

# Reconsidering the FHTF

BY ALAN E. PISARSKI

**A**S THE NEW FEDERAL TRANSPORTATION bill winds its way through Congress, many libertarians and free-market advocates are urging policymakers to de-emphasize the Federal Highway Trust Fund (FHTF) and federal involvement in highway transportation. Instead, they want increased state funding and management as well as more private involvement in financing and operating roadways. For instance, in the pages of *Regulation* a year ago, Gabriel Roth argued for abolishment of the FHTF, elimination of the taxes dedicated to it, and restoration of highway financing powers to the state (“Road Policy for the Future,” Spring 2003.)

I have great respect for Roth, and the article is erudite and eminently readable as is customary for his work. But, concerning his thesis, I am reminded of the old Hungarian proverb: “That’s so wrong that even the opposite isn’t true!” Not only are all three of his demands questionable, all three are wrong. It is the FHTF and the concept of dedicating revenues from fuel taxes to roads that protects us from a federal fuel taxation system that would almost certainly become onerous and dangerous. Further, there is nothing now or in the past that suggests that the feds can grant or withhold highway financing power to the states. Finally, does anyone know a way to have Congress renounce a tax as a source of revenue and make it permanent, assuring that future Congresses will not reinstate it when needs are great, or deemed great? It seems that, as the federal transportation bill moves along, now is a good time to remind libertarians and other free-marketers of those points.

**SHRINKING ROLE** The federal dollars that Roth discusses are not the centerpiece of American transportation; they are only about 25 percent of the action in public highway investments, even less if we add in sizeable private spending. Most of the federal dollars are focused on capital spending and have been close to 60 percent of total capital at times in the past — but that was 20 years ago. At present, the federal share of highway capital is around 39 percent, and declining. Nothing in the present reauthorization process holds out expectations of that share changing. Even with major increases in federal funding from expanded trust fund revenues over the last 10 years, the federal share of capital spending on roads has declined as states and local governments increased their own spending to meet expanding needs.

The federal government does not have to “restore” any authority to the states for them to size their programs as they

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see fit. It is easy sitting around Washington, D.C. and watching the congressional show to conclude that this is the center of the beehive. But in fact, most of the small incremental changes made with each reauthorization have further reduced federal control. Recognize that the 18.4¢ federal gasoline tax today is less in real terms than the 3¢ enacted in 1956.

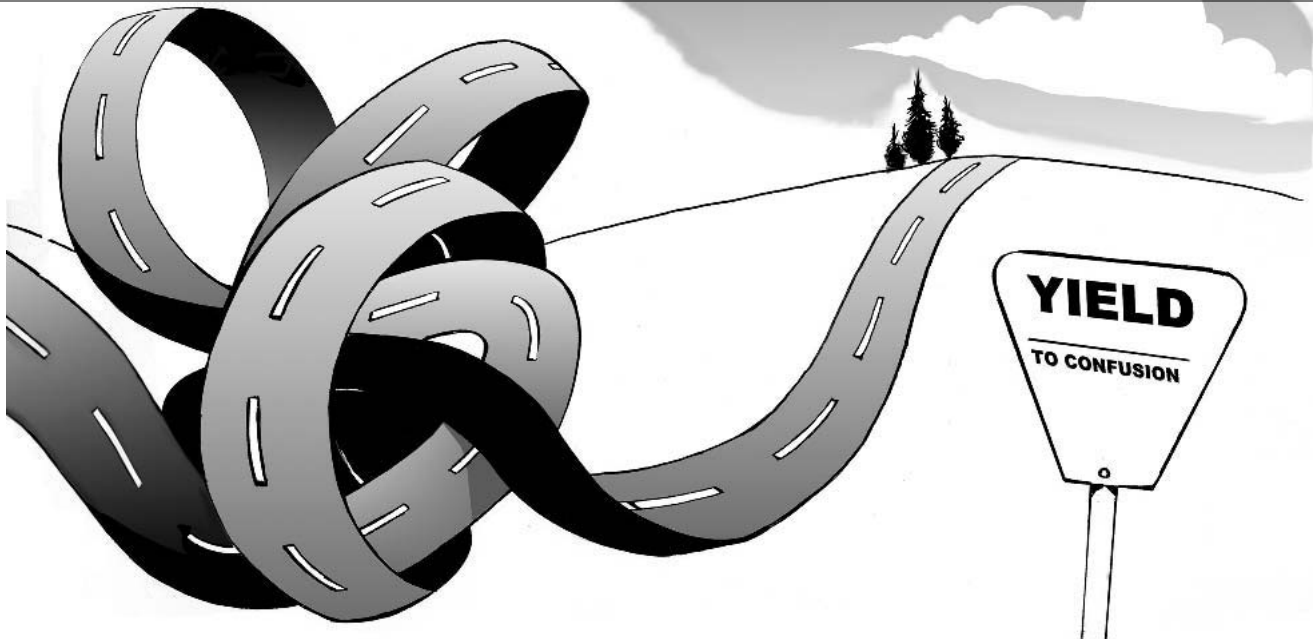
The nation’s highway system really is a state program that is federally aided, not a federal program. Like any pile of federal money, it does tend to slide toward a centralized “jump through the hoops to get your money back” arrangement, which we know is close to inevitable. But the states keep reminding people of the FHTF’s original intent and guard zealously their freedom of action. They do see those trust funds as their money that is “returned,” not federal largesse that is “granted.”

In some sense, you could say that the federal funds pay for the costs of federal requirements in such areas as the environment and safety. The notion that, if the states ran the entire show, the mandates would go away is ingenuous — they would simply be unfunded mandates.

**CROSS-SUBSIDIES** The FHTF program has been understandably criticized for redistributing gas tax money from some states to others. I agree that when poorer states start sending money to richer states, it looks a little weird and we need to assure that less and less of that happens. But at the same time, there is a case to be made for some cross-subsidy among states. National policy and transportation needs should pursue some funding of local programs in specific areas in order to meet truly national needs.

The defense aspect of the interstate highway program is certainly one example, though some people have criticized that aspect as either obsolete or an outright ruse to enable federal involvement. But in fact, Eisenhower had a real focus on the need for road-based logistical support for military needs when he proposed the program. The bridge heights and underpasses were designed to handle tank carriers and other military transport vehicles. We have a very real, very effective National Defense Highway System that consists of the interstates plus military access roads and some other pieces of the national highway system.

There is a further case to be made for some level of cross-subsidy, particularly from metropolitan areas to rural areas. Metropolitan areas should subsidize rural roads to support the need to traverse long distances across unpopulated regions as part of inter-metropolitan commerce. We are a very large country of low average density. We have no choice but to care greatly about transportation and cannot allow ourselves to forget that. Overcoming the tyranny of distance is a major enabler of our economic and social future.



**THE TRANSPORTATION BILL** With all of that said, there is room for reform and improvement in federal transportation funding. A new system of “revenue alignment” should be extended that assures that all user-fee dollars paid into the FHTF are, in short order, spent on transportation projects instead of being held in Washington, D.C. to cloak deficits, which clearly was a temptation in the past and may become so again. In theory, the current system supposedly forces the federal government to pay interest into the FHTF when that occurs, but the system needs to be restructured and strengthened so as to discourage that behavior.

Even with the need for reform, I believe the FHTF is an efficient way to cover national transportation needs, and that dissolving the system would leave motorists open to considerable government mischief. One cent of federal gas tax generates about \$1.8 billion a year; that kind of money attracts sharks. The great attack on personal transportation by European governments is the severing of the connection between road taxes and road funding. As Roth aptly pointed out, the dedicated road fee sets the upper limit on what taxes it is rational for government to impose. I made this point 20 years ago in a study for the American Association of State Highway and Transportation Officials on foreign taxation systems. European nations consciously set out to break through that constraint. With that connection severed, European taxes can be — and are — three, four, and even five times road spending levels. This imposes an extreme tax on road use that has the power to destroy it. Think how convenient it is for government to tax auto travel heavily when government happens to own the competition — transit and railroads. Hence, not only can government strangle the competition to its very expensive stepchildren, but political leaders can raise a lot of money as well, and look environmental while doing it. European governments have seen the fuel tax for the cash cow it is, and thus use it as a substitute for deficient income tax systems on their own citizens and a way to zing tourists and truckers just passing through. I cannot conceive of a government policy more inimical to libertarian thinking than one that severely taxes free movement in order to protect a gov-

ernment-owned and subsidized entity.

If thoughtful think-tankers really want to make some progress in this area, they need to discover and promote ways to protect the road user from the threat of a government free to tax fuel use for whatever convenient purposes it chooses. The federal system is a superb system of tax collection — states should have the option of having the feds be the collection agent, for a fee. (Maybe those nasty congressionally earmarked demo projects are that fee.) A future world of states charging economically based road fees to cover the cost of roads and a federal government using road fees to do “good things” is not a better world than the one we have today. One in which road pricing and toll roads are employed is not a better world as long as federal or state governments have the power to destroy through fuel taxation. Nor can we assume that tolls and other pricing mechanisms will not be as subject to manipulation and diversion. Let us think of ways to wean the federal program down to an appropriate share of activity — perhaps 5¢ or 10¢ — and let the states pick up the remaining burden, so as to assure an appropriate balance between the state and federal programs.

**CONCLUSION** Like Roth, I have my own very real concerns about the program. We really need a strong public discussion regarding the appropriate federal and state roles in transportation. Recent legislation has tended to make everything in transportation federal; there is nothing local anymore. Bicycle paths and sidewalks are now federally funded activities. We have expanding “constituencies” for the funds. (Government is always pleasantly surprised by how many people are willing to take taxpayers’ money.) We need to restore the focus on national needs of the federal system using the great strength of the federal taxation process, not try to junk the system because it is sometimes used inappropriately.

The connection between road taxation and road funding based on use at the state and federal levels is our greatest protection against abuse of the power to tax. If we care at all about freedom of mobility, preserving it has to be the starting point for our thinking. **R**

# Do the Mutuals Need More Law?

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**I**N 2002, ELIOTT SPITZER put a scare into investors who pick their own stocks by questioning the reliability of securities analysts. He recently followed that performance with an encore frightening of the millions of Americans who trust their investments to mutual funds.

The New York attorney general decried mutual funds trading that occurs around or after the funds' 4 p.m. closing time by traders with information that makes the closing price "stale." In fairness, some of that trading is illegal "late trading," while a lot of it is late-day "market timing" that may violate some funds' policies against excessive trading. Both practices effectively give the traders who engage in them a price break. Some fund managers also arguably breached their fiduciary duties by engaging in trading themselves or by granting favors to big traders who promised to buy the managers' other funds if the managers allowed the big traders to skirt the 4 p.m. deadline. One analyst estimated that market timing costs passive fund investors at least \$5 billion a year, and late trading another \$400 million.

Taking Spitzer's cue, Congress is considering rules such as requiring increased disclosure of fees and commissions and more independent fund directors. The Securities and Exchange Commission is also proposing to require more independent fund directors, as well as regulation dealing with market timing and late trading.

Let us assume that those practices are wrong and should stop. Does it then follow that we need, or want, more law? We already have laws to deal with those problems: Late trading is illegal, and injured shareholders can bring state law derivative suits without help from new federal law or politically ambitious attorneys general. What is more, the cost of demonstrating compliance with the new laws could cost investors more than the alleged abuses. The high estimates of the cost of late trading and market timing — \$5.4 billion — are less than one-tenth of one percent of the \$7 trillion now invested in mutual funds.

The right regulatory response is elusive. It seems obvious that funds should have to more clearly disclose their trading



KEVIN TUMA

policies, as the SEC is proposing. Informed investors can decide whether to invest in funds that permit market timing or buy funds that make market timing difficult, such as funds with stricter trading policies, exchange-traded funds whose prices are constantly updated, or low-fee index funds whose managers lack incentives to make deals with big investors. Or investors could just hire their own professional portfolio managers.

**COST OF REGULATION** But even without more regulation, funds already have a big incentive to come clean. And mandatory disclosure is not free; investors would be overwhelmed by even more information and the overburdened SEC would have to spend still more time nitpicking prospectuses rather than catching bad guys.

Beyond stricter disclosure rules, potential policy solutions get murkier. For example, the SEC or Congress might restrict traders' ability to exploit gaps between price and value by mandating higher redemption fees. But while higher fees might reduce market timing, they could also trap investors in poorly managed funds. That is why the SEC has been skeptical of higher fees, though it is considering requiring a two percent redemption fee in some situations. And rigid trading limits ignore significant differences among funds.

Funds might be required to update their prices continuously to current net asset value. That would limit traders' ability to

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arbitrage stale fund prices. But updating is no panacea. Somebody must appraise infrequently traded stocks, and that often involves guesswork. A lot of the problems at Enron involved marking assets to market. Because funds fear litigation over inaccurate pricing, they might like the comfort of an industry pricing standard. But hard-and-fast standards might also produce inaccurate prices that sophisticated traders will exploit.

Regulators seem to like the idea of requiring mutual fund directors to be independent of the manager and the fund company. But independent directors lack the information and expertise necessary to prevent the next scandal. Indeed, there is ample evidence that more board independence does not mean better management in corporations generally, and some of the funds involved in the recent scandal had independent directors.

Regulators could insist on tying management fees to performance rather than the size of a fund's assets. That would reduce fund managers' incentives to make deals that attract large investors while hurting small ones. Current fees owe a lot to Section 205 of the Investment Advisors Act, which restricts compensation based on fund returns. Ironically, wealthy investors are allowed to buy into private investment pools, or hedge funds, that are not subject to that restriction. In any event, performance-based fees are no panacea. Laws seeking better-designed compensation encouraged corporations to overuse stock options. That, in turn, led to claims that managers were over-compensated or that they managed for the short term.

Optimism about regulation is further tempered by regu-

lators' inherent shortcomings. No single regulation can adequately reflect differences among funds, such as those between international and domestic funds. Nor are regulators necessarily disposed to do the right thing. Regulators are not necessarily seeking the optimal long-term solution. They may just be tempted by some quick fix that gets the public off their backs. Most importantly, regulation has unknowable costs. It institutionalizes practices that deal with yesterday's problems, not tomorrow's. That can inhibit the competitively driven innovations that have done a marvelous job of adapting to new markets and technologies.

The real problem is not a lack of law, but an oversupply of alarmism and political grandstanding. Do we really want people to pull out of mutual funds and pick their own stocks? Or would we rather have investors get out of the stock market altogether and instead put their money in precious metals or hide it under their mattresses? Of course, that trend would only last until some alarm is sounded about gold purity or mattress safety. Worst of all, more laws lull investors into falsely assuming that the government has all potential problems in hand.

Mutual funds have won trillions of dollars in investments from consumers who chose funds over competing banks, insurers, and other financial service providers. Any problems came despite, or perhaps because of, 60 years of pervasive federal regulation. The first question we ought to ask, then, is do we really need more mutual fund laws—or just better enforcement of the ones we already have? **R**

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