or lower than the government would determine under general funding. This constraint is less meaningful, however, to the extent that the earmarked tax can be easily adjusted to satisfy an expenditure target.

A softer version of earmarking involves the earmarked tax funding only part of a specific expenditure programme, with the remainder funded from general revenue. This represents a major departure from pure earmarking because segregation of the earmarked tax becomes meaningless when it is mingled with general revenue to fund a programme. As the allocation of general funding to the programme is elastic at the discretion of government, the earmarked tax represents neither a floor nor a ceiling on the size of the programme, and earmarking tells taxpayers nothing about the cost of the programme being funded.

A variant of the soft approach to earmarking involves an entirely new tax or an increase in an existing tax being used to fund the expansion of an existing expenditure programme.<sup>1</sup>

The soft forms of earmarking do not impose meaningful budget constraints. They run into the reality that money is fungible; a dollar allocated to a spending programme from an earmarked tax is indistinguishable from a dollar allocated from general revenue.

The variations in the form of earmarking are not mere semantics. When it comes to finding a rigorous case for earmarking, it is easier to do so for pure earmarking than for the softer versions, which are more political opportunism than sound fiscal policy. In practice most earmarking has been of the soft kind.

Earmarking is sometimes thought of as being associated with fundamental changes in the way tax and spending is determined in the democratic system, such as subjecting each earmarked tax and its associated expenditure to a public referendum. Earmarked taxes are also sometimes introduced to meet a temporary expenditure need, and therefore made subject to a sunset clause. These are, however, variations on the basic idea rather than defining characteristics of earmarking.



In practice earmarked taxes have often been called ‘levies’ or ‘charges’ but these are just other names for what the Australian Bureau of Statistics classifies as taxes under the internationally accepted methodology. (In some cases it seems that the ‘levy’ label has been used to avoid the political opprobrium associated with a new or increased ‘tax’.)

## 2. Why earmark at all?

Tax earmarking in its pure form, with the revenue segregated for a specific purpose and determining the amount of expenditure on that purpose, is unpopular with governments because it imposes rigidities on their budgets. Earmarking favours particular categories of expenditure by giving them monopoly access to specific revenue sources and makes it more difficult to reallocate resources at the discretion of executive government. If revenue determines expenditure then budgeting for deficits or surpluses is also more difficult. Opponents of earmarking also question why the level of expenditure on a particular programme should be determined by the amount of revenue that the earmarked tax happens to yield each year, rather than by an evaluation of the benefits and costs of the programme relative to all other programmes that the government spends on.

But earmarking has supporters among ‘smaller government’ advocates because they believe that the link between specific taxes and specific expenditure programmes drives home to taxpayers the true cost of the programmes they are paying for and leads to more informed fiscal choices being made through the democratic process. On this view, earmarking helps overcome the problem of inconsistent voter demands for more public services and less taxation. The ‘smaller government’ advocates believe that with earmarking these inconsistencies would be reconciled in the direction of lower taxes. They also believe that through earmarking the composition of government expenditure will more closely reflect taxpayer preferences. In short, advocates of smaller government—or at least some of them—see earmarking as a way of controlling the leviathan.

Curiously, earmarking also enjoys support among those who favour *more* government expenditure. On this view, earmarking will lead to a higher overall level of taxation by exploiting what higher taxing groups believe to be the public’s willingness to pay more in taxes for the government programmes they favour. The argument is that, if there was an identifiable tax for education, another one for health, another for law and order, another for roads, and so on, then taxpayers would support a higher overall level of tax than if these programmes were funded from general revenue and the link between taxes paid and benefits received was more obscure.

There are other advocates of earmarking who believe it will lead to a better allocation of resources without taking any view as to whether that will entail smaller or bigger government.

Clearly, not all of these opinions can be right at the same time.

**In short, advocates of smaller government—or at least some of them—see earmarking as a way of controlling the leviathan.**

## 3. The benefit principle of taxation

The practice of tax earmarking gains some support from the benefit principle of taxation. Early writers on tax attempted to develop principles to guide the appropriate design of tax systems. One of the results of this work was the benefit principle, which states that ‘... people should contribute to taxation according to the benefits they receive from government expenditure.’<sup>2</sup>

The benefit principle emphasises efficient resource allocation and the establishment of a tight link between expenditure and revenue decisions in budget preparation. On some interpretations it has been stretched to provide a basis for taxation based on ‘capacity to pay’ as well.<sup>3</sup> It is said, for example, that the better off stand to benefit more from the defence of the realm, containment of crime, and so on. However this extension of the benefit principle seems capable of justifying almost any tax policy depending on the policymaker’s value judgments. If the benefit principle is to have relevance it would seem to be as a principle that does *not* require value judgments to be made in the process of formulating tax policy.<sup>4</sup>

Tax earmarking is a logical application of the benefit principle. For it to work in practice, however, all of the costs of a particular expenditure programme should be fully funded, no more nor less, by the earmarked tax. If not, then taxpayers do not receive the correct ‘price’ signal to guide them to democratic choices consistent with efficient resource allocation. In practice the situations in which the benefit principle can be applied are very limited for the following reasons:

- Unlike in Adam Smith’s time, many of today’s government programmes have a social security or welfare purpose and it makes no sense to ‘charge’ the beneficiaries of these programmes through the tax system.
- Even when the beneficiaries of a programme are an identifiable sub-group of the population and it is appropriate on resource allocation grounds to charge them through the tax system, it is difficult in practice to determine what the benefits are—they may exceed or fall short of the financial costs of the programme.
- It may be difficult to find a tax instrument that targets the beneficiary group.
- The ‘capacity to pay’ principle of taxation also has a place in the design of the tax system, but may well lead to different conclusions from the benefit principle.

For these reasons the situations in which the benefit principle provides a clear case for tax earmarking are relatively few. The benefit principle is essentially a ‘user pays’ approach to taxation. In situations where the beneficiary group can be clearly defined and the benefits well measured, an appropriately targeted tax instrument can be found, and the expenditure programme is not intended to be redistributive, then user pays taxation has a place in the tax system. But given the restrictions on its suitability, it is unlikely to be at the core of the system.

#### 4. Theories of fiscal choice

Public finance theorists have long grappled with the problem of explaining in abstract terms how government budgets are determined in a democratic system, given that the process is as much a political as an economic one. This work has led to the development of theories of fiscal choice which may be broadly described as ‘voluntary exchange’ and ‘voting’ models of budget determination. These approaches attempt to model how both the spending and revenue sides of the budget are determined and reconciled.

Voluntary exchange models do so by applying the price mechanism to public finance and viewing taxation as the price of public goods and services. Voting models analyse the determination of taxation and government expenditure in terms of individual participation through a democratic political process. These are different approaches but they both attempt to explain how individual preferences for public goods and willingness to pay through taxation are aggregated, reconciled and expressed through the democratic political process—ultimately producing a budget.

Earmarked taxes are not an essential feature of these models but are at home within them because of the link that earmarking establishes between the expenditure and revenue sides of the budget. Individuals may make more informed, rational choices if earmarking enables them to see this link more clearly.

James Buchanan has explored the implications of earmarking versus general financing within a voting model of fiscal choice.<sup>5</sup> The tentative conclusion from Buchanan’s analysis is that institutional structures that favour general financing ‘produce somewhat larger public expenditures in total’. At the risk of oversimplification of Buchanan’s analysis, general financing tends to produce larger public expenditures because taxpayers will be willing to pay (vote for) a higher overall level of taxation to make sure policymakers allocate enough to the programmes they value most highly. In other words, they are willing to pay more to make sure they get what they want (such as ‘free’ public hospitals) even if that means also getting what they don’t value. Under general financing

**Individuals may make more informed, rational choices if earmarking enables them to see the expenditure and revenue link more clearly.**

they have to accept the ‘bad’ with the ‘good’ because policymakers determine the allocation. Under this system it is easier for the minority (the vocal and politically active beneficiaries of narrowly targeted spending programmes) to foist the cost of those programmes onto others. Under a regime of earmarked taxes, taxpayers would vote down the taxes for what they don’t want and vote up the taxes for what they do want, resulting in a lower overall level of taxation.

This is a powerful and attractive conclusion for the advocates of smaller government, but Buchanan notes that it requires ‘a fiscal system characterised by substantially complete revenue segregation’. In other words, it doesn’t hold where earmarking and general financing are mixed together. Indeed that is likely to be the worst of both worlds, particularly if the earmarked taxes

are used to finance the more widely popular expenditure programmes and the general taxes finance everything else. Buchanan also qualifies his conclusions by noting that higher transaction costs under an earmarking regime could offset if not negate its superiority over general funding. Buchanan does *not* explicitly comment on the difference between ‘hard’ and ‘soft’ earmarking, but he surely had in mind the hard form, otherwise earmarking would fail to inform taxpayers of the true financial cost of particular programmes.

Buchanan’s analysis was based on a simple model containing two public goods—fire protection services and law enforcement—which benefit the broad population. While simplification does not necessarily invalidate the conclusions of economic models, in this case the relevance of the model to more welfare-oriented spending programmes is open to question. By definition such programmes are (or ought to be) narrowly targeted, but in this form they would be constrained by being tied to a tax that, also by definition, would have to be paid by someone other than the beneficiaries.

**Executive government  
has been more willing  
to embrace soft  
earmarking where it has  
suited their purpose.**

## 5. Modern criteria of tax design: Efficiency, equity, simplicity

Tax design nowadays, at least in principle, is guided by the criteria of efficiency, equity and simplicity. These, at least, are the criteria that policymakers claim to apply, although in practice tax policy often fails to live up to them. While the modern approach contains elements of the benefit principle (allocative efficiency) and the capacity to pay principle (equity), it recognises that there are trade-offs among the criteria. It is a framework for analysis of taxation rather than an all-embracing theory.

This framework has led to an emphasis on broad-based taxes such as value-added (goods and services) tax, income tax and property tax levied at low rates with a minimum of exemptions and concessions. (That, at least, is the theory; the practice is often quite different.) The objective of this approach is to minimise economic efficiency costs and maximise simplicity subject to equity considerations which are taken into account through the setting of thresholds, design of rate structures and so on.

The emphasis on broad-based taxation does not rule out more narrowly based taxes, but broad-based taxes are certainly expected to do most of the revenue-raising work in the modern system. In this scheme, narrowly-based taxes are justified on allocative efficiency grounds and can include selective excises and user-pays type taxes.

This conventional approach to tax design has tended to confine tax earmarking to the peripheries of the tax system. Broad-based taxes generate too much revenue to be earmarked for a single expenditure programme, even when defined broadly such as ‘health’, ‘education’ and ‘defence’.<sup>6</sup> There is, of course, no reason why a portion of a broad-based tax could not be earmarked for a particular programme, although in practice such partial earmarking has been rare. It is more common for earmarking, where it exists, to be based on narrower taxes. To the extent that widespread earmarking required a plethora of smaller taxes, this would be fundamentally at odds with the broad-based approach. Fragmentation of the tax system would serve neither the economic efficiency nor simplicity objectives. The conventional dismissal of pure tax earmarking is, of course, reinforced by executive government’s repugnance of the resulting budgetary rigidities, but executive government has been more willing to embrace soft earmarking where it has suited their purpose.

## 6. Summary: Is there a role for tax earmarking?

There is a good case for earmarking on allocative efficiency grounds where the tax acts like a user charge, provided:

- the tax fully funds the service being delivered, or does so in conjunction with another price mechanism (that is, the service is only part tax-funded), and does not over-fund it (that is, generate a contribution to general revenue as well); and
- the tax is paid by the beneficiaries of the service.

If used in this way, earmarking would have a useful but peripheral role in government budgets. In some instances where it could be applied in this way, the service may be privatised anyway.

There is an in-principle wider role for earmarking in such programmes as defence, law and order, education and health, with the benefit being a size and composition of government expenditure more in line with taxpayer preferences. However, the conditions for it to work on this broader scale are restrictive:

- The earmarking should be of the ‘hard’ form, with the tax fully funding the expenditure programme, no more nor less.
- The coverage of earmarking would need to satisfy Buchanan’s requirement of ‘a fiscal system characterised by substantially complete revenue segregation’. In other words, governments should not ‘cherry pick’ the most widely popular expenditure programmes for earmarked financing and leave everything else to general funding.
- Sufficient suitable tax instruments would need to be available or broadly-based taxes broken into earmarked components. The taxes should be ones that voter-taxpayers actually pay and not ones where the legal incidence falls on others only to be shifted (such as company income tax and the state payroll tax).
- Some way must be found to protect each expenditure programme from the cyclical nature of earmarked taxes such as income tax. This would mean under-spending the tax proceeds in boom years and over-spending it in lean years. Under-spending would be politically difficult to sustain when the tax is understood by the public to be exclusively for the stated purpose, while over-spending represents a step towards undesirable ‘soft’ earmarking.
- It would have to be accepted that redistributive expenditure programmes (targeted transfer payments to individuals) may well come under pressure to shrink because those paying the earmarked tax would be a different and broader sub-set of the population than those benefiting from the programmes.
- Ideally voters would have an opportunity to vote separately in referenda on each earmarked tax and its associated expenditure.
- In the Australian context there is another complication—namely the joint federal-state financing of areas such as health and education. Because some public expenditure on these programmes is funded federally and some by the states, neither level of government can be held accountable (through an earmarked tax) for the totality of spending in those areas.

Pure earmarking requires a suitable constitutional basis. The Australian Constitution requires that all revenues be paid into a single consolidated revenue fund, which is inconsistent with revenue segregation.<sup>7</sup> Earmarking could still be applied by appropriating the proceeds of an earmarked tax from the consolidated fund for the specified purpose of the tax, but this approach rests on policy decisions of government rather than any constitutional principle.

These are serious obstacles to the proper use of earmarking on a wide scale. So what is wrong with soft earmarking—such as applying it selectively and mixing ‘earmarked’ and general revenue to fund particular programmes? There are fundamental problems with soft earmarking:

- If the earmarked tax only partly funds a programme, it deludes taxpayers as to the true cost of what they are paying for. The classic example of this in Australia is Medicare, the cost of which is only around one-quarter funded by the Medicare levy.<sup>8</sup> One of the advantages of earmarking is supposed to be that it strengthens the link between expenditure and revenue decisions and makes them more consistent. Part-funding through earmarking goes in the opposite direction.
- ‘Cherry-picking’ the most widely popular public programmes for earmarking while leaving the bulk of programmes to be funded from general revenue is a recipe for a bigger public sector. It panders to the public popularity of the earmarked services and the public’s willingness to pay for them, while leaving the unpopular programmes in place and funded from general revenue. ‘Cherry-picking’ is a form of public sector self-promotion aimed at making government bigger.
- Increasing a tax or introducing a new tax and earmarking it to pay for the expansion of an existing programme or for a new programme is a way of governments avoiding the hard work involved in looking for savings in other expenditure programmes to make way for the new. Incrementalism is much easier than the hard work of reordering priorities.
- Mixing earmarked with general funding makes the earmarking meaningless. Mixed in this way, earmarking neither constrains expenditure on the purpose for which it is intended, nor puts a floor under it, for the simple reason that the general funding component is elastic up or down at the discretion of government. This is another reason why soft earmarking deludes rather than informs voters.

## 7. Earmarking in Australia

Some details of earmarked taxes imposed at the three levels of Australian government are set out in Table 1 below. No doubt the list is incomplete, but it includes the best known examples.

**Table 1 – Earmarked Taxes and Levies in Australia**

Title of tax/levy	Level of government	Start date	Description and purpose	Comments
Medicare levy	Commonwealth	1984	Levy of 1.5% on personal taxable income to help fund Medicare. Originally 1%.	Funds only about 25% of the cost of Medicare
Gun buy-back levy	Commonwealth	1996	Additional 0.2% on Medicare levy for one year to fund buy-back of guns from the public.	Temporary (in place for one year).
Aviation fuel excise	Commonwealth	1995	Aviation fuel excise is set at a level to cover costs of air services.	Revenue aims to fully fund the cost. User-pays type tax.
Passenger movement charge	Commonwealth	1978	Originally the departure tax. Levied on international passenger departures to fund border protection costs.	User-pays type, but over-funds the activity.
Aircraft noise levy	Commonwealth	1995	Fixed levy on air tickets through Sydney and Adelaide to fund sound-proofing of homes under flight paths.	Payers are the beneficiaries of conveniently located airports. Levy is temporary-

Ansett ticket levy	Commonwealth	2001	Levy of \$10 on air tickets to guarantee employee entitlements following failure of Ansett	Ended in 2003. Levy over-funded the activity. Payers were not beneficiaries.
Wool tax	Commonwealth	1964	Tax on wool growers to fund wool research and promotion.	Tax is set by ballot of wool growers. Currently 4%.
Milk levy	Commonwealth	2000	Levy of 11 cents per litre on milk to fund dairy industry adjustment to deregulation.	Set to end in 2010. Payers are not beneficiaries.
Sugar levy	Commonwealth	2003	Levy of 3 cents per kg on sugar sales to fund sugar industry restructuring.	Set to end in 2008. Payers are not the beneficiaries.
Fire services levies	State	Various	Levies on insurance (NSW, VIC & TAS) or property (others except NT) to fund fire brigades.	Payers are beneficiaries, but property is the better base. Only partly funds the fire services.
Parking space levies	State	NSW 1992 VIC 2006	Fixed levies on commercial parking spaces in inner city areas to combat congestion and help fund public transport initiatives.	An imprecise congestion tax. Revenue is a small contribution to public transport.
Health insurance levies	State	NSW 1983 ACT 1999	Fixed levies on private health insurance premiums to fund members' usage of ambulances.	Payers are only a sub-set of the beneficiary population.
Insurance Protection Tax	NSW	2003	Tax on insurance companies to fund NSW government costs in HIH collapse and to establish a fund for future similar events.	Similar to deposit insurance paid by banks in some countries.
Health Benefits Levy	VIC	2003	Levy on gaming machines.	Revenue of \$130 million partly funds public hospitals
Community Ambulance Cover levy	QLD	2003	Fixed \$ levy on electricity bills to help fund ambulance service.	All revenue to ambulance service, but only part funds the service.
Metropolitan Regional Improvements Tax	WA		Levy on Perth land other than owner-occupied housing to fund acquisition of land for regional purposes.	
Save the River Murray levy	SA	2003	Levy on SA Water customers water bills to fund SA government Murray River restoration costs.	User-pays to the extent that SA Water customers rely on Murray River water.
Environment and infrastructure levies	NSW local government	Various	Rate increases to fund environment and infrastructure works.	Only partly funds councils' environment and infrastructure works.

The Medicare levy was introduced in 1984 at a rate of 1%. It has since been increased three times to its current level of 1.5% and those with taxable incomes above a certain level who choose not to have private health insurance are now charged an additional 1%. The levy applies from the first dollar of income (that is, there is no tax-free threshold), although low income earners are exempted. Significantly, the increase in the Medicare levy rate since its introduction is the only increase in statutory personal income tax rates since the 1970s. The levy will raise \$7 billion this year, but will cover only around 25% of the cost of Medicare (which includes medical benefits, the pharmaceutical benefits scheme and Commonwealth grants to the states for public hospitals).

The gun buy-back levy of 0.2% was superimposed on the Medicare levy for one year, 1996–97, to cover the cost of the gun buy-back offer in the wake of the Port Arthur massacre. It was introduced in the context of the new government's drive to slash the budget deficit and its 'no new taxes' election pledge. The popularity of the buy-back made it easier for the government to cherry-pick this programme for a tax increase. Arguably in easier budget conditions the gun buy-back would have been funded without a levy.

The Commonwealth introduced the international departure tax in 1978, the first of what was to become a stream of imposts on air travellers. It has since been converted to the Passenger Movement Charge with the stated purpose of covering the cost of border control (immigration control, customs, quarantine and so on). In fact, the charge has over-recovered these costs and made a contribution to general revenue.<sup>9</sup> The Passenger Movement Charge was followed by the aircraft noise levy in 1995 to fund sound-proofing of homes near Sydney and Adelaide airports. The noise levy has a ‘beneficiary pays’ justification and is being phased out as the work is completed. The Ansett levy, which applied from 2001 to 2003, was intended to fund the Commonwealth’s commitment to guarantee selected employee entitlements following the failure of Ansett. Leaving aside whether this was an appropriate use of taxpayer money, the levy had no basis in tax principles and in fact raised more than the government needed for the stated purpose.

Also in the aviation area, the Commonwealth sets aviation fuel excise at a level to fully fund the cost of air navigation services to airlines. The excise is adjusted each year to meet this target. This tax is a form of pure earmarking and can be justified as a ‘user pays’ tax.

**In the case of more recent milk and sugar levies intended to finance dairy and sugar growing restructuring, consumers are paying for benefits to producers.**

Among a range of agricultural levies, the wool tax has existed since 1964 to fund wool industry research and promotion. It is a classic earmarked tax of the ‘beneficiary pays’ kind. The same cannot be said of the more recent milk and sugar levies, which are being imposed for a finite period and are intended to finance dairy and sugar growing industry restructuring. In these cases consumers are paying for benefits to producers.

In addition to the list in Table 1, it must not be forgotten that the Commonwealth government intended to impose a temporary ‘Timor levy’ on personal taxable incomes from 1 July 2000 ostensibly to prevent the costs of the Australian military intervention in East Timor from putting the budget into deficit. However the levy was not implemented when it met with public opposition and revised budget estimates showed that a deficit could be avoided without it.

The states and territories impose a range of earmarked taxes, none of which is important in overall revenue terms but some of which are important to the funding of particular activities. One theme that appears is the funding of emergency services (fire brigade and ambulance services) through various levies on insurance, property, private health insurance or electricity bills.

New South Wales local governments in recent years have taken enthusiastically to the practice of imposing rate increases variously labelled ‘environment’, ‘infrastructure’ and ‘asset replacement’ levies.<sup>10</sup> Some of these increases have been very substantial and are imposed on top of the government-imposed annual cap on standard rate increases.

## 8. Evaluation of Australian practice

Earmarked taxes in Australia, although they have increased in number, make a marginal contribution to revenue. Those listed in Table 1 account for only about 5% of total tax revenue. Thus, Australia comes nowhere near Buchanan’s requirement of ‘substantially complete revenue segregation’ for earmarking to deliver the claimed benefits in terms of superior fiscal choice. In many cases the revenue either partly funds or over-funds the purpose for which it is ostensibly raised. Few of the earmarked taxes come with a legislated restriction on the use of the revenue for a specific purpose. In practice, they contribute to general revenue.

Some of Australia’s earmarked taxes can be defended as user-pays type taxes conducive to more efficient resource allocation—for example aviation fuel excise, the passenger movement charge, fire service levies—though even in these cases there can be over-funding. More generally, Australian earmarking practice has been of the opportunistic cherry-picking kind that obscures the true cost of services and has been designed to facilitate the growth of government spending. The best examples of this are the Medicare levy, the guns buy-back levy, the mooted but aborted Timor levy, the Ansett, milk and sugar levies, and at local government level the ‘environment’ and ‘infrastructure’ levies.

The Medicare levy pays for about 25% of the cost of Medicare but deludes the public into believing that they are paying in full for the programme through this levy and encourages an inflated sense of entitlement. In reality the level and growth of spending on Medicare has little to do with the level and growth of revenue from the levy. Ultimately the government determines the level of spending on Medicare through the amount of general revenue it allocates to it. The levy is virtually indistinguishable from general revenue. But due to the public popularity of Medicare—no doubt in part because of the belief that it costs much less than it actually does—governments have been able to increase the levy in three steps since 1984 from 1.0% to the current level of 1.5% (or 2.5% for higher income earners who fail to take out private insurance). This is the only increase in income tax *rates* that the government has dared to impose over the last twenty years or so, and it has been able to do so because of the ‘Medicare’ tag attaching to the increase.

The same criticism could have been levelled at the mooted but aborted Timor levy in 1999, but that at least was to be temporary. The government thought the levy was politically sustainable because the Australian military involvement in East Timor was popular at home, and because the levy was structured to apply only on personal incomes above \$50,000. If the Commonwealth budget were tighter today, would the government dare to propose an ‘Iraq levy’? The obvious unreality of such an idea serves to illustrate the politically opportunistic nature of these levies.

It is quite possible that a future federal government in more difficult budgetary conditions will seek to increase the Medicare levy further or extend the principle to some other popular area of spending such as education or the environment. Worthy as the goals of the spending programmes *might* be, it would be wrong to use soft earmarking for the same ill-conceived reasons as the Medicare levy.

The local government rate levies for ‘infrastructure’ and ‘the environment’ that have been used heavily, at least in New South Wales, in recent years are among the worst examples of earmarking. ‘Infrastructure’ can mean something as basic as street repairs and ‘environment’ can mean storm water drains, but the fancier labels seem designed to tap into current community interest in the environment and infrastructure. These levies are nothing but increases in rates to finance increments in the ‘bread and butter’ activities of local government. They are indistinguishable from general rate funding and can provide no guarantee to ratepayers that the funds raised will be used for the stated purpose because the larger general rate funding of ‘infrastructure’ and ‘environment’ works will ultimately determine the level of spending on them.

**If the Commonwealth budget were tighter today, would the government dare to propose an ‘Iraq levy’?**

## 9. A case study—What to do with the Medicare Levy

The Medicare levy, being the largest and best known earmarked tax, is worth using as a case study in how current earmarking practice could be reformed for the better. There are four basic options.

First, the levy could simply be abolished. This would provide a tax cut of 1.5 percentage points for all who pay the levy,<sup>11</sup> lowering the Commonwealth tax take by \$7 billion per year. The problem with this option, apart from its affordability to government, is that although the levy is deficient as an indicator of the cost of Medicare, its existence in any form means that its removal would send the wrong signal to taxpayers about the cost of publicly funded health care.

Second, the levy could be greatly increased so that it covers the full cost of Medicare, offset by a reduction in marginal income tax rates to make the switch revenue neutral. The attraction of this option is that it makes the full cost of Medicare more transparent to taxpayers and therefore (perhaps) curbs demands for its enhancement. Provided successive governments resisted any pressure to supplement levy proceeds from general revenue, the growth in the cost of Medicare over time would be capped at the growth of the personal income tax base, thereby exercising a useful discipline on health funding. However, it is unlikely that proviso would be met. Also, it is not clear why Medicare should be singled out from all government programmes and quarantined in this fashion.



Third, the levy could be abolished but folded in to statutory marginal income tax rates to make the change revenue neutral. The statutory marginal rates would become 16.5, 31.5, 41.5 and 46.5%.<sup>12</sup> Most people already know that these are the true marginal rates they pay, but formalising them would be more consistent with fiscal transparency. Actual funding of Medicare would be determined simultaneously with competing priorities, as is effectively the case now.

Fourth, abolition of the levy could be accompanied by an increase in the minimum superannuation contribution rate from 9 to 10.5%, with the increase to come directly out of employees' pockets as they benefit from the abolition of the levy. This would give superannuation contributors an enhanced capacity to self-fund their health costs in retirement and would fit in with the government's policy emphasis on preparing the ground for future rapid growth in health care costs as the population ages. One problem with this approach is that the population of taxpayers benefiting from the tax cut does not perfectly match the population of superannuation contributors. However the main problem would be with the relatively few low income superannuation contributors who would have to make higher superannuation contributions but who do not currently pay the Medicare levy. This problem could be addressed in the detailed design of the change.

The fourth option is the most appealing. It reduces the tax burden, eliminates the current misuse of the earmarking concept in Medicare funding, achieves some of the increase in superannuation contributions that is widely recognised as being needed, and introduces the principle of compulsory employee contributions.<sup>13</sup> It shares with the first and third options the drawback of sending the wrong signal to taxpayers about the cost of publicly funded health care, but the change can be explained as a way of increasing compulsory saving for individuals to meet more of their own health care costs in retirement.

## **10. Conclusion—Taxpayers beware!**

There is a fairly narrow set of circumstances in which earmarked taxes are both workable and have a basis in taxation principles. Australian governments have made appropriate use of earmarking in some such circumstances, but have also abused the concept in other situations by applying it selectively to popular areas of government spending and mixing earmarked and general revenue together, which makes earmarking meaningless. Taxpayers should be alert to such practices and see them for what they are—increases in general taxation dressed up to appear as something more appealing. Taxpayers may still choose to accept a greater burden, but governments should enable them to make that choice on the basis of fully transparent information.

## Endnotes

- <sup>1</sup> This classification of earmarking is similar to Margaret Wilkinson's 'strong' and 'weak' earmarking. Margaret Wilkinson, 'Paying for Public Spending: Is There a Role for Earmarked Taxes?', *Fiscal Studies* 15:4 (November 1994), pp 119–35.
- <sup>2</sup> Peter Groenewegen, *Public Finance in Australia—Theory and Practice* (Melbourne: Prentice-Hall of Australia, 1984), p 99.
- <sup>3</sup> For example, Adam Smith has written, 'The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.'
- <sup>4</sup> Sinclair Davidson points out that this proposition can be turned on its head, because it can be argued that the rich would be better able to protect themselves in the absence of law or government. Sinclair Davidson, 'Who's Not Paying Their Fair Share of Income Tax?' in *Taxploitation—The Case for Income Tax Reform*, ed. Peter Saunders (Sydney: The Centre for Independent Studies, 2006).
- <sup>5</sup> James Buchanan, *Public Finance in Democratic Process* (Chapel Hill: University of North Carolina Press, 1967), ch 6.
- <sup>6</sup> There can be exceptions to this. For example, Samuel Brittan has advocated that the UK value added tax be earmarked for the National Health Service: *The Financial Times*, 14 March 2002.
- <sup>7</sup> Section 81 states, 'All revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities imposed by this Constitution.'
- <sup>8</sup> Medicare levy revenue is estimated at \$7 billion in 2006–07 against a cost of Medicare of \$28 billion.
- <sup>9</sup> Australian National Audit Office, *Audit Report No 12* (Canberra: ANAO, 2000), p 13.
- <sup>10</sup> Twenty-seven councils in 2005–06 and 23 in 2006–07. New South Wales Department of Local Government Annual Reports, 2004–05 and 2005–06. New South Wales legislation requires councils to obtain ministerial approval for rate increases above a cap set by the government each year.
- <sup>11</sup> Some taxpayers above certain income thresholds pay an additional 1% because they choose not to have private medical insurance. The government uses this mechanism to encourage take-up of private insurance. If the Medicare levy were to be removed, this policy 'stick' would be lost but it is not a major feature of the health system and the government could no doubt develop other mechanisms to serve the same purpose.
- <sup>12</sup> The marginal rates would in fact need to be slightly higher than these for revenue neutrality because they apply with a tax-free threshold whereas the Medicare levy does not.
- <sup>13</sup> Employees are in effect contributing already because the economic incidence of the 9% superannuation guarantee falls on them, but an explicit payment by employees would still help to enhance the value employees place on their superannuation savings efforts.



**The Centre for Independent Studies** is a non-profit, public policy research institute. Its major concern is with the principles and conditions underlying a free and open society. The Centre's activities cover a wide variety of areas dealing broadly with social, economic and foreign policy.

The Centre meets the need for informed debate on issues of importance to a free and democratic society in which individuals and business flourish, unhindered by government intervention. In encouraging competition in ideas, The Centre for Independent Studies carries out an activities programme which includes:

- research
- holding lectures, seminars and policy forums
- publishing books and papers
- issuing a quarterly journal, *POLICY*

**FOR MORE INFORMATION ABOUT CIS OR TO BECOME A MEMBER, PLEASE CONTACT:**

**Australia**

PO Box 92, St Leonards,  
NSW 1590 Australia  
Ph: +61 2 9438 4377  
Fax: +61 2 9439 7310  
Email: [cis@cis.org.au](mailto:cis@cis.org.au)

**New Zealand**

PO Box 5529,  
Lambton Quay, 3785  
New Zealand  
Ph: +64 4 499 5861  
Fax: +64 4 499 5940

[www.cis.org.au](http://www.cis.org.au)

**COUNCIL OF ACADEMIC ADVISERS**

Professor Ray Ball  
Professor Jeff Bennett  
Professor Geoffrey Brennan  
Professor Lauchlan Chipman  
Professor Kenneth Clements  
Professor Sinclair Davidson  
Professor David Emanuel  
Professor Ian Harper  
Professor Max Hartwell  
Professor Warren Hogan

Professor Helen Hughes  
Professor Wolfgang Kasper  
Professor Chandran Kukathas  
Professor Kenneth Minogue  
Professor R.R. Officer  
Professor Suri Ratnapala  
Professor Steven Schwartz  
Professor Judith Sloan  
Professor Peter Swan  
Professor Geoffrey de Q. Walker



## About the Author

Robert Carling is a Senior Fellow at the Centre for Independent Studies. He was Executive Director, Economic and Fiscal at the New South Wales Treasury from 1998 to 2006. He was a senior official with the New South Wales Treasury until 2006 and prior to that with the Commonwealth Treasury, the World Bank and the International Monetary Fund. He holds academic qualifications in economics and finance from the London School of Economics and Political Science, Georgetown University and the University of Queensland.

CIS Policy Monograph • PM75 • ISSN: 0158 1260 • ISBN: 978 1 86432 150 1 • AU\$9.95

Published July 2007 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

© 2007. The Centre for Independent Studies

This publication is available from The Centre for Independent Studies.

PO Box 92, St Leonards, NSW 1590 Australia • **p:** +61 2 9438 4377 **f:** +61 2 9439 7310 **e:** [cis@cis.org.au](mailto:cis@cis.org.au)



[www.cis.org.au](http://www.cis.org.au)