

Washington State Tax Structure Study

Alternatives Subcommittee Meeting

4/18/02

Dedicated Taxes

What are Dedicated Taxes?

When a state levies a tax, it has a choice of how the funds are to be used. It can choose to place all of the receipts in a general account, like Washington's general fund, where receipts are available for any purpose determined through the budgetary (appropriation) process. The alternative is to place the receipts in a fund for use only for a specific purpose. Dedicated taxes represent the latter choice. They are taxes where a portion or all of the future receipts are dedicated for a specific purpose defined by law. Dedicated taxes are also referred to as earmarked or restricted taxes.

What Share of Taxes are Dedicated?

A study was done in 2000 by Fiscal Planning Services that compiled data on the extent and composition of dedicated taxes for each of the fifty states. The report covered state imposed taxes only, excluding local taxes.

On average, states dedicated slightly more than a fifth (21.7%) of their total tax collections in the fiscal year 1997 for purposes defined in statute or the constitution. Of the dedicated total 87% was dedicated to the following three purposes: transportation (34%), education (27%), and local governments (26%).

Three tax sources generated the majority of dedicated receipts. They are: motor fuel and highway use, sales and use, and corporate and personal income taxes. Combined, they comprised 82% of the total tax receipts dedicated in fiscal 1997. Motor fuel taxes are the only taxes dedicated in all fifty states.

The percent of tax receipts dedicated in Washington for this period was 26.2%, ranking Washington 15th from the top. Excluding highway user taxes, Washington's ranking is also 15th, at 19.0%, compared to the national average of 15.3%. The situation is essentially the same now as it was then. The only major change is the repeal of the motor vehicle excise tax, which was dedicated for a number of purposes.

Historically, for all states, the percent of dedicated state taxes has remained relatively stable in recent years. Studies covering the fiscal years of 1979, 1984, 1988, and 1993 all

show the national average to be between 21% - 24%. This contrasts with 1954 and 1963 when the percent was 51% and 41% respectively.

For Washington, the historical figures show the dedicated portion to range from 26% to 29% between the 1979 and 1997 study periods, with a high of 35% in 1954.

Dedicating Taxes - Considerations

The budgetary policy question that dedicating taxes raises is whether the inflexibility earmarking imposes on a state revenue system is sufficiently balanced by the guaranteed level of funding it provides programs. Earmarking limits the budgetary process of weighing funding priorities against one another to a greater degree than it would otherwise be. Alternatively, earmarking may be a desirable budgetary tool to maintain a stable and secure source of revenue for a particular program.

The basic arguments for and against dedicating revenue to fund programs are as follows.

Justifications for Dedicating Funds

- It enforces the benefit principal; those who receive a service should pay for it.
- It assures a minimum level of support and continuity of funding for specific projects or services.
- It contributes stability to a program's financial situation.
- It is often used as a way to induce the public to support new or increased taxes.

Criticisms of Dedicating Funds

- One of the principles of good budgeting is to take all of the revenues and all the potential expenditures into consideration, and then, through the give-and-take of the legislative process, determine spending priorities. Earmarking hampers this ability by removing revenues and expenditures from the review that occurs during the appropriations process.
- It may distort policy on the basis of decisions made in earlier years.
- It increases the difficulty of adapting budgets to changing economic and social conditions.
- It removes a portion of governmental activities from periodic review. Programs that are not reliant upon appropriations are likely to get less scrutiny than others are. Past decisions to earmark revenue for a program may remain after the need for the program has changed.
- If the revenue source(s) chosen to support a program are volatile or not dependable, it will be very difficult to sustain the program at the desired level.