

**POLICY BRIEF**  
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## Earmarking State Tax Revenues

Earmarking is a budgeting practice that dedicates tax or other revenues to a specific program or purpose. This policy brief <sup>1</sup> explains earmarking and discusses some of its advantages and disadvantages. It discusses the rationale for earmarking user fees and benefit taxes, as contrasted with general taxes.

This policy brief does not discuss the practice of combining earmarks with automatic spending authority (that is, an open appropriation of an earmarked revenue source). Ongoing or automatic spending provisions raise separate, but similar, budget process and policy issues.

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### Contents

<a href="#">Executive Summary</a> .....	2
<a href="#">An Explanation of Earmarking</a> .....	2
<a href="#">Advantages of Earmarking</a> .....	3
<a href="#">Disadvantages of Earmarking</a> .....	5
<a href="#">Earmarking User Fees and Benefit Taxes</a> .....	7
<a href="#">Impact or Effects on Budget Decisions</a> .....	9

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<sup>1</sup> The discussion in this policy brief relies heavily on materials prepared by the National Conference of State Legislatures (Arturo Perez and Ronald Snell, *Earmarking State Taxes* (NCSL, 1995)), the Office of the Legislative Auditor (*State Park Management* (January 26, 2000): 92-94), the 1985-86 Minnesota Tax Study Commission (*Earmarking State Revenues*, a discussion paper prepared for the commission (August 8, 1984)), and Richard E. Wagner, ed., *Charging for Government: User Charges and Earmarked Taxes in Principle and Practice*, 2011 ed. (New York: Routledge).

## Executive Summary

Earmarking dedicates tax or other revenues to a specific program or purpose. This can be done by statute or in the constitution, as with the 2008 Legacy constitutional amendment, which increased the state sales tax and dedicated the revenues to natural resources, clean water, and cultural heritage.

**Advantages.** Supporters of programs advance earmarking as a way to guarantee a steady and reliable funding source for the favored programs. Constitutional earmarks provide a legal guarantee that constrains the legislature's ability to reduce funding for the benefited program below the earmarked amount. While statutory earmarks can be avoided by legislative action (the statute can be changed or the earmark waived by the legislation), they create a presumption of a minimum funding level. Earmarks are also often seen as a way to build political support for funding increases. Earmarks can provide voters with a clearer tie between taxing and spending decisions by the legislature.

**Disadvantages.** Critics contend that earmarks, particularly constitutional earmarks, reduce the legislature's budgetary flexibility; they may hinder its ability to construct an overall budget based on its funding priorities, including assessment of changes in circumstances that have occurred since the earmark was adopted. If the legislature perceives an earmark as contrary to its priorities, it may reduce other funding for the program or modify the revenue source, subverting the original goal of the earmark. Earmarks may also have indirect effects on tax and revenue policy and can increase administrative and compliance costs.

**Earmarking Benefit Taxes or User Fees.** There is a general consensus that earmarking benefit taxes or user fees for related expenditures is an appropriate budgeting practice (e.g., earmarking a special tax on highway fuels for construction and maintenance of highways). However, there may be disagreement about what constitutes a benefit tax.

**Impacts on Spending Levels.** The impact of earmarks on spending levels—either for programs benefiting from earmarks or on overall spending levels—is ambiguous. Reasonable arguments can be made that earmarks lead to increased spending on benefited programs, but it is also possible that they lead to lower spending in some cases. Similar contradictory arguments can be made regarding overall spending levels. Empirical studies have been unable to find a clear effect.

## An Explanation of Earmarking

Earmarking is the budgeting practice of dedicating tax or other revenues to a specific program or purpose. This practice typically involves depositing tax or other revenues into a special account from which the legislature appropriates money for the designated purpose. Earmarking can be done either in the constitution or by statute. Recent examples of **constitutional earmarks** include the dedications of a portion of lottery proceeds to the environmental trust fund (adopted in 1990 and extended in 1998) and the motor vehicle sales tax revenues to transportation funding (2006), and the increase in the sales tax rate with the revenues earmarked for natural resources,

arts, and cultural heritage (2008). **Statutory earmarks** are provided by statute or legislation and can be changed or modified by the legislature. The Minnesota Legislature earmarked the revenues of both the income and sales taxes when those taxes were first enacted; the income tax to the “Income Tax School Fund” in 1933<sup>2</sup> and the sales tax to the “Property Tax Relief Fund” in 1967.<sup>3</sup> During the 2015 legislative session the initial budget passed by the House of Representatives provided for earmarking some sales tax revenues (e.g., from purchases of motor vehicle repair parts and tires) for highway purposes.

Earmarks can also be divided into full and partial earmarks. Under a **full earmark**, the earmarked revenue source is the only source of revenue for the program, while a **partial earmark** permits the legislature to supplement the earmarked revenues with other moneys. In Minnesota, all earmarks are partial earmarks as a legal matter. However, in practice, the Minnesota Legislature may treat some earmarks as full earmarks and not consider supplementing them with other revenues, despite its legal authority to do so.

Use of **special purpose units of government**—such as school districts, watershed districts, and similar—can be considered a form of earmarking, as well. Because all of the revenues of these special purpose governmental units are, by definition, used for the special purpose, their funding is essentially an earmark. Funding activities through a special purposes government assures voters that all of the unit’s revenues go to the dedicated or special purposes. That should be contrasted with paying for these operations out of the funds of a general purpose unit of government (e.g., a city or county at the local level, where most of these special purpose units operate in Minnesota).

## Advantages of Earmarking

Some advantages of earmarking are that it provides a reliable and predictable source of funding, it can build support for funding increases, and it can constrain overall public spending and taxing.

### Funding Guarantees: Reliability and Predictability of Funding

A principal advantage of earmarking or dedicating revenue is to provide a guaranteed and reliable stream of revenue for a program to spend. Most of the advantages are elements or features of this core principle. Some of these include the following:

- **Guarantee of funding.** Earmarks are intended to insulate or remove a spending program from competing with other budget priorities for revenues. Because the program has a

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<sup>2</sup> [Laws 1933, ch. 405](#), § 57, codified as [Minn. Stat. § 290.62](#) (1934). The Income Tax School Fund continued until its repeal in 1967. [Laws 1967, 1<sup>st</sup> spec. sess., ch. 48](#), § 91.

<sup>3</sup> [Laws 1967, 1<sup>st</sup> spec. sess., ch. 32](#), art. 13, § 44, codified as [Minn. Stat. § 297A.44](#) (1968). The legislation earmarked additional tax revenues to this dedicated fund. *See, e.g.,* [Laws 1967, 1<sup>st</sup> spec. sess., ch. 32](#), art 9, § 1 (earmarking deed tax revenues).

prior legal claim on the revenues, earmarking should increase the likelihood that it will receive these revenues and can spend them.

- **Predictability and budget planning.** Earmarks implicitly promise funding of at least the level of the earmark. This should allow for longer range planning and budgeting (such as for capital improvements) and may make it easier to deliver the services (for example, to attract and retain good employees for the program, enter long-term supply contracts on favorable terms, and so forth).
- **Depoliticize funding decisions.** Earmarks—especially ones required by the constitution—may remove funding decisions from the rough and tumble of the political arena. This could affect the overall level of funding; the earmark is presumed to have decided the appropriate level. An earmark may provide political cover for making some unpopular funding decisions or prevent the diversion of money to more politically popular alternatives (inoculating the benefited program against the argument “Shouldn’t this money be spent on motherhood and apple pie instead?”).

## Garner Political Support for Funding Increases

Earmarks can be used to build political support for a funding or tax increase.<sup>4</sup> This is a time-honored technique in Minnesota, where dedications have been used to deflect opposition to or gather support for individual income and general sales tax increases, as well as for increases in more minor taxes (such as increasing the cigarette tax and imposing the sales tax on athletic and health club dues). The recent passage of the Legacy constitutional amendment, which increased the state sales tax rate and dedicated the revenues to natural resources, the arts, and cultural heritage, is the latest example of this. This amendment passed in a decade when very few other revenue increases were adopted; it was the largest single increase in tax revenue enacted into law during the first decade of this century, a fact which may be fairly attributable to its earmarking of the revenue to programs that are popular with the voters.

## Constrain Overall Public Spending and Taxing

Some have suggested that dedicating or earmarking revenues for programs with the greatest support among the voters could constrain overall government expenditures.<sup>5</sup> This is based on a theory that support for overall spending levels will decline if acceptable levels of spending are guaranteed for the most popular public programs. Voters may not support increases in general revenues if they perceive that the increases will not benefit the programs that they favor most

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<sup>4</sup> Susannah Camic Tahk, a University of Wisconsin law professor, in a series of articles relies on public choice principles or variants on them to conclude that earmarking can build political support for either revenue generation or the corollary of protecting or reforming the tax base. *See, e.g.,* Susannah Camic Tahk, “Making Impossible Tax Reform Possible,” *Fordham Law Review* 81 (2013): 2683 – 2728; Susannah Camic Tahk, “Public Choice Theory & Earmarked Taxes,” *Tax Law Review* (forthcoming 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2311372](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2311372).

<sup>5</sup> This argument is generally attributed to “public choice” economists. *See, e.g.,* James M. Buchanan, “The Economics of Earmarked Taxes,” *Journal of Political Economy* 71 (1963): 457-469.

(those benefiting from earmarks). Depending upon one's view of the tendency of governments to over or under-provide public goods or to use revenues to inappropriately provide private goods or transfers, this effect may be categorized as a disadvantage.

## **Link Specific Tax and Spending Decisions**

Earmarking can be used to provide a direct link between both elements of the fiscal equation: taxing and spending. Some may view this as providing an advantage of fiscal transparency to citizens and voters. This may be particularly true if spending for a specific purpose either constitutionally or by a well-established practice is tied directly to a specific revenue source: the price of increased spending is a tax increase; conversely, the price of a tax reduction is a reduction in that spending. Accountability and transparency may be increased by making the tax price of the spending very clear to the public. This general point can be viewed as a corollary of the advantage of building political support for revenue raising (or conversely constraining spending, which is not supported by the electorate). Any advantage would not be realized by ad hoc earmarks that change as the politics or perceived advantages of a particular earmark change. It is probably best realized by a constitutional earmark.

## **Disadvantages of Earmarking**

Disadvantages of earmarking include budgetary inflexibility, issues of manipulation and compliance, substitution of revenues, implications on tax policy, and higher tax administration and compliance costs.

### **Budgetary Inflexibility**

The core disadvantage of earmarking is the inflexibility or rigidity that it introduces into the state budget process. Earmarking blocks or makes it more difficult for the governor and the legislature to determine which of competing spending priorities provide the most public benefits for the budget dollar spent. Assessing all competing priorities is generally considered to be the hallmark of good budgeting practice. Elements of this budgetary rigidity or inflexibility caused by earmarking include the following:

- **Decisions on overall funding levels.** Earmarked revenues, not program needs or benefits relative to the competing priorities, may determine overall funding levels for the programs. The legislature may simply adopt (or “default to”) the earmarked level of spending. If the constitution earmarks the revenues, the legislature cannot spend less than the earmarked revenue, even if it believes less should be spent. It could choose to spend more, but may not seriously consider that possibility because of the earmark. With a purely statutory earmark, the legislature could enact an appropriation “notwithstanding” the earmark. But it still may simply take the earmark as the appropriate level of spending and fail to examine or compare it with competing priorities. A typical assumption is that earmarking revenues leads to “overspending” (as compared with a comprehensive budget that encompasses all revenues). That is why proponents of programs lobby heavily for

earmarks. However, it is also theoretically possible that earmarks, in some instances, result in lower overall spending for the benefiting program.<sup>6</sup>

- **Less review.** Programs benefiting from earmarks may receive less scrutiny of their relative merits than the portions of the budget that are subject to comprehensive budget review.
- **Weaken legislative power.** Constitutional earmarks explicitly take power away from the governor and the legislature to develop a comprehensive budget, since they prevent allocation of resources below the mandated level. Although statutory earmarks can be overridden by changes in the law, they create a presumption of the appropriate level of funding during the budgeting process.
- **Subject to revenue fluctuations.** Depending upon the earmarked revenue source, funding for the program may fluctuate, perhaps significantly. These fluctuations may or may not reflect changes in service needs. Some revenue sources (for example, the tobacco tax) may be in steady decline, while others (for example, MinnesotaCare taxes) may grow faster than the overall economy.
- **Changing circumstances.** Earmarks, particularly if they are enshrined in the constitution, make it more difficult for the governor and legislature to respond to changes in needs and the demands for public services. This is particularly true of dedications or earmarks for more narrowly defined categories of services.

## Manipulation and Compliance Issues

The legislature may seek to avoid or minimize the effects of constitutional earmarks if it perceives they are out of step with needs or political demands. For example, the legislature could do this by redefining tax bases, substituting new taxes, or making other changes in the tax law. As an example, the legislature in 1989 imposed an “in lieu” sales tax on lottery games, in effect, diverting a share of the lottery proceeds to the general fund from the environment and natural resources trust fund.<sup>7</sup> The legislature may also attempt to expand the definition of activities that qualify for use of earmarked funds. Passage of the Legacy constitutional amendment in 2008 has led to debates in the legislature over what types of activities may be funded by the amendment’s earmarks, particularly those for cultural heritage, a budget category with little prior legal definition of its content. Any of these types of legislative actions could lead to litigation over their legality.

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<sup>6</sup> See the discussion on page 3 of how earmarking may constrain overall public spending and taxing.

<sup>7</sup> [Laws 1990, ch. 610](#), art. 1, § 54; [Laws 1989, 1<sup>st</sup> spec. sess., ch. 1](#), art. 12, § 10. This was done in anticipation of the vote in the 1990 general election on the constitutional dedication of a portion of lottery proceeds to environmental purposes. (The voters enacted the constitutional amendment.) Later legislatures reversed this decision and redirected these moneys to environmental and natural resource-related purposes. See [Minn. Stat. § 297A.94\(e\)](#).

## **Substitution of Revenues**

Earmarking may not increase funding levels, if that is their supporters' goal. The legislature may allow the earmarked revenues simply to substitute for revenues it otherwise would have appropriated. Attempts to prevent substitution for existing programs moneys may be difficult to enforce, particularly at the margins. In 2008 voters ratified the Legacy constitutional amendment, which increased the sales tax rate and dedicated the resulting revenues for natural resources, arts, and cultural heritage. In implementing the amendment, the legislature has debated whether reduced legislative authorization of spending from other sources (e.g., the general fund) for the purposes covered by the amendment's earmark are, in effect, using earmarked moneys to supplant (or reduce) funding from those sources (typically the general fund). The amendment explicitly prohibits using earmarked revenues to substitute for spending from other sources, but applying and enforcing this restriction is difficult and is subject to legislative manipulation and avoidance.

## **Tax Policy Implications**

Earmarking may create supporters or opponents of tax policy changes, depending upon the effects on revenues for the affected programs. This may make it more difficult (or easier) to "reform" a tax by expanding or contracting the tax base and/or changing the rates.

## **Increased Tax Administration and Compliance Costs**

Earmarks require separately tracking and accounting for revenues and expenditures. This naturally increases state government's accounting and financial reporting costs. If revenues derived from a portion of the tax base are earmarked—such as the sales tax on one type or class of commodity—tax compliance costs for private taxpayers can increase as well, as they must separately track and report these revenues to the state.

## **Earmarking User Fees and Benefit Taxes**

### **Earmarking User Fees and Benefit Taxes Easier to Justify**

The preceding discussion of advantages and disadvantages is directed at dedication of general taxes, such as dedicating a portion of the general sales tax to pay for arts, education, or the environment. The discussion does not apply to earmarking or dedication of user fees or of limited or special taxes to pay for related or complementary services (such as benefit taxes). Examples of such dedications or earmarks include the dedication of state park fees to paying for state parks or the dedication of hunting and fishing license fees to pay for services related to hunting and fishing. Dedication of the gas tax and the motor vehicle registration tax to pay for highway fuels is an example of a benefits tax earmark.

Dedication of user fees or benefit taxes can be justified as more comparable to a market type transaction. The fee a state park user pays is more nearly comparable to a charge to use a private campground or hotel. Dedicating these charges to pay for the costs of acquiring, maintaining, and operating the state park is not troubling. Users are simply paying for a quasi-private good that may also be subsidized by other public revenues.

With regard to benefit taxes, such as the highway motor fuels tax, the *Encyclopedia of Taxation & Tax Policy* describes the rationale for earmarking them as follows:

Earmarking finds its strongest equity rationale in the benefits connection, where it extends the quid-pro-quo concept (the accepted basis for private market transactions) into the tax-financed sector. Dedication of highway user tax revenues for highway purposes represents the benefit principle at its best (notwithstanding the tenuous relationship between taxes paid and benefits received by different categories of highway users). The equity rationale for earmarking general taxes finds its limit in the fact that there are very few services or facilities for which there is an “earmarkable” tax.<sup>8</sup>

However, this rationale does not apply to dedication of general tax revenues. For example, as a matter of principle, the base for the general sales tax is broad-based consumption. The tax applies to most purchases of goods and many services for personal use or consumption. The portion of the sales tax paid on a particular type of consumption (e.g., auto parts and motor vehicles) is not a user fee or benefit tax on that type of consumption, justifying dedication of the revenues to pay for related government services (e.g., highways). Rather, these tax revenues are simply part of the revenues derived from a broad-based tax. Dedication of such tax revenues is subject to the considerations discussed above under advantages and disadvantages of earmarking of general taxes.

## **Caveat on Minnesota’s Highway Fuels Tax as a Benefit Tax**

The discussion of earmarking benefit taxes and the conventional wisdom that dedicating highway user taxes is an earmark of a benefit tax might lead one to conclude that this rationale justifies Minnesota’s earmarking of its highway fuels taxes. However, an important caveat must be kept in mind. Minnesota law subjects highway fuels to special excise tax (the “gas tax”).<sup>9</sup> Fuel that is subject to the excise tax qualifies for an exemption from the sales tax.<sup>10</sup> Thus, to a certain extent, the liability for the gas tax is offset by not paying the sales tax. Since the sales tax is a broad-based tax, which is deposited in the general fund, it is reasonable to characterize earmarking of Minnesota gas tax receipts as a partial earmark of a general tax, rather than of a

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<sup>8</sup> *The Encyclopedia of Taxation & Tax Policy*, ed. Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, 2<sup>nd</sup> ed. (Washington, D.C.: Urban Institute, 2005), 90.

<sup>9</sup> There are separate taxes on gasoline and “special fuels,” but the taxes are commonly referred to as the gas tax. [Minn. Stat. §§ 296A.07](#) (gasoline); [296A.08](#) (special fuels).

<sup>10</sup> [Minn. Stat. § 297A.68](#), subd. 19(1). Fuel purchases that are not for highway use—e.g., a construction contractor that purchases motor fuels to operate off-road construction equipment—do not qualify for this exemption and are subject to the general sales tax.



benefits tax. Absent the gas tax, purchases of highway fuels would generate sales tax liability and general fund revenues. The amounts involved are substantial. The Department of Revenue estimated that the exemption reduced sales tax revenues for fiscal year 2015 by \$747 million.<sup>11</sup> This amount equals a little less than 85 percent of the collections from the excise taxes.<sup>12</sup> In short, most of the dedicated tax is really a transfer of money that would go to the state general fund, if the sales tax applied and the excise tax were reduced by an equivalent amount. This same caveat does not apply to dedication of the motor vehicle registration tax for highway purposes, since that tax is a special or additional personal property tax. It is neither in lieu of nor does it confer an exemption from a general fund tax, since personal property is generally exempt from property taxation for general government purposes.<sup>13</sup>

## Impact or Effects on Budget Decisions

As suggested above, one would naturally expect earmarking to lead to higher spending levels for the affected programs. Anecdotes support that view, as well as the common sense view that the proponents of individual earmarks support them for precisely that reason. In theory, though, earmarked revenues may primarily substitute for other revenues, and earmarks could actually hold down revenues for the favored programs in some situations.

Thus, whether earmarks actually increase revenues and spending for the favored program is an empirical question. However, few empirical studies have been done on the effects of earmarking and the results are conflicting. Economics Professors Dye and McGuire did a sophisticated study in the early 1990s.<sup>14</sup> Their study analyzed the effect of state earmarks for three broad categories of spending—education, highways, and state aid to nonschool local governments—using two years of data from 1984 and 1988 compiled by NCSL. Controlling for a variety of economic, demographic, and other factors likely to affect spending levels, they found that the effects of state earmarks on spending levels were ambiguous. One specification found a small effect for highways and a larger effect for aid to local governments (but less than the amount of the earmark), but other specifications found no effects. None of the specifications found an effect on education spending. They characterized their results as finding “either no change in expenditures or in increases in expenditures that are much smaller than a dollar.”<sup>15</sup>

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<sup>11</sup> Tax Expenditure Budget, Fiscal Years 2014-2017 (February 2014): 105.

<sup>12</sup> Fiscal year 2014 collections from motor fuels excise taxes were \$881 million. Minn. Dept. of Revenue, *Minnesota Tax Handbook* (2014 ed.).

<sup>13</sup> That was not true when the tax was originally enacted and dedicated to highway purposes. At that point, it was imposed as a higher property tax on vehicles and all of the revenue was dedicated. Until a general personal property exemption was provided, its status was analogous to the current status of the gas tax and the sales tax. At the time of enactment of the gas tax, a general sales tax was not imposed.

<sup>14</sup> Richard F. Dye and Therese J. McGuire, “The Effect of Earmarked Revenues on the Level and Composition of Expenditures,” *Public Finance Quarterly* 20, no. 4 (1992): 543-552.

<sup>15</sup> *Id.* at 554. The study did not control for any effects on local government spending of state earmarks. Local revenues and spending could also substitute for state earmarked revenues, since each of these services is also delivered by local governments.

By contrast, a 2009 study of earmarking of state revenues for highways, in combination with federal matching grants, found a much more robust relationship: one dollar of earmarked highway revenue led to a 94-cent increase in highway spending.<sup>16</sup> The conflicting results in the studies probably reflect the empirical challenges of disentangling the relevant relationships and potential limitations of the data. In particular for highway revenues, nearly all states use some, often substantial, amounts of earmarking, and earmarking itself may reflect underlying political support for the spending, confounding the ability of researchers to determine the causal factors.<sup>17</sup>

Some empirical research tentatively confirms that earmarking can reduce the volatility of spending for highway purposes. Professors Nguyen-Hoang and Duncombe found that increasing shares of highway spending from earmarked motor fuels taxes led to less volatility in spending; the effect of other earmarked transportation revenues on transportation spending was less clear.<sup>18</sup> The difficulty of determining the “strength” of the legal restrictions may have contributed to this, as well as the complexity of various spending and revenue relationships.<sup>19</sup>

*For more information about state budgeting practices, visit the government finance area of our website, [www.house.mn/hrd/](http://www.house.mn/hrd/).*

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<sup>16</sup> Todd M. Nesbit and Steven F. Kreft, “Federal Grants, Earmarked Revenues, and Budget Crowd-Out: State Highway Funding,” *Public Budgeting & Finance*, vol. 29, No. 2, pp. 94 – 110 (2009).

<sup>17</sup> Economists refer to this as the problem of determining the endogeneity of the earmarking. In addition, information (data) on the exact type of earmarking, as described in the policy brief, may be difficult to include in the analysis to the extent it is relevant.

<sup>18</sup> Phoung Nguyen-Hoang and William Duncombe, *Earmarked Revenues and Spending Volatility: The Case of Highway Finance* (June 2012) (Mid-America Transportation Center, University of Iowa), <http://digitalcommons.unl.edu/matcreports/81/>

<sup>19</sup> The authors used 30 years of state highway spending, which requires categorizing the nature of the relevant earmarking in each state for each year. For example, Minnesota’s earmarking rules for transportation—both constitutional and statutory—changed over their time period. Sharing of dedicated revenues with local government (e.g., as is provided for Minnesota’s earmarked transportation revenues) may affect the measurements, as the authors note.