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To Earmark or Not to Earmark

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Earmarked revenues are dedicated to a particular use and are not available for general spending purposes. Earmarked revenues are a common practice among states. There are three arguments for earmarking, and two against this practice.

The first argument is that there is an element of quid pro quo, or a market-like exchange. Some taxes, are earmarked on the basis of who benefits from the service it supports—the gasoline tax for highway construction and maintenance being the most obvious case. Many fees and charges are payments for service, much like private sales, such as water and sewer service and use of recreational facilities. Good accounting practice suggests that these enterprise activities should segregate their revenue and spending streams from the general public budget.

Second, there is an fairness argument for earmarking. Many fees are designed to ensure that the cost of additional service, or services to particular groups or areas, falls on those who demanded that service, rather than on taxpayers in general. Impact fees in particular are a way to share the cost of public capital among newcomers to the community, rather than imposing additional tax burdens on existing taxpayers.

Finally, the third and most important argument is political; earmarking may make a tax or fee more acceptable if people know it will all be spent on some desirable purpose. For example, states that have adopted lotteries almost always have had to have a referendum, because most states had anti-lottery provisions in their constitutions. To make a lottery more attractive, legislators promised to use the revenue for specific desirable purposes, such as education, economic development, local government, or senior citizen programs. If citizens have to vote on any kind of tax or revenue increase, earmarking increases the chances for approval.

Most economists support limited earmarking such as with fees for service or a clear benefit relationship between the revenue source and the object of the earmarking. However, earmarking usually extends far beyond the fee for service or benefit to ensure preferential treatment for certain groups or programs in the budget process. Sometimes schools or local governments are guaranteed the proceeds of a particular revenue source regardless of the competing demands on the state budget. Other times supporters of parks, or highways, or some service with a vocal and effective lobbying group within or outside of government that succeeds in obtaining an earmarked revenue source. When earmarking is not clearly justified in terms of some kind of "user pays" principle, then it needs to be reexamined.

The arguments against earmarking are powerful because they are grounded in fundamental economic principles about choices and tradeoffs. When revenues are earmarked, they are removed from that process of weighing one expenditure against another that lies at the heart of good budget practice. The amount of revenue going to a particular purpose, such as gasoline taxes for highways, may be too much or too little relative to how much would be spent if highways were funded through the general budgetary process. If it is too much, the surplus is not available for other uses. If it is too little, that spending category may find it difficult to compete for additional funding out of general revenue because it already has preferential access to its "own" funds. For example, lottery funding for education has made it more difficult in some states for public education to get increased funds from general revenue sources, even though most state lotteries generate only a modest portion of the funding needed to provide for public education. At the other end of the spectrum, tourism destination states have been involved in a costly and escalating advertising war simply because state tourism departments had preferential access to dedicated revenues from accommodations and admissions taxes.

Finally, earmarking can make a budget crunch even worse when the economy turns down. It is easy to earmark specific revenue sources for pet programs when revenue is rising and competition for public resources is not too severe. But with a revenue downturn, legislators may find that a big part of their revenue stream has been taken off budget and placed in special funds. That practice means that preferred projects cannot be cut because their revenues are protected. The burden of budget cuts then falls much harder on those public programs and services that do not have access to earmarked revenues. In the next budget upswing, there will be increased pressure to earmark revenue for some of these programs and services that suffered during the previous recession, further limiting the flexibility in making adjustments in future budgets.

In spite of its political popularity, most economists advise against earmarking as a general principle, although with some exceptions. The burden of proof is on those who are trying to make a case for earmarking. Most of the revenue needs to be available to the general fund so that legislators have the freedom to make tradeoffs among spending priorities.

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