Hypothecated taxation

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Hypothecation is the term used to describe the process of assigning tax revenues to a specific end, or - in certain cases - ensuring that they are not spent on one particular end. Earmarking taxes may be in relation to a given proportion of a wider pool of revenue (such as spending the receipts from an extra 1p on the basic rate of income tax on education), or a single tax base (such as spending all receipts from motoring taxes on road building). In each case hypothecation contrasts with the funding of all government expenditure from a consolidated fund. Some commentators have argued that hypothecation allows voters to make a stronger connection between the taxes they pay, and the services those taxes are spent on. By increasing 'transparency', the hope is that taxpayers will be better informed about the funding of the public sector. The case has been made by those who think funding should be increased - often in particular areas, such as health or education - and those who think it should be cut - including those who would wish their own taxes not to be spent on certain things, such as military weaponry. More recently hypothecation has been proposed as a way of encouraging public acceptance of environmental taxes.

Hypothecation has never been a central feature of the UK tax system and governments have opposed its adoption on the grounds that spending priorities should not be determined by the way in which money is raised. That said there have been some recent examples where governments have deliberately linked new tax increases with spending commitments. This note looks at the case that has been made for hypothecated taxation, before looking at a number of areas where its potential use has been discussed and the very limited way it has featured to date in the UK tax system.

Contents

1 The case for hypothecation

Shoppers in a supermarket may each choose how much they are going to spend and what items they are going to buy. But when it comes to public goods like defence, every citizen has to have the same amount. At election time voters are required to choose between two or three manifesto bundles of policy covering all issues, none of which may express his or her preferences, but which he or she has to take or leave as a whole. Some voters may want more provision for medical care than education, some the opposite. It is as if shoppers were required to choose between two trolley-loads of goods from competing supermarkets, rather than choosing the individual goods they wanted. This is termed the problem of 'full line supply' and, as the commentator Samuel Brittan has pointed out, hypothecation of taxes has been seen for some time as an answer:

> One way of introducing a little more coherence might be by some form of hypothecated or earmarked taxes, designated for specific public services. There can, but need not, be a close connection between the nature of the tax and the service for which it pays. A historical example of an earmarked tax was 'Ship Money', levied on English seaports and coastal regions to finance the Royal Navy. When Charles I revived the tax in 1634-38, he started a chain of events which contributed to the English civil war, his own beheading and a period of republican government. But that was because the levies were extended to inland regions and Parliament was not consulted. Earmarked taxes that are carefully and sensitively applied may still be a lesser evil than today's habit of putting all official revenues into a pool to be allocated at the government's discretion.[1]

Another example from the 20th century is vehicle excise duty (VED), first introduced for four-wheeled motor road vehicles on 1 January 1889 by the *Customs and Inland Revenue Act 1888*. Historically the receipts from VED were used for the building and upkeep of roads. The Road Fund was set up by the *Roads Act 1920*;[2] it received the money derived from the taxation of motor vehicles which was collected by county councils and it paid it back to local authorities to finance expenditure incurred on roads. The fund was in practice never spent in full and was notorious for being raided for other purposes. It was finally wound up by the *Finance Act 1936* and since then the revenues from motor vehicle taxes have been collated with receipts from all other national taxes into the Consolidated Fund – the common pot from which government finances all public spending.[3]

The case for hypothecation was made more recently in a pamphlet published by the independent think tank, Demos in the early 1990s. The authors suggested hypothecation was one way to increase people's willingness to pay tax, to "reconnect taxes and services" and so "to share sovereignty between elected representatives and citizens":

> There is no clear link between taxes and services, no consultation beyond occasional elections, and little if any reference to public views … Hypothecation [renders] services more independent of central budgetary processes. [It] encourages providers to look outwards - to the publics they have to convince, and to the sources on which they depend. This is why the Treasury and many senior politicians are so hostile to hypothecation. It weakens central control by making lateral connections.[4]

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1 "Time to know what you pay for", *Financial Times*, 15 December 1994

2 It replaced the Road Board, which had been set up in 1909 and financed under the Road Improvement Grant by the Exchequer.

3 For more details see, David M Newbery & Georgina Santos, "Road taxes, road user charges and earmarking", *Fiscal Studies* vol 20 no 2 1999 pp 103-132

4 G Mulgan & R Murray, *Reconnecting taxation*, Demos 1993 pp 10, 25

However, emphasising the connection between services and people's pockets may have contrary effects, as Samuel Brittan observed, in the piece quoted above:

> Earmarked taxes cannot remove all the defects of state provision. They cannot enable different voters to have different military budgets or different sized health services to suit their individual preferences. But they can at least make sure that the services come with a price tag and that expenditure is representative of what the middle of the road taxpayer is prepared to finance. An example is public expenditure on health. This was running in the UK in 1993-94 (the last year for which a functional breakdown of public spending was available) at almost £44bn - slightly more than the yield of VAT.
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> Why not then earmark the proceeds of VAT for the National Health Service and let voters put their money where their mouths are? If they desire ever more NHS expenditure, they should be ready to see the VAT rate creep up from 17½ to 18, 19, 20 per cent and however much more it takes. Eventually even the belligerent uniformed nurses who turn up at every televised election brains trust with their demands for 'more, more, more' will begin to be heard more critically.[5]

Despite the advantages in terms of transparency and public awareness, there are three strong arguments against hypothecation. First, it seems likely that the system would soon lead to HM Treasury being deluged with petitions, as taxpayers decided they might prefer not to pay for a given service in the light of a particular aspect of current Government policy. The Government of the day would need to aggregate individual demands for greater spending on different services, balancing preferences in some way without leading to arbitrary outcomes. This threatens a basic shift in the country's democracy. At present our elected government is responsible for allocating resources, and has to account for its decisions to the electorate. Hypothecation could transform the job of politicians into simply lobbying voters on the future uses of tax revenues before a referendum.

Second, many proposals for earmarked taxation might be termed tokenism, making little contribution to informed decision making. To put it bluntly, the request that taxpayers pay an extra 1p on the basic rate of income tax to boost education spending, in itself, may do little to improve their understanding of how their money is spent in practice. Further, there will be practical difficulties of ensuring tax revenues only go to specified causes, especially in deciding if any given project qualified or not. Tying expenditure on individual services to the yields of individual taxes makes spending vulnerable to the vagaries of the business cycle, as tax yields rise and fall in line with incomes, profits and sales.[6] Marginal topping up - say during a recession when incomes are depressed - can tackle this problem.

Third, government spending might well fall prey to how emotive it proves to be with the electorate. Hospitals and schools might easily argue for greater spending - less glamorous but no less necessary services might suffer in the short run - military spending, say, or the costs of running HM Revenue & Customs. If taxpayers reacted to cash crises in the Ministry of Defence or HMRC by having a change of heart, the end result might simply be a ballooning in public expenditure, something taxpayers had not bargained for when they made their first hypothecated decisions. In addition, hypothecation might require the public to put *more* trust in politicians' promises - not less -, given they would have to believe the Government would not change the terms under which revenues are spent, once they have been collected.

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5 "Time to know what you pay for", *Financial Times*, 15 December 1994

6 Naturally changes in the structure of taxes - altering the rate of tax charged, say - mitigate this effect.

This last point was put strongly by the Institute for Fiscal Studies in its *1994 Green Budget*:

> There has been a good deal of recent discussion about the possibility of increasing the use of hypothecation in the tax system. An hypothecated tax is one the revenue from which is committed to a particular spending programme. The clearest example of an hypothecated tax in the UK tax system is National Insurance contributions (NICs), the great bulk of which are automatically spent on social security benefits.
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> NICs portray very clearly the inadequacies of hypothecated taxes, but also the quality which makes them attractive to politicians. There is a clear choice to be faced for any so-called hypothecated tax: is spending on the specified area really to be determined by revenue from the hypothecated tax or not? If the hypothecated tax is truly to determine spending we have the absurdity that spending will be cut during recessions and increased during booms. We surely cannot intend that health or social security spending should be cut or raised simply because of the state of the economy. In the case of NICs there is certainly no link between social security spending and the state of the economy. In the early 1980s when NIC revenue was low because of unemployment, the government simply raised NIC rates. In the late 1980s when the boom raised NIC revenues, general taxation subsidy to social security was cut. In the 1990s, as recession has cut revenue and increased spending, the general subsidy to social security was increased. NICs as so-called hypothecated tax have imposed neither an upward or downward constraint on government spending, or revenue, or the allocation of spending between programmes.
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> NICs *do* demonstrate the quality that politicians like about hypothecated taxes, which is that because the population seems to believe that NICs are spent on something 'good', and determine in some way the level of that spending, they are less resistant to paying NICs than they are to paying other taxes. The fact that more of the population believe that NICs are allocated to the NHS, which they are to only a small extent, than believe that they are allocated to the retirement pension, which they are to a far greater extent, demonstrates the further fact that misinformation here is rife.
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> Hypothecated taxes could only constrain government where they were allocated to genuinely marginal projects and where the level and allocation of government spending apart from the marginal project is entirely and irrevocably set in current and future years. Since such a set of criteria cannot be met, we must accept that any further hypothecated taxes would principally be an exercise in deceiving voters that their tax payments controlled government spending in a way which they simply will not. Further hypothecation might make it possible to raise more revenue, but if our experience with NICs teaches us anything, it would be on the basis of misleading taxpayers rather than expanding democracy. [7]

Taking up this theme one commentator writing in the journal *Tax Journal* argued that hypothecation might well have the *opposite* effect as intended – and was no substitute to improving the conversation between government and the governed on tax:

> Increasingly we are seeing hypothecation suggested as the way to make taxation acceptable and consumerised … [However] hypothecation is a double edged sword. … you might be able to use it to obtain funding for things people generally support, such as hospitals or schools, but it is harder to use it to pay for necessities which aren't so appealing, or which some people might not actually agree should be provided. And where the link between the taxed activity and the recipient service is not very clear, it is hard to make hypothecation persuasive …

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[7] *Options for 1994: The Green Budget* , October 1993 pp 64-65. Many critics have argued that the distinction made by the operation of the Fund between NICs and other national taxes is cosmetic – though the presentational appeal of using an increase in NICs, rather than income tax or VAT, was illustrated in 2002 when the Labour Government announced a rise in NICs to fund a major increase in health expenditure. The issue is discussed at more length at the end of this note.

> Too often, it isn't really genuine hypothecation. But if it is presented as such, taxpayers could become seriously disenchanted if they discover that the tax they were paying had not in fact been used for the causes they had been led to believe. The Government's argument that fuel duties paid for all sorts of public goods did not go down well with those who had thought they were being recycled into policies to improve transport. Hypothecation, then, is not a substitute for communication. It can, in a limited way, help focus public debate on tax and spending issues ... But any sort of hypothecation, whether full or partial, is open to misuse and misunderstanding. There is no alternative to raising the day to day standard of communication on tax between government and governed.[8]

2 Hypothecation & the NHS

In the early 1990s there was considerable interest in the possibility for using hypothecation to underpin health expenditure, seen in policy papers published by the Institute of Health Services Management (IHSM), the Independent Healthcare Association (IHA), the National Economic Research Associates (NERA) and the British Medical Association's Health Policy and Economic Research Unit. The IHSM's discussion of hypothecation formed part of a larger study of funding options for the NHS, which concluded that general taxation remained the best way of funding healthcare, but that some form of social insurance could provide an alternative source if political constraints prevented general taxation from delivering optimal levels of resources.[9] The IHA and the BMA, however, both considered the possibility of 'full-blown' hypothecated taxation, while NERA carried out a comparison of a number of developed countries' systems and proposed a new prototype based on social insurance.

The BMA identified three possible forms of hypothecation: a flat rate or graduated health tax, which would incorporate the widest tax base; a form of social insurance, setting up an NHS fund on the lines of the National Insurance Fund; and a consumption tax levied on goods and services.[10] Potential problems identified with both the first and third proposals included the regressive nature of flat-rate and consumption taxes. The major drawback to the second proposal was felt to be that the yield from the tax would decrease in times of recession, whereas the demand for NHS services would at least remain steady and probably in fact increase. The authors anticipated that the responsibility for assessing and distributing the receipts from a new tax would need to be given to a new, independent body, to ensure the levy was free of political control. However, opposition to establishing such an authority was likely to be considerable, given the impact that its decisions would have on general economic policy.

The Independent Healthcare Association looked at the three options raised by the BMA as well as a fourth option: apportioned income tax.[11] It concluded that the most likely form of hypothecated health tax would in fact be a variety of health taxes and insurance schemes at local and national level, and that if such revenues ended up being channelled into one general health fund, then the system would end up differing little from the current system of general taxation. If the benefits of hypothecation were to be retained, then particular health taxes would have to be linked to particular programmes of health expenditure.

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8 "Reconnecting with the taxpayer", *Tax Journal*, 12 February 2001

9 IHSM Policy Unit, *Future health care options: final report*, 1993

10 BMA Health Policy and Economic Research Unit, *Hypothecated fax funding for the NHS: a briefing/ discussion paper*, February 1994

11 IHA, *Hypothecated taxation and the future of UK healthcare: an initial discussion paper*, 1994

The National Economic Research Associates published a series of reports sponsored by a group of pharmaceutical companies which compared the health care systems of eleven developed countries, and proposed a prototype health care system to replace them.[12] The suggested prototype was a form of social insurance: competing insurance funds, all required to offer a "guaranteed health care package", required to accept all comers, and funded through income related premiums. Patients would also be expected to make co-payments when using the healthcare system.

In 1995 the Office of Health Economics published an evaluation of the different proposals that had been made for a hypothecated health tax, including the work of the BMA and NERA, as well as suggestions for earmarking taxes made at this time by the Liberal Democrats.[13] The OHE assessed all the proposals to see how well they would meet a number of objectives of NHS financing: equity, efficiency, the "benefit principle" (the principle that the costs of a public service should be borne by those using it), the revenue base, flexibility, transparency and responsiveness. They concluded that "it would be hard to make a case for hypothecated funding of the NHS which is able to satisfy *all* the broad objectives of health care financing in the UK" and that "this suggests that the advocates of earmarked funding need to do more to elucidate the mechanisms by which hypothecation may lead to greater transparency and responsiveness in health care financing."[14]

The BMA returned to the issue in its report on healthcare funding published in February 2001.[15] The Association found that "people would be prepared to pay more tax if they were confident that the money would be well spent and would result in genuine improvements. But there is a general loss of confidence in governments and in their ability to spend money effectively." Hypothecation was one of the possible funding solutions considered, though the BMA concluded, "the very characteristics which make hypothecation popular with the public also make it unpopular with governments, and funding the health service from a specific tax source would be unlikely to provide any advantages over the current system."[16]

The case for hypothecation was also examined by the Commission on Social Justice, an independent think tank set up in 1992 by the late John Smith MP when leader of the Labour party, in its inquiry into social and economic reform in the UK. The Commission was sceptical about any plans to hypothecate recurrent expenditure, but proposed the establishment of a hypothecated 'National Renewal Fund' containing a proportion of tax revenues, to fund important capital-investment projects:

> Apart from social insurance contributions, where there is a clear link between contributions and benefits, earmarked taxes make the best sense when they are devoted to one-off capital investments. Once the national accounts have been reformed to identify investment clearly, we propose that government establish a National Renewal Fund to help finance major investment projects. Each year, the Budget would allocate a proportion of tax revenues to the Fund. This could come from existing income taxes, or from a less visible tax, such as capital gains tax, corporation tax or death duties, which could have the desirable effect of raising people's interest in how efficiently these taxes work …
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> Unlike capital expenditure, however, hypothecating taxes for regular expenditure risks leaving a crucial service vulnerable to a drop in revenue … The reverse is also

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12 published in 2 vols by Hoffmeyer & McCarthy, eds, *Financing health care*, 1994

13 In June 1994 the Liberal Democrats published a report on 'proposals to increase public confidence in the way taxes are raised and spent', which suggested that both state pensions and the NHS could be appropriate subjects for earmarked taxes (Liberal Democrats, *Being honest about taxation*, June 1994 p12).

14 OHE, *Hypothecated health taxes,* 1995 p27

15 BMA press notice, *New report urges open and honest approach to rationing*, 6 February 2001

16 "Executive summary" in BMA, *Healthcare Funding Review*, 2001 pp 5-6

possible, with a hypothecated tax producing more money than can actually be spent on a particular service (as happened in some Central London boroughs, where parking-meter revenues may only be spent on more parking spaces but there is nowhere to build them). It is possible to overcome these problems, but only by making hypothecation a cosmetic rather than a real change. The extension of hypothecated taxes may also increase the pressure for tax reductions to people who opt out of services … For those reasons, we do not generally favour hypothecated taxes.

There is, however, a case for earmarking any tax *increase* which government might decide upon, so that citizens know exactly why the increase is needed and how it will be spent … If tax increases are needed, a clear link with the purpose for which they are raised could be part of the far more open Budget process we advocate.[17]

In November 2000 the Commission on Taxation and Citizenship, set up by the Fabian Society, published a report on public spending,[18] which recommended the use of an earmarked tax for the NHS; an extract from a press notice issued by the Society is given below:

Drawing on original research into public attitudes towards taxation and public spending, the Commission found the public to be 'disconnected' from their taxes: unsure how much tax they pay, unable to say where the money goes, and cynical about the competence and honesty of all governments and politicians. Arguing that this 'disconnection' undermines public support for the whole system of taxation and public services, the report makes a series of recommendations designed to 'reconnect' people to their taxes and to the public services which these pay for.

- An earmarked or 'hypothecated' income tax to fund the National Health Service. The Commission proposes that around half of income tax, along with tobacco and alcohol duties, should be earmarked for the National Health Service. This would make it absolutely clear to the public that taxes pay for the services they value. If health spending rose by more than the natural rise in income tax revenues, the NHS tax would have to be increased (though other taxes, including the remaining General Income Tax, could be reduced if the government so chose.) The Commission notes the practical and constitutional issues raised by this proposal, and some members of the Commission opposed it, but the majority felt that it would be an important symbol 'connecting' citizens to their taxes.

- The use of 'tax and public service pledges' when governments otherwise seek to raise taxes. Governments should specify to the public what the additional money is to be used for and the benefits in improved services it will bring. Environmental and transport taxes, in particular, should be at least partially earmarked for environmental and transport spending.

The Commission argues that earmarking taxes in this way will increase the public's willingness to pay tax.

In an opinion poll conducted for the Commission by the Office for National Statistics, members of the public were asked if they would pay an extra 1p on the basic rate of income tax for unspecified increases in public spending. 40% said yes. But when they were asked if they would pay an extra 1p if the money were earmarked for the NHS, the proportion saying yes doubled to 80%. (For education the figure was 68%.) The Commission argues that this 'earmarking effect' could prove a powerful tool for governments seeking to improve public services.[19]

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[17] Commission on Social Justice, *Social Justice : Strategies for National Renewal*, October 1994 pp 391-393
[18] *Paying for progress: a new politics of tax for public spending*, November 2000
[19] Fabian Society press notice, 27 November 2000; see also, "Fabians want to earmark income tax for NHS", *Financial Times*, 27 November 2000

An editorial in the *Financial Times* was critical of the proposal:

> You need to be an optimist about human nature to believe that people can be persuaded to vote cheerfully for higher taxes. Perhaps that is why the Fabian Society has been driven to some desperate expedients in its latest attempt to roll forward the frontiers of the state. Its recent report on the politics of tax suggests, for example, that British taxes may rise to harmonise with average rates in continental Europe - hardly a vote puller. The society's commission on tax discovered from opinion surveys that people dislike the taxes they pay, are unsure of where the money goes and suspect that it is not well spent. But people value public services such as health and education and would like them to be better. No surprises here. The commission concludes that if citizens could be better "connected" to taxes and spending, they would willingly hand over more for better services.
>
> But how could that be done? The commission runs through some worthy but unexciting suggestions such as better information on public spending, tighter targets and more independent monitoring. Plainly it does not think that these will persuade taxpayers to pay more for the services they desire. But suppose half of income tax were allocated specifically to health? Would that not take the sting out of PAYE deductions?
>
> The report devotes 32 pages of fair and rigorous analysis to this option. It shows that a fully hypothecated health tax would be immensely complicated, leaky at the edges, hard to understand and politically hazardous. In spite of this, the committee says it is the way forward. Its plan would double the number of income tax rates and require a special health fund with its own borrowing powers to even out years of surplus and famine. And the government could fall into the absurd position of adjusting other taxes to maintain the total tax take at what it would have been without hypothecation.
>
> These are not mere technicalities. They demonstrate that under a modern, centralised system, hypothecated taxes are either a lie or a fraud. A health tax would be no exception. No one would believe that non-health taxes would be set independently. Nor would the special fund needed to help finance the service in recessions be credible. Governments would surely raid the surplus in good times and be forced to bail it out (from other taxes) when debts became too large. The service would appear incompetent and taxpayers would be even more confused. The Fabians have identified a real problem. But their solution is a triumph of hope over analysis.[20]

Two of the report's authors, Professor Julian Le Grand and Richard Titmuss, responded to this piece in a letter to the paper some days later:

> Sir, In your editorial on the Fabian Commission's proposal for a hypothecated health tax (November 28) you described it as a "triumph of hope over analysis". Yet, in many Continental countries, social insurance funds high quality health services, as well as other forms of social protection. Even in Britain, the BBC licence fee has managed to sustain a quality public service for nearly 70 years. Although both of these forms of hypothecated taxes have had their problems, they are not more troublesome than other taxes and are certainly not regarded as a "lie and a fraud". Moreover, under our proposals, there would be built-in safeguards against government manipulation.
>
> The Office of Public Accountability would monitor the NHS Fund and ensure that it was only used for the purposes for which it was set up. It would also assess the performance of the NHS against the government's own targets - to the ultimate benefit of both the NHS and the government. So far from damaging government credibility, our proposals, taken as a whole, would help restore it.[21]

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[20] "Editorial: Fabian taxes", *Financial Times*, 28 November 2000

[21] "Letter: not all experience of hypothecated taxes is bad", *Financial Times*, 4 December 2000

Writing in the paper the commentator Samuel Brittan – quoted on the issues surrounding hypothecation writing at the start of this note – was more favourably disposed to the report; part of his article written on its publication is reproduced below:

> The Commission's most interesting proposal is for a fully hypothecated tax - that is, one that covers the whole cost - for the National Health Service. It also favours environmental and local tax increases earmarked for specific projects. Unfortunately it is such ideas that attracted most opprobrium. Finance ministries have long detested "hypothecation" and the dissenting minority on the Commission included a former senior Treasury official. The earmarking proposal stemmed from opinion research showing that while people were, in principle, in favour of paying more to fund health or education, they were extremely suspicious of the links between the taxes they in fact paid and improved public services. The commission's guiding idea is to "reconnect" payments and services. This should be equally acceptable to people who differ widely on the desirable extent of collective provision …
>
> Earmarked taxes cannot remove all the defects of state provision or finance. They cannot enable different voters to have different levels of provision to suit their personal preferences. But they can at least make sure that services come with a price tag and that voters know they will have to put their money where their mouths are. If carried out carefully, earmarking ought to appeal both to those who want the state to spend much more and those who do not. Indeed, both left-of-centre and free market think-tanks have published papers in favour of earmarking … The only way citizens can know what is being spent on state medical provision, and whether they want to increase it, is to make it clear what they are paying for it. The commission's other ideas for re-establishing the link between taxes and public services are much more flimsy. They consist mainly of the popularisation in some form or other of tax and spending pie charts … But such "good citizen" propaganda has been attempted many times in the decades since the second world war - and it has had as much effect as water dropped on to a duck's back.[22]

3 A peace tax

Though hypothecation has been discussed most in relation to health spending, there has been a small but consistent campaign that it should be applied to military expenditure, and that taxpayers who are conscientious objectors should be allowed to have that part of their taxes diverted into a specific fund - a peace tax - and spent on other ends. In December 1993 sixty two Members signed an EDM which Neil Gerrard MP had put down supporting such a tax,[23] and in January the next year Mr Gerrard put the case for this reform when presenting a Ten Minute Rule Bill:

> The Bill's simple purpose is to allow people who have a conscientious objection to their taxes being used for public expenditure on military purposes to be able to register that objection and to divert that part of their taxes to a specific fund that will be used for peaceful purposes connected with the development of international security…
>
> When a Government of whatever persuasion have been elected, they have the right to decide how to spend our taxes which end up in a single consolidated fund. We cannot allow someone to say, "Do not spend my taxes on roads or education". To change that, one can vote for a different party at the next election; we cannot expect Governments, local authorities or anybody spending public money to please everyone

[22] "In defence of earmarked taxes", *Financial Times*, 7 December 2000

[23] EDM 304 of 1993/94, "Peace tax", 16 December 1993. Similar EDMs were put down by John McDonnell in the 1998/99 session (EDM 115, "Conscientious objection", 10 December 1998), and by Harry Cohen in the 2000/01 session (EDM 76 of 2000/01, "Human Rights Act 1998 and conscientious objection", 11 December 2000), attracting 46 and 43 signatures respectively.

> all the time. I agree with that, as do others who support the Bill. However, it is a special case. I do not consider that it is a special case that I have to prove to justify the Bill as it has already been recognised by Parliament. If conscientious objection can be recognised in wartime, why not in peacetime as well? In practical terms, it is not a difficult exercise. All that would be necessary is for the number of registered conscientious objectors to be known by the Inland Revenue. The average individual contribution to the Ministry of Defence budget can be calculated and a simple multiplication of the two figures produces a sum of money to be paid into a peace fund. That would certainly satisfy people who support my view.
>
> The Bill would specify in general terms the purposes for which the fund could be used. I mentioned the need for research and development into converting industry from military to non-military production, the study of causes and resolution of conflict, community-based work to develop and maintain democratic structures and human rights in areas of potential conflict ...
>
> People have strong personal objections on religious, ethical or moral grounds to taking part in war, and I am asking the House to recognise that similar objections are held by people in respect of the spending of their taxes on arms. One need not be a pacifist to respect the sincerity of the beliefs of those who are or to acknowledge that people have the right to a conscience. I am asking the House to allow the means for that conscience to be expressed and not violated. I ask the House to support my Bill.[24]

The Bill did not make any further progress, though in October 1998 John McDonnell introduced a similar Ten Minute Rule Bill, when he put the case as follows:[25]

> The Bill would give all taxpayers the opportunity to express on their tax return their conscientious objection to the expenditure of their taxes on preparations for war or the prosecution of war. Taxpayers would be able to express their desire for that proportion of their income tax that would otherwise be spent on military purposes to be spent instead on the prevention of war--to be invested in the search for peace rather than the pursuit of war.
>
> Tax revenues would be diverted either to the Department for International Development, to assist areas of the world deemed at risk of conflict, or to a non-military security fund. The fund, which would be established by the Bill, would have three purposes. First, it would support research into non-military conflict resolution and peace building. Secondly, it would establish a United Kingdom mediation and arbitration service, for use at an early stage in areas of potential conflict. Thirdly, it would support international peace-building organisations, including the United Nations. The fund would be managed by trustees, appointed by the Government, with experience of non-military security, who would report annually to Parliament on the disbursement of the moneys allocated to the fund …
>
> The rationale behind the Bill is as follows. The right of conscientious objection has been acknowledged in this country for centuries. In the late 17th century, the Government sought to induce Quakers to engage in military activities. They refused, and went to prison in a body. Subsequently, in the Militia Ballot Act, Quakers as a body were excluded from military service. The general right to refuse on the grounds of conscience to participate as a combatant in military service was included in the Military Service (No.2) Act 1916, which introduced conscription for the first world war … The right to conscientious objection has also been recognised in the United Nations declaration on human rights and the European Union convention on human rights. More recently, the legal right to act in accordance with one's conscience has

[24] *Conscientious Objection (Public Expenditure) Bill* [Bill 35 1993/94] (HC Deb 19 January 1994 cc 893-895).
[25] *Military expenditure (Conscientious Objection) Bill* [Bill 151 1998/99]. Mr McDonnell's Bill did not make any further progress.

been placed firmly on the statute book by the Government through the Human Rights Act 1998 ...

Various arguments have been used against the measures proposed in the Bill, and some have expressed opposition to the principle of the Bill, but the right of conscientious objection has been accepted in principle in Britain for a considerable period. The Bill does nothing more than put that principle in a modern setting. The Treasury initially raised some practical objections to the operation of the Bill's proposals, and argued that it broke the Treasury's sacred rule of opposing hypothecation of taxation. With the introduction of the system of self-assessment for individual taxation, there are no practical hurdles left. As for the alleged offence of hypothecation, the Government have introduced hypothecation of taxation in their congestion charging proposals. Another charge is that the Bill would set a precedent for others to direct their taxes, thus opening the floodgates to other objections to Government expenditure programmes.

Although many may wish to divert their taxes for political reasons, the right to refuse to kill or to pay others to kill on our behalf uniquely rests on a basic human right that is recognised in domestic and international law. Last year, this country budgeted for more than £21 billion of military expenditure. That represents about 8.5 per cent. of the Government's total expenditure and an annual contribution of roughly £500 per taxpayer for military programmes. With such large sums, a relatively small number of taxpayers opting to exercise their rights under the Bill would result in a major investment of resources in preventing conflicts in the world by promoting peace-building measures. [26]

In March 1999 Mr McDonnell, Mr Gerrard and Mr Jeremy Corbyn each presented petitions in support of the right conscientiously to object to the military proportion of taxes.[27] Mr Corbyn also raised the issue during Treasury Questions in June, when the then Chief Secretary, Alan Milburn, responded by saying, "the Government have a duty and obligation to make proper provision for our country's defences. That is precisely what we are committed to doing. I say in all candour that his proposal would undermine our ability to do that, and that is why the Government will not contemplate it."[28] Although Members have raised the issue in subsequent EDMs,[29] and the lobby group Conscience has continued to lead the campaign for a peace tax,[30] there has been no indication that the idea has ever been actively considered by the Government.

4 Hypothecation and green taxes

There has been some discussion that earmarking revenues from environmental taxes would be a way to increase public support for these charges. In 2009 the Enviromental Audit Committee argued that the Government should make an explicit connection between receipts from road fuel duty and the spending targeted to reducing the wider impact of motoring:

If the Government is serious about reducing CO_2 emissions from private motorists it will need to increase prices at the pump, where people most regularly experience the cost of motoring. Were the Treasury to do this, it would be important that some portion of the revenue was seen to be used for the benefit of the environment, to help make

[26] HC Deb 19 October 1999 cc 283-286
[27] HC Deb 8 March 1999 cc 144-145
[28] HC Deb 24 June 1999 c 1278
[29] EDM 116 of 2004-05, 23 November 2004 (31 signatures); EDM 1658 of 2005-06, 15 February 2006 (24 signatures)
[30] Conscience, 601 Holloway Road, London N19 4DJ www.conscienceonline.org.uk

> such increases politically more acceptable. We recommend that the Treasury looks again at linking an element of fuel duty revenues to increased funding for public transport and the development of alternative technologies, such as electric cars, in order to develop public support for more consistent use of fuel duty as an environmental tax.[31]

At the time the Labour Government simply stated that "hypothecating taxes to particular spending programmes can reduce flexibility in spending decisions and lead to a misallocation of resources, with reduced value for money for taxpayers. The Spending Review process ensures that resources are allocated efficiently to deliver Government priorities."[32] Nevertheless in a recent report on the current Government's approach to environmental taxation, the Committee argued that there remained a case for "greater use of at least *partial* hypothecation":

> Hypothecating revenues—earmarking them for a specific propose—would be likely to increase support for environmental taxes. Research by the Green Fiscal Commission found that while 51% of people supported environmental taxes, this rose to 73% if revenue raised by them were hypothecated for reducing emissions [Ev27]. The Campaign for Better Transport argued that Government should, in particular areas such as motoring, spend at least as much as it collected in taxes [Ev27] … We questioned the Economic Secretary on the current Government's view. She told us that she does not see a role for greater hypothecation, but wanted a "more thoughtful and genuine approach" that changes behaviours.[33]
>
> Andrew Leicester, from the Institute for Fiscal Studies, argued that tax and spend decisions should be driven by the overall effectiveness of taxation and expenditure programmes rather than by hypothecation, and that the only merit of hypothecation was in terms of "a kind of public acceptability role … of trying to ensure that people believe that environmental taxes are not just there to take a few extra pounds from their pocket but are designed for a specific purpose" [Q6]. An example was the Aggregates Levy Sustainability Fund which was funded by partial hypothecation (around 10%) of Aggregates Levy revenue and aimed to support projects that reduce the effects of aggregate extraction on local communities and the natural environment. The 2010 Spending Review announced that the scheme would be discontinued.
>
> **Hypothecating revenues for environmental ends can restrict spending flexibility. It can also help, however, to build trust and acceptance of environmental taxes. The Treasury should therefore consider greater use of at least *partial* hypothecation of revenues from environmental taxes, as applied for example to the Aggregates Levy.**[34]

As noted in this extract, Andrew Leicester at the IFS had been critical of the idea in evidence to the Committee, and following the publication of its report, Mr Leicester co-authored a piece which rehearsed many of the arguments against hypothecation, to suggest that "while winning public support is clearly an important consideration for policy makers, it should not be an excuse for poor policy making":

> One of the [Committee's] key recommendations was that in order to "... build trust and acceptance of environmental taxes", consideration should be given to "... greater use of at least partial hypothecation of revenues from environmental taxes [for environmental ends]." What does this mean, and is this a good idea?

[31] *Third report*, 16 March 2009 HC 202 2008-09 para 57

[32] *Fourth special report*, 8 June 2009 HC 563 2008-09 p10

[33] [In evidence to the Committee as part of its report on the Green Investment Bank, the Minister said, "I think it's probably wrong to say that we want to see more hypothecation, but what we do want to see is green taxes and an approach to environmental tax—and, indeed, the environment more generally—that works and that actually does change behaviour" (*Second report*, 11 March 2011 HC 505 2010-12 Q252 Ev65)].

[34] *Sixth report*, 7 July 2011 HC 878 2010-12 paras 25-26

'Hypothecation' means earmarking tax revenues for specific, identified purposes. 'Pure hypothecation' would see spending on a particular programme linked directly to the revenue raised by a particular tax or set of taxes: the licence fund used to finance the BBC is perhaps the best example of this. 'Incremental hypothecation' would see revenues raised from tax increases used to raise spending on a particular public service: net revenues from London's congestion charge, for example, are spent on public transport in London. A related concept is that of a 'tax switch', where revenues from new or increased taxes in one area are used to pay for cuts in other taxes. When the Climate Change Levy (CCL) was introduced in 2001, a 0.3 percentage point reduction in employer National Insurance Contributions (NICs) was also implemented with the idea that the overall package would on average be 'revenue neutral' for businesses.

But hypothecation has significant problems. In particular:

1. With pure hypothecation, it is highly unlikely that the optimal amount to spend on a particular programme will be the same as the optimal amount of money raised from a particular tax. The tax base may also be volatile, which would lead to inappropriately volatile spending, and (particularly for environmental taxes) may even erode away over the long term if behaviour changes. Governments should be seeking to raise revenue in the most efficient way possible and to spend that revenue in the most efficient way possible. It is highly unlikely these objectives will marry up neatly in a way that justifies pure hypothecation.

2. With incremental hypothecation, it is usually impossible to verify that the government's promises have actually led to any changes in the allocation of spending. Suppose, for example, the government took the advice of the Environmental Audit Committee to use higher fuel duties to raise spending on public transport. Without detailed plans for expenditures in the absence of the tax increase - which certainly do not exist beyond the current Spending Review period - it would be impossible to verify that this is actually how the extra receipts had been spent.

3. In the past some promises of hypothecation have turned out to be meaningless. Revenues from the Aggregates Levy, introduced in 2002, were earmarked for a 0.1 percentage point cut in employer NICs and a "Sustainability Fund" which paid for projects to reduce the local impacts of extracting aggregates. This fund, however, was abolished in the 2010 Spending Review without any commensurate cut in the Levy. Similarly the 'revenue neutral' cut in NICs following the CCL introduction has been anything but: the cost of lower NICs has significantly outweighed the receipts from the CCL. For example, in 2011-12 the CCL is forecast to raise £0.7 billion. However, increasing employer NICs by 0.3 percentage points would raise around £1.3 billion.

What about the benefits of hypothecating green taxes for environmental spending as a means to increase public support for green taxes? While winning public support is clearly an important consideration for policy makers, it should not be an excuse for poor policy making. It may well be true that there is a clear rationale both to raise green taxes and to spend more on environmental objectives. But if so the case for each should be made on its own merits rather than making one contingent on the other. It is hard to disagree with the Committee's conclusion that the Government needs to take "... a more coherent and clearly articulated approach to environmental taxes ... setting out their objectives and rationale, the basis on which rates are set and how their impact will be evaluated." Doing so could in itself help instil public support for green taxes, rather than relying on hypothecation which at best would be meaningless and therefore misleading, and at worst inefficient.[35]

[35] Arun Advani, Andrew Leicester and Peter Levelll, *IFS Observations: Hyping hypothecation: should green tax revenues be earmarked?*, 7 July 2011

5 Earmarking revenues: road fuels, tobacco duties, and NICs

Although it has always seemed quite unlikely that hypothecation would be a central principle to the UK tax system, there have been examples where Governments have been keen to ear mark the receipts from tax increases for certain types of spending. The then Chief Secretary to the Treasury, Des Browne, noted this in answer to a PQ in 2006:

> **Mrs. Riordan:** To ask the Chancellor of the Exchequer what his policy is on using tax revenue sourced from particular taxes for particular areas of Government spending.
>
> **Mr. Des Browne:** The primary aim of tax policy is to raise sufficient revenue for Government to pay for public services. In some cases, where the Government are raising revenue for a specific purpose, it is appropriate to reinforce the purpose of the tax measure by linking it to the spending which it finances.[36]

In its first Budget after the 1997 General Election the new Labour Government made a commitment to increase excise duties in real terms on tobacco and fuel by a minimum percentage each year - 5% and 6% respectively: the so-called 'duty escalator'. Two years later public concerns over pump prices lead the then Chancellor, Gordon Brown, to announced in November 1999, in his Pre-Budget statement, that in future duty levels would be set "on a Budget by Budget basis".[37] Mr Brown went on to say that any additional revenue raised from real increases in either tobacco duties, or petrol & diesel duties, would be allocated specifically to health care, or "a ring fenced fund for improving public transport and modernising the road network."[38] However, this had little impact on government spending in either of the areas, or on public perceptions about the tax system.

In the case of road fuel, duty rates were only increased in line with inflation in the March 2000 Budget, and, for ultra low sulphur fuels, *cut* in real terms in the March 2001 Budget. In later years the general pattern was for duties to be frozen or increased in line with inflation only, and the commitment to channel any 'extra' receipts to public transport does not appear to have been mentioned since then.[39] By contrast tobacco duties were increased by 5% in real terms in March 2000 – raising £235 million in 2000-01.[40] However, this tax rise was dwarfed by the Government's announcement in the 2000 Budget that NHS spending for the UK would rise from £49.3 billion in 1999-00 to £54.2 billion to 2000-01:[41] the proceeds from the real increase in tobacco duties would have represented just under 5% of this £4.9 billion increase. Indeed, total receipts from all tobacco products were 'just' £7.6 billion in 2000-01.[42]

In its 2000 Green Budget the Institute for Fiscal Studies was strongly critical of the Government's announcement; part of its analysis is reproduced below:

> In addition to the end of the road fuel and tobacco escalators, the Chancellor also announced in the Pre-Budget Report that any additional revenue from real increases in tobacco duties will in future be allocated, or hypothecated, to healthcare spending, while any additional revenue from real increases in road fuel duties will be allocated to

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[36] HC Deb 1 February 2006 c607W; see also, HC Deb 1 September 2003 c892W
[37] HC Deb 9 November 1999 cc 889-891
[38] *Pre-Budget Report* Cm 4479 November 1999 pp 94, 106
[39] For more detail see, *Taxation of road fuels*, Library standard note SN00824, 1 August 2011.
[40] HC 346 March 2000 p 151. Duties rose in line with inflation the next year (HC 279 March 2001 p 143).
[41] HC 346 March 2000 p 96
[42] HMRC, *Tobacco factsheet*, September 2006 table 1.1

spending on transport and roads. In order to be sure that the hypothecated revenue is really additional money, it is important to know what the level of spending would have been in the absence of hypothecation.

In the Comprehensive Spending Review (CSR), the government set out its spending plans for the period up to March 2002. In theory, any revenue allocated to transport and roads or healthcare will have to be over and above the amount specified in the CSR, making the hypothecated revenue easier to identify. There is, however, a contingency fund which sets aside additional funds to be used if necessary, over and above amounts set out in the spending plans. Currently, there is £3.9 billion set aside for 2000-01 and £6.4 billion for 2001-02 …

In the past, the NHS has often been allocated funds; for example, in November 1998, an extra £250 million was allocated to the NHS. Health and transport could in the future receive less from the contingency fund than they would have done in the absence of hypothecation, so there is no way of guaranteeing an increase in spending even in the short term. In the longer term, any new spending plans beyond March 2002 could take account of the potential hypothecated revenue, and so higher spending in these areas cannot be guaranteed in the future.

In practice, the amount of revenue that is raised from tobacco duty is small in comparison with total spending on health. Spending on health in 1998-99 was £45 billion, which contrasts with £360 million that would be raised in 2000-01 from a 5% real increase in duty on tobacco. This and the fact that tobacco revenue is also small compared with the size of the contingency fund make it even harder to monitor whether spending is higher than it would otherwise have been …

One argument made in support of hypothecation is that it makes people more willing to pay tax, so that more revenue would be collected if hypothecation were used more widely. But if the reason why people are more willing to pay tax is that they believe the government is required to spend a minimum amount in those areas as a result, the fact that this is difficult to guarantee even in the short term, and even harder in the longer term, should be made clear.

Even if the government could guarantee that allocating revenues in this way would lead to an increase in spending in these areas, it is still not clear that it is a good idea. Although there are some links between smoking behaviour and health spending, for example, the optimal levels of tobacco taxation and health spending are determined by a wide range of different factors. In addition, if spending in the absence of the hypothecation were fixed, and revenue from tobacco and road fuel duties were lower than expected, it is unlikely that people would be happy that spending on health and transport would be lower than expected as a result.

Equally, if revenue from tobacco and road fuel duties were higher than expected, people might prefer the extra funds to be spent oil areas other than health and transport, such as education for example. Also, the fact that the government is trying to reduce the consumption of tobacco and road fuel to meet health and environmental targets might imply lower revenue in future. Under genuine hypothecation, any reduction in consumption would lead to lower spending on health and transport, which does not seem sensible.

Hypothecation of tobacco and road fuel taxes cannot guarantee higher spending on health and transport, particularly in the long term. Since it is not clear that it is desirable to link taxation on tobacco to spending on health or taxation on road fuel to spending on transport, even if it were possible to guarantee higher spending, this new development in taxation policy is not very appealing.[43]

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[43] IFS, *The IFS Green Budget : Commentary 80*, January 2000 pp 109-110

A second case of earmarking the extra receipts from a tax increase occurred in 2002, when the then Chancellor Gordon Brown in his Budget that year announced that UK NHS spending should rise from £65.4 billion in 2002-03 to £105.6 billion in 2007-08. Several tax measures were introduced, by far the most important of which were increases in the rates of National Insurance contributions (NICs) from April 2003. In his Budget speech Mr Brown argued that using NICs in this way was preferable to a formal system of hypothecation as that "would make the public services subject to the ups and downs of the economic cycle and unpredictable changes in revenues. And it might achieve the opposite of what its supporters and the NHS needs: a sound long-term and sustainable stream of funding."[44]

At this time employees were charged NICs at a rate of 10% on earnings above the 'primary threshold' (which was then £89 a week), up to the upper earnings limit (which was then £585 a week). Employers were charged NICs on employee earnings at a rate of 11.8%, on earnings above the 'secondary threshold' (which was then also £89 a week). Self-employed persons are liable to pay NICs on their profits in a similar fashion to employees paying NICs on earnings: at the time they were charged NICs at a rate of 7% above the lower profits limit (set at £89 a week), up to an upper profits limit (set at £585 a week). A proportion of NICs charged on employees, employers and the self-employed is allocated to the NHS rather than going to the National Insurance Fund to pay for contributory benefits. This share is one fraction for the rate of NICs paid on earnings and profits: so, for example, for employees at this time 1.05% of earnings between the primary threshold and the upper earnings limit (UEL) was allocated in this way.[45]

From April 2003 the main rate of NICs for employees rose by 1 percentage point to 11% *and* a new 1% rate was charged on earnings above the UEL. For employers the rate of NICs rose by 1 percentage point to a rate of 12.8% on earnings above the secondary threshold. For the self-employed the main rate of NICs rose by 1 percentage point to a rate of 8% *and* a new 1% rate was introduced on earnings above the upper profits limit. It was estimated that taken together these changes would raise around £7.9 billion in 2003/04.[46] All of this extra money was directed to the health service by amending the rates of NICs set for the NHS allocation: so, for employees this was now set at 2.05% of earnings between the primary threshold and the UEL *and* 1% of earnings above the UEL.

It is hard to say whether the decision to increase NICs in this way has had any impact on the 'transparency' of NHS funding or public spending as a whole. It is notable that several years later the Labour Government announced a second increase in NICs, when in his March 2010 Budget the then Chancellor Alistair Darling confirmed that NI rates would rise by 1% from April 2011.[47] At the time many commentators argued that the choice to use this tax, rather than income tax or VAT, was dictated by the fact that relatively few ordinary people understood NICs to be a tax, and that far from illuminating the very difficult decisions posed

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44 HC Deb 17 April 2002 c589

45 It is projected that in 2010/11, NICs will raise just over £98 billion, of which £77.6 billion will go into the NI Fund and £20.6 billion will go to the NHS (Government Actuary's Department, *Report … on the draft of the social security benefits up-rating Order 2011...*, February 2011 pp25-6). For more details on the way NICs works see, *National Insurance contributions*, Library standard note SN04517, 29 July 2011.

46 *Budget 2002*, HC 592 April 2002 p121, pp154-5. Further detail on this reform is given in, *The National Insurance Contributions Bill* Library Research paper 02/32, 8 May 2002.

47 Mr Darling did not propose any change to the NHS allocation, and the current Government has taken the view that the additional funds raised by this tax increase should be directed to the Fund. The issue was debated at the report stage of the *National Insurance Contributions Bill* which implemented the rise in NIC rates (HC Deb 13 January 2011 c475).

by the economic downtown, this had disguised or concealed the significant amounts of extra money that the Exchequer needed to raise.[48]

From this perspective the prospects for a significant improvement in 'the day to day standard of communication on tax between government and governed' are little better than they were when drivers paid VED into the Road Fund almost a century ago.

48 For more details see, Library Research paper 10/76, 17 November 2010 (in particular pp 8-10).