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## EARMARKING OF TAXES: ECONOMY OR POLICY?

**Abstract.** One of the topical issues for the governments is financing of the state expenditures in conditions of scarcity. The governments search for possibilities to increase efficiency of expenditures financing. One of the methods is the earmarking of taxes which means attracting any tax or a part of it to the particular needs of the society. In the world practice and financial science, there are contradictory views and conclusions about the earmarking of taxes application. The author investigates theoretical aspects of the earmarking of taxes from the point of different groups of motivators: government, politicians, taxpayers, and from the perspective of financial experts. In the research, the pros and cons of the earmarking of taxes have been weighed up and meanwhile the political nature and the main risks are indicated in the conditions of changing economy. Investigating experience of the taxes earmarking in Latvia in the period of crisis and weighing up the latest trends in the tax policy, the author recommends to analyse the meaning of the future earmarking of taxes in connection with the ensurance of the sustainable state fiscal policy and to make thorough economic calculations in order to avoid the political influence on the fiscal decisions.

**Keywords:** fiscal policy; earmarking of taxes; basic budget; special budget.

**JEL Classification:** H02, H03, E06

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#### ПРИМЕНЕНИЕ НАЛОГОВ ЦЕЛЕВОГО НАЗНАЧЕНИЯ: ЭКОНОМИКА ИЛИ ПОЛИТИКА?

**Аннотация.** Важным вопросом для любого правительства является финансирование государственных расходов в условиях лимитированных бюджетных ресурсов. Поэтому правительства изыскивают возможности повышения эффективности использования средств. Один из методов решения данного вопроса – применение налогов целевого назначения, т. е. конкретных налогов к конкретным видам расходов. В мировой практике и финансовой науке встречаются противоречивые взгляды и выводы о таком методе управления финансами. Автор статьи исследует теоретические аспекты применения налогов целевого назначения с позиций правительства, политиков, налогоплательщиков и финансовых экспертов. Были выявлены положительные и отрицательные стороны налогов целевого назначения, а также указано на политический характер и основные риски применения данного метода в условиях нестабильной экономики. Исследуя практику Латвии в условиях кризиса, а также оценивая последние идеи политиков о расширении сферы использования налогов целевого назначения, автор рекомендует проводить тщательные экономические расчеты с тем, чтобы исключить политическое влияние и не повторить ошибки прошлого, обеспечивая стабильность финансовой политики.

**Ключевые слова:** фискальная политика, налоги целевого назначения, базовый бюджет, специальный бюджет.

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#### ЗАСТОСУВАННЯ ПОДАТКІВ ЦІЛЬОВОГО ПРИЗНАЧЕННЯ: ЕКОНОМІКА ЧИ ПОЛІТИКА?

**Анотація.** Важливим питанням для будь-якого уряду є фінансування державних видатків в умовах лімітованих бюджетних ресурсів. Тому уряди вишукують можливості підвищення ефективності використання коштів. Один із методів вирішення цього питання – застосування податків цільового призначення, тобто конкретних податків до конкретних видів видатків. У світовій практиці та фінансовій науці зустрічаються суперечливі погляди і висновки про такий метод управління фінансами. Автор статті досліджує теоретичні аспекти застосування податків цільового призначення з позицій уряду, політиків, платників податків і фінансових експертів. Були виявлені позитивні й негативні сторони податків цільового призначення, а також наголошено на політичному характері та основних ризиках застосування цього методу в умовах нестабільної економіки. Досліджуючи практику Латвії в умовах кризи, а також оцінюючи останні ідеї політиків про розширення сфери використання податків цільового призначення, автор рекомендує проводити ретельні економічні розрахунки для того, щоб унеможливити політичний вплив і не припуститися помилок минулого, забезпечуючи стабільність фінансової політики.

**Ключові слова:** фискальна політика, податки цільового призначення, базовий бюджет, спеціальний бюджет.

**Introduction.** In the conditions of changing economic development during the last years the governments have been facing new challenges of the stabilization of economic development. The crisis has substantially changed the socio economic environment in many countries and also in Latvia, therefore the governments should be flexible and cautious in decision-making. Practically, all the countries and governments face the situation when the needs of the society exceed the possibilities of the governments to satisfy them. Basically, it means to review the possibilities to increase the revenues or to decrease the expenditures. In the society both methods are perceived negatively, therefore, politically they are unpopular. Therefore, the efforts are made to seek the ways of increasing the efficiency of the use of the existing resources, at the same time decreasing the unproductive expenditures which means to produce a maximal effect with minimal resources. The earmarking of taxes is offered as one of the methods of fiscal policy, although in the financial

science it is not investigated to the full and there are also different opinions about it. In the public discussions in Latvia we can also find the proposals that the earmarking of taxes should be used more widely in financing the state expenditures.

**The overall aim** is to find out advantages and disadvantages of the earmarking of taxes and to evaluate the situation in Latvia. This aim is achieved by approaching the subject from two aspects. The task of the first chapter is to investigate, sum up and critically analyze the opinions in the scientific literature about the meaning of the earmarking of taxes and its pros and cons. The second chapter analyzes the experience of the earmarking of taxes in Latvia. In the conclusion the author provides a summary of his findings and propose some suggestions as to the further use the earmarking of taxes in the state fiscal policy.

In the research there are used the qualitative research methods: such as the investigation and generalization of the literature and scientific publications, content analysis, the

research method of special cases, as well as the methods of statistical analysis.

#### Theoretical aspects of the earmarking of taxes

Traditionally, in the literature about public finance we can find discussions and investigations about the choice of state expenditure planning methods: zero-based budgeting, the budget based on the results, performance budgeting, budget planning based on the efficiency indicators and others. There is a lot of discussions about the increase of the effectiveness of the use of the funds applying different methods of planning the expenditures. In this article the author deals with another approach to the increase of the effectiveness of budgetary resources, i.e. the earmarking of taxes. The earmarking of taxes is a controversial subject, both in the political circles and among academic economists.

Buchanan J. M. (1963) is the starting point of the discussions about the earmarking of taxes in modern public finance. He has analyzed the economic effects of the earmarking of taxes and their influence on the behavior of an individual within a theoretical model. Buchanan J. M. offered the first steps in the theory of earmarking the taxes. He made great progress by abandoning the traditional public finance approach, in which a fully informed, monolithic planner takes all the decisions, so as to integrate political dimensions into the analysis of earmarking. Afterwards there were other investigations containing the diversity and ambiguity of the opinions about the results of the experience. This method of fiscal policy is very contradictory from the point of different evaluators – economists, politicians, governments, taxpayers. We should be careful when evaluating the arguments of various lobbies. For example, motorists may argue that a road tax should be fully earmarked for road improvements, while non-motorists may argue that the road charges should go to funding the public transport. These arguments may have no rationale for economic efficiency or welfare, but they merely express the desire of each group, to capture a larger share of the „public cake“. In this case the groups would argue that any tax should go to their most preferred use (Marsiliani & Renstrom, 2000). In the literature reviewed, there is only one question: where is the conformity of opinions, i.e. what is earmarking? Defining the earmarking of taxes and its general meaning, basically it is indicated that earmarking is the budgeting practice of channeling taxes or other revenues to a specific program or purpose (Joel, 2012; Buchanan, 1963). But, if we speak about the implementation of this practice, the opinions are different. The main discussions are about the following: whether to earmark the whole tax or a part of it; how big a part should be to be earmarked. Some authors speak about strong earmarking, some authors speak about soft earmarking. What do these variations mean in fiscal policy? How big is the potential risk? How will it influence the fiscal policy in general? As we can see, there are a lot more questions than answers. The author considers that before taking a decision about the application of earmarking it is important to define whether it is a strong or soft earmarking because this is the basis for the further financial management. Strong earmarking means that the earmarked tax is the only source of resources for certain activities. The earmarking in its strong form is generally unpopular with governments because it imposes rigidities on their budgets. Using strong earmarking there is an additional question (and risk) – will this amount be sufficient for a particular activity? Or maybe it is too much and a part of resources could be channeled to other expenditures. Soft earmarking means that an earmarked tax covers only a part of certain expenses. The governments also attract other revenues for full financing of a particular activity. Soft earmarking is more popular but there are also questions: what is the benefit from partly financing? what will other resources be? what part of financing should be earmarked? how do we manage it? As we can see, in both cases there are additional difficulties of financial management, therefore, there is a question – why do governments use this practice? In which cases does it take place? Studying the scientific literature as well as the experience of the countries, the author would like to highlight the following motivators in the earmarking of taxes: the government, politicians and the taxpayers.

From the perspective of a government the practice of the earmarking of taxes is used in order to minimize the tax avoidance strategies and evasion behavior; to strengthen the links between the tax and public spending; to ensure certain amount of money for certain activities; earmarking is a useful strategy for building trust. But after a thorough analysis it becomes more and more difficult to separate government interests and the interests of politicians. Studying the literature we can often find a strong view that earmarking is mostly advantageous for politicians. In his research the author Anesi Vincent (2003) analyses the relationships between earmarking and the potentiality of the parties to win the elections. The obtained results testify that by the earmarking the political parties may acquire and also lose the support of certain groups of voters. Mostly, it has been emphasized that as a political strategy, the earmarking could be highly effective. Earmarking can be used: to explain the variety of tax systems; to increase the acceptance of tax systems; where applicable, to minimize tax avoidance strategies and evasion behavior; to show the solution of the taxpayers' problems – lobby groups argue that it can increase welfare and ensure transparency of the use of taxes.

There is a question – does the government have the same interests as politicians? Is it good or bad? The author of the article has not found a particular answer to these questions because in each society it depends on the political balance of forces and the model of forming a government. Every government faces shadow economy and the tax evasion, therefore, it may be useful to conduct a study about how it looks from the perspective of taxpayers. Does the earmarking of taxes influence the willingness to pay taxes? Would you pay taxes more honestly in this case? However, there is an opinion in the society that the tax evasion is connected with a lack of information about how the government spends the taxpayers' money because it is concentrated in one fund, i.e. the state budget. In their investigations some authors (Hundsdoerfer et al., 2013) have proved that the effects of the earmarking of taxes can substantially increase taxpayers' willingness to contribute, therefore, the earmarking of taxes often get a support in the society which at the same time ensures more trust to the government policy. In such a situation the earmarking of taxes may have political and also economical benefit. However, the taxpayer has information about how the tax revenue is spent only in the case of a strong earmarking. If the earmarked tax finance a programme only partly (soft earmarking), it deludes taxpayers as to the true cost of what they are paying for. According to the author, it is important to emphasize one more fallacious opinion in the society that the earmarking of taxes ensures the increase of the amount of the expenses in the particular area. Sometimes it may be true but in general it does not happen like this because a problem arises from the fact that revenues are highly fungible.

The main question is whether the earmarking leads to a significant new spending in the designated areas or it simply displaces the preexisting funds leaving the aggregate spending unchanged. According to Joel Michael (2012), the tax earmarking does not increase the funding level but one source is simply substituted by another. Such behaviour can actually undermine the public confidence in the tax system if it is perceived to be manipulative.

Finally, what we can speak about the earmarking of taxes from the perspective of financial experts. The practice of earmarking mainly remains unpopular with fiscal experts. As Bingyuan Hsiung (2001) points out, traditional literature on public finance generally opposes the earmarking of taxes because an effective budget management is likely to be adversely affected. The author of the research agrees with Wilson Prichard (2010) who has pointed out that from the point of view of fiscal management the earmarking of taxes has one major drawback – the earmarking of taxes reduces fiscal flexibility in the long-term. But, as it has been mentioned before, there are proponents of the earmarking of taxes, who say that the earmarking protects high-priority programs from shifting majorities, inefficiency, and corruption, that it guarantees a minimum level of funding, and that it can facilitate the agreement

about raising revenues (Buchanan, 1963; Goetz, 1968; Browning, 1975; Navarro, 2002).

In general, we can make a conclusion that the practice of the earmarking of taxes has not been fully investigated yet, and it may cause additional problems in public finance. The earmarking of taxes is an additional constraint on the fiscal management; the earmarking introduces inflexibility in the budgets and fiscal policy; there are risks of purely political earmarking; if it is realized in a soft form the earmarking becomes meaningless; it is too risky to base important state expenses on the revenues of one tax. The cyclical character of revenues would create problems, which was demonstrated by the crisis in Latvia.

As we can see, in the financial science there are contradictory views and conclusions about the attraction of particular taxes or a part of them to definite expenditures of the state budget which has extensively been discussed in the literature. The main statement is that outcomes will only be achieved if earmarking is applied effectively and honestly. This means that earmarking must be: 1) substantial and specific which guarantees an actual increase in spending the money in the designated area; 2) transparent and easy to monitor.

Accountability and transparency of special funds as well as the possibility for the citizens to be fully informed are the biggest problems.

As Robert Carling (2007) has pointed out, the earmarking of taxes can be beneficial, but the conditions for this are quite strong and are rarely met in practice. The earmarked tax needs to be kept separate from other revenues, applied exclusively to the expenditure programme for which it is identified, fully funding (but not over-funding) that programme rather than being mixed with general revenues.

Despite this criticism, there may be a particularly strong case for using the earmarking of taxes in the developing countries. On the one side, in the situation of a political instability the earmarking of taxes can stabilise the funding of the priority needs, such as the road funds created by fuel taxes. Moreover, from a governance perspective the earmarking of taxes may be a useful strategy for building trust, achieving important revenues and setting objectives, improving monitoring and increasing the involvement. Perhaps, it is more important to say that in practice many tax earmarks serve a political purpose, but do not actually affect spending patterns or improve monitoring.

In each country there must be an independent investigation according to the real situation.

#### The earmarking of taxes in Latvia – lessons from crisis

In its practice Latvia has also undergone the reforms in the field of tax earmarking, the opinions of which are different. The most serious reform in this field was carried out in 2003. Until 2003 the earmarking of several taxes was introduced under different motivations, i.e. to connect it with specific kinds of expenses. Such taxes as personal income tax, excise tax, lottery and gambling tax, natural resources tax and obligatory state social insurance contributions were completely or partly earmarked. From nine taxes, existing at that time, five taxes were earmarked. Essentially, the tax earmarking means that the state builds up special budgets and special funds for financing a specific kind of expenses. In 2003 there was a number of special budgets and funds, among which we can point out the following: the social insurance budget; the state special budget of health care; the state fund of motorways; the environment protection fund; the fund of capitals of culture; the fund of port development; the fund of outstanding achievements in sports; the fishing fund. The situation was such that almost each ministry had a special budget or a fund under its supervision. In 2003 the state general budget was divided into the following proportions: the basic budget formed 56%, but the special budgets made up 44%. With the change of the government and taking into consideration the suggestions of experts radical changes were made in 2004. The earmarking of four taxes from the above mentioned was cancelled and later these taxes were paid into the government basic budget. Only one earmarked tax was left – obligatory state insurance contributions (VOSAI) and one special budget remained – the Social budget. The proportion between the government basic budget and the special bud-

get has significantly changed in favour of the basic budget and since 2004 it accounts for 70% against 30%.

There were sharp debates about the reform carried out in 2003. One of the opinions was that the financing of particular kinds of expenses and programmes was destroyed. It was declared that there would be a lack of financing of some important programmes in the future. Another opinion was that in such a case there would be a better control and transparency of the budget and the utilization of funds and so, it was denied that the financing of certain programmes would be stopped because these programmes were transferred to the basic budgets of ministries.

Characterizing the situation of the budget in Latvia before 2004, the author considers that it was negative because, after the decision about allocating the necessary funds to the implementation of state important priorities, in reality there was only a little bit more than half of the whole state budget at the disposal of the state. According to the author, definitely the situation had to be changed. At the beginning of the article the author has already indicated the risks of the earmarking of taxes. The experience in Latvia has already affirmed a high degree of these risks. The period from 2004 until 2008 is characterized by a very rapid development, as a result of which the tax revenues increased and the state successfully fulfilled its financial liabilities of the social budget and certain financial reserves were made. When the crisis set in, there was a rapid change of the situation. Under the crisis the only earmarked tax revenues of the state obligatory social insurance contributions have dramatically decreased but the expenses from these revenues remained unchanged and even increased because of the rapidly increasing unemployment. The reserves, made in the social budget until 2008 before the crisis, somehow helped in this situation but still they were not enough in order to avoid the deficit of the social budget (Table 1).

| Year | Reserves, million USD |
|------|-----------------------|
| 2005 | 337,1                 |
| 2006 | 690,3                 |
| 2007 | 1406,8                |
| 2008 | 1846,8                |
| 2009 | 1432,6                |
| 2010 | 780,6                 |
| 2011 | 319,6                 |
| 2012 | - 89,9                |
| 2013 | - 69,7                |

Source: Indicators of the social budget, 2012

As we can see from the table 1, before the crisis the reserves of social budget had almost reached two billion USD in 2008. After that the situation dramatically changed. Under the influence of crisis the production sharply declined which meant the lay off of the employees and the reduction of wages. The salaries were significantly reduced for the people working in the state sector, too, including teachers and doctors and, as a result of reforms, a lot of people lost their jobs. The shadow economy grew and the emigration started on a large scale. As a result of this, an overall tax income to the state budget dramatically decreased including social insurance contributions. At the same time, there was an increase of the number of people needed social assistance, as a result of which the need for payments from the social budget increased. The government was forced to implement a number of reforms in the area of social insurance, the aim of which was to reduce the expenditures of the social budget because the only source of revenues – the earmarked tax – could not ensure the expenses any more: the increase of the retirement age, the cancellation of additional payment to the pension; the freeze of the indexation of pensions; the freeze of deductions of the second pension level. These revenue enhancement measures were not enough and therefore, it was necessary to make changes in the whole financing system of the state budget expenditures transferring

some kinds of expenses from the special social budget to the state basic budget. The forecast shows that in 2014 there will be a surplus in the social budget, although it is not connected with a substantial increase of social payments but with the transfer of some kinds of expenses to the basic budget. We can make a conclusion that the basic principle of the self-financing of the social insurance is not safe in the changing conditions of the economic development and it does not work in the situation of crisis.

According to the author, the tax earmarking justifies itself only in the situation of a stable economy when the tax revenues can be predicted and stable, and the necessary expenditures are predicted. Otherwise, the tax earmarking is subject to the above mentioned risks. In the present situation in Latvia, when there are no real grounds for optimism about a rapid increase of social payments in the nearest future, the discussions are needed about the principles of building up and use of the general state budget. The discussions must be about the basic points and the necessity of the social budget as well as about the best possibilities to ensure the social guarantees to the society.

Despite the problematic situation referring the social benefits and the financial guarantees of the pension pay-out, at present in Latvia the discussions about the earmarking of taxes have become topical in connection with the proposal of the government to introduce the obligatory health insurance which is based on shifting (earmarking) the part of personal income tax to the special budget of health care.

At the same time, there are no discussions about the influence of earmarking on the state basic budget, nothing has been said about the earmarking problems in order to finance particular tasks and there is not a scientifically theoretical substantiation and a critical assessment of the experience in the previous years in Latvia. The author considers that, due to the Parliament (Saema) elections in October 2014, the ideas and discussions have an obvious political character. From the economic point of view there are a lot of unclear questions about the provision of services referring to the part of the society which for justifiable reasons does not pay any of the taxes as well as referring to the people who pay taxes in other countries. The author assumes that, when earmarking the income tax the income of the health care institutions could even decrease because it is known that a lot of Latvian people working abroad come to Latvia to receive treatment because of the difference in prices.

According to the author, the government decision has only one aim – to find out whether a person pays the tax or not. In this way the government tries to reduce the shadow economy which is also important. However, it must not be the reason for the accessibility to the health care services. One more problem is that the politicians would like to renew a special road maintenance fund which existed until 2003 and was formed from the excise tax which was paid when buying the fuel. This activity of the politicians is connected with the pressure and criticism of the society to improve the road quality in the country which is really in a critical condition. There are the endeavours of the politicians to show the society that something is being done but they do not guarantee the improvement of the situation. It seems like blaming the budget and taxation system created by the government.

The author wants to emphasise that the tax earmarking does not increase the amount of money as a whole. The government must decide how much money to transfer from the basic budget of the Transport ministry to the road maintenance programme. So, the question is about the political will to solve particular problems.

## Conclusions and suggestions

1. Earmarking is a budgeting practice that dedicates tax or other revenues to a specific program or purpose. This method of fiscal policy is very contradictory from the point of different evaluators – economists, politicians, governments, taxpayers. The task of the theoretical conclusions is to give an advice to the governments about the consequences of the action and the influence on the society, therefore, theoretical conclusions are important.

2. Advantages. Minimization of tax avoidance strategies and evasion behavior; strengthening the links between tax and public spending; ensuring certain amount of money for certain activities; predictability and budget planning. Earmarking is a useful strategy for building trust to the government and it can increase taxpayers' willingness to contribute.

3. Disadvantages. Earmarking of taxes reduces the budgetary flexibility which can negatively influence the satisfaction of the common needs of the society. In the conditions of changing economic development it is too risky to finance important state expenses only from one tax. In the conditions of crisis there could be problems of accumulating the needs of financial resources. Earmarking increases the administrative and compliance costs. Earmarking of taxes does not basically create more money for certain activities because of fungibility.

4. In the present situation in Latvia, when there is no real grounds for optimism about the rapid increase of social payments in the nearest future, the author considers that it is necessary to take into account the past mistakes and abandon the future tax earmarking leaving only one special budget existing up to now – the state social budget. In the situation of a disbalanced development of economy in such a small country as Latvia the fragmentation of funds in separate special funds and budgets is not recommended.

5. There should be discussions about the content of the expenditures in the social budget. It would be reasonable to start debates about the possibilities to decrease the expenditures in the social budget by forming it as a state pension budget and by shifting other expenses to the state basic budget.

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