South Dakota Legislative Research Council

Issue Memorandum 94-27

DEDICATED REVENUES

The legislative fiscal practice of earmarking revenues has been around for a long time, appearing in different forms and to different degrees in different states. For years, the most prominent example of earmarking revenues in South Dakota has been the constitutional dedication of gas tax money to highway construction. There are other specifically earmarked revenues, such as the fee on marriage licenses, the proceeds of which go to funding domestic violence and abuse shelters, and the fee on birth certificates, which is earmarked for the Children's Trust Fund. Those exemplified by these latter items, however, tend to pale in significance when compared in terms of revenue generated.

Over the years of South Dakota's statehood, there have been no significant number of attempts, if any, to dedicate general fund revenue. With Chapter 112 of the 1989 Session Laws (Senate Bill 120), however, the South Dakota Legislature took arguably the most significant and ambitious step in the area of earmarking tax revenues it had ever taken. That law mandated that 56.25 percent of the revenues from the retail sales and service tax (SDCL Chapter 10-45), the use tax (SDCL Chapter 10-46), and the amusement device tax (SDCL Chapter 10-58) "be allocated for educational purposes."

The law defines educational purposes as those "prescribed in chapters 13-1 to 13-47, inclusive," which are those chapters that pertain to K-12 education. The Board of Regents' institutions--which include the South Dakota School for the Deaf and the South Dakota School for the Visually Handicapped, also known as the special schools and both of which are just elementary and secondary schools--are not included; neither is the State Library, an institution which is very important to K-12 education in South Dakota. (The Board of Regents is Chapters 13-49, 51, etc. The School for the Deaf is Chapter 13-62, and the School for the Visually Handicapped is Chapter 13-61. The State Library is in Title 14.) Thus, the statutory formula for the dedication of more than half of the state's general fund revenue specifically ignores most of the general fund education appropriations made by the Legislature.

In the 1994 Legislature, not only was this dedication of the largest portion of general fund revenue increased to 56.8 percent, but the Legislature also created the Sales and Use Tax Collection Fund. This fund is primarily an accounting mechanism to "incur administrative costs from tax collections before they are deposited in the general fund," according to Governor Walt Miller's summary in his 1994 BUDGET REPORT. In effect, a certain amount of money is skimmed off the top of these revenue collections and used to pay for the operations of a portion of the Department of Revenue before that money is eligible for splitting off the portion for education. The testimony presented during the 1994 Session supporting this concept stressed that this would "make education pay" for some of the cost of administering the tax from which it receives benefit.

For Fiscal Year(FY) 1995, some $319.3 million was projected for sales and use tax revenue, with $3.2 million planned for deposit in the Sales and Use Tax Collection Fund. Of the $319.3 million, the 56.8 percent dedication means that $181.4 million should go to education. The Legislature, in fact, appropriated $184.9 million just for State Aid to Education, partially as a result of the cumulative effect of actual FY 1993 and projected FY 1994 revenues exceeding amounts projected during the 1993 Session entailing an adjustment, and partially because of $.9 million appropriated specifically as a special education supplement. Thus, almost 60 percent of the state's general fund is dedicated to just two uses, K-12 education and tax collection.

It can be argued that the particular dedication of money toward education is too strict in that the State Library and the two special schools are not considered in calculating the amount of money spent "for educational purposes," as was earlier mentioned. This means that the more than $5 million spent on these institutions is excluded from consideration, not to mention the more than $100 million in general fund expenditures at the rest of the Board of Regents' institutions.

Whether or not earmarking of general fund revenue should be done to such a significant degree, however, is also arguable. It was argued during this immediate past session that the dedication to education may have become too expensive or burdensome on the rest of the state's general operating budget, and the Governor's rationale for the creation of the Sales and Use Tax Collection Fund somewhat attests to that. This hefty dedication of the lion's share of general fund revenue is partially to blame for the state's fiscal woes as a result of the South Dakota Supreme Court's decision that video lottery is unconstitutional. There certainly would have been much more flexibility to adjust to the lack of those revenues if so much of the rest of the general fund was not locked by statute into a particular, narrowly-defined purpose.

In assembling a list of budget cuts, Governor Miller specifically excluded State Aid to Education, among other items (like most of Medicaid and the prison system). In the cut list which was ultimately implemented, Executive Order 94-9 (and then struck down by a circuit court), payments to the counties for replacement of personal property tax were nearly eliminated, causing the counties to file a lawsuit against the state claiming the unconstitutionality of SDCL 4-8-23, the statute referenced by the Governor in implementing the cuts. Commissioner of the Bureau of Finance and Management Jim Hill testified during the trial that State Aid to Education was left out of consideration because of the statutory dedication of revenue.

Attached to this Issue Memorandum are copies of statutes containing the earmarks or dedications heretofore described. Attachment 1 is the dedication of 56.8 percent of retail sales and service tax, use tax, and amusement device tax revenues *to education*. Attachment 2 shows the dedication *to the State Aid formula* of 56.25 percent of the revenues from the tax on the transfer of large vehicles. Attachment 3 is the statute creating the Sales and Use Tax Collection Fund.

National experts disagree on the worth of earmarking revenues, in general. Opponents say the "great disadvantage of earmarking state taxes is that it stands in the way of comprehensive budgeting" ("The Trouble With Earmarking" by Ronald K. Snell, STATE LEGISLATURES, February 1991). They say that it is contradictory to principles of sound budgeting because it does not allow the Legislature to "take all revenues and objects of expenditure into account, and to weigh the relative merits of [diverse] programs" (Snell).

Intuitively, this would appear to be contrary to the notion of running government like a business. Does a company earmark strictly for one purpose the revenue from a particular region, item, or service? Snell concludes by saying:

> Earmarking revenues adds to the complexity of state budgeting, which is already complicated enough. It limits legislative oversight and cuts down on flexibility, both of which will be needed more than ever before in the tough budget conditions likely to exist in the 1990s.(*ibid.*)

This is not to say a business ignores profitability, which would be ludicrous. For example, though, if every single item in a grocery store were profitable, there would be no "loss leaders," those items sold at an extraordinary markdown--sometimes below cost--just to generate traffic to the store. Hence, a store or company is more concerned with the overall picture of its business rather than each, individual little item.

Supporters of earmarking say that at least some of the previously described problems may occur because of excessive rigidity in application of the practice. "Besides being subject to annual legislative adjustment, earmarking of selected revenues does not constrain the legislature from using the remaining funds for annual priorities"("The Case for Earmarking" by Jim Rosapepe and Christopher Zimmerman, STATE LEGISLATURES, September 1991). Supporters point to the utility of earmarking as a way to make clear to the public that programs and activities have costs, and that legislatures need to continually reassure the voters that what is being legislated makes fiscal sense.

Rosapepe and Zimmerman say that "general fund budgeting may be 'comprehensive,' but it is rarely comprehensible to the average person. The size and complexity of public budgets breeds public distrust over the nature of fiscal decision making and the objects of public expenditure."(*ibid.*) Thus, they stress the virtue of earmarking as a way of making clear to voters that a particular revenue has a particular purpose--or the converse--and that once all is known, the public will be more supportive of lawmakers' decisions.

On the other hand, though, in addition to the fact that overzealously earmarking revenue can hamstring a Legislature, earmarking a revenue source can lead to a bureaucratic and complex maze of funds and expenditures, as exhibited by Chapter 5-27, the Capital Construction Fund. Into that fund are deposited each fiscal year the net revenues of on-line lottery tickets and the first $2 million dollars transferred to the general fund from the Cement Plant. From the Capital Construction Fund, a series of statutes specifies that specific amounts of money are annually appropriated or transferred: to the Youth-at-Risk Trust Fund as an interest payment; to the Ethanol Fuels Fund for production incentives to ethanol producers; to the Public and Special Transportation Assistance Fund; to the Water and Environment Fund; to the Capitol Complex Maintenance and Repair Fund; to the Department of Human Services, Department of Corrections, and State Veterans' Home Maintenance and Repair Fund; to the Special Schools and Agriculture Experiment Station Maintenance and Repair Fund; and to the Statewide Maintenance and Repair Fund. Each and every one of these statutory payments may very well be worthy of funding year in and year out from the general fund. However, each is an annual appropriation in statute, and, therefore, is an **automatic** payment that will be made every year unless the Legislature repeals or revises the appropriate statute(s). *(See* Attachment 4 *for a summary of these statutes.*) Would this scheme be comprehensible to the average taxpayer, or viewed as a shell game?

Further complexities are the result of exemptions from a particular tax for the benefit of a certain special interest. For example, added to South Dakota's myriad scheme of sales and use tax exemptions are aspects of earmarking attributable to or as exemplified by the treatment of endo- and ectoparaciticides and other pesticides and herbicides used for agriculture. The allowance, extension, or repeal of an exemption from sales and use tax can make the difference in whether a given project, say construction of the new Animal Disease Research and Diagnostic Laboratory, gets funded. Thus, if the Legislature decides to alter a given earmark, a number of parties may become involved in the decision, including particular state agencies that might be transferring or receiving from other agencies, and lobbyists or representatives of any number of special interest groups. What might have been a simple revenue raising or appropriation decision one year now requires a complex flow chart and compromises.

Earmarking too inflexibly may also create a quandary when revenues from that source are less than projected. While earmarking may work in some cases to somewhat guarantee a flow of income for an ongoing project or cause, consider the gas tax, the most commonly earmarked tax. Obviously, the theory behind the gas tax is that it puts the burden of constructing and maintaining highways, roads, and bridges on their users. With vehicles that are more and more fuel efficient, however, it is conceivable--if not already proven--that more miles driven can still result in less revenue because there is, overall, fewer gallons used per mile. With the needs of the infrastructure still present, the Legislature may be left with no other option but to raise the tax. Again, is this comprehensible to the average taxpayer? This argument also ignores the fact that non-drivers benefit from highways, yet do not effectively share directly in the costs.

South Dakota is probably about average in the intensity or degree to which it earmarks revenues. According to the National Conference of State Legislatures (STATE LEGISLATURES, February 1991, p. 35), Alabama has the highest proportion of earmarked taxes at 89 percent, and Rhode Island has the lowest at 5 percent. The most commonly earmarked tax is the motor fuel tax, and the least commonly earmarked tax is the personal income tax. While South Dakota earmarks 56.8 percent of its sales tax to education, South Carolina earmarks 100 percent. It is interesting to note that "the long-term trend has been for state governments to earmark less of their tax collections" during the period ranging from 1954 to 1987 (*Earmarking State Taxes*, Martha A. Fabricius and Ronald K. Snell, National Conference of State Legislatures, p. 1). During that time there have been numerous discussions of tobacco taxes, etc., for specific purposes.

In conclusion, earmarking revenues is a controversial practice and needs to be carefully considered on a case-by-case basis. While it can certainly be a way of showing to taxpayers that services have costs and users can be made to pay for those services, with too much rigidity earmarking can backfire.

This issue memorandum was written by Mark Zickrick, Principal Fiscal Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.

ATTACHMENT 1

§ 10-45-56. Allocation of certain revenues for educational purposes.

Of the total revenue collected as a result of taxes imposed in chapters 10-45, 10-46 and 10-58, inclusive, less an amount deposited into the sales and use tax collection fund for the administration of the collection of sales, use, and contractors' excise tax as provided for in § 10-1-44, 56.80 percent of the remaining total revenue shall be allocated for educational purposes as prescribed in chapters 13-1 to 13-47, inclusive. However, for fiscal years 1994 through 1996, the first five hundred thousand dollars in revenue is exempt from this section.

Source: SL 1989, ch 112, § 1; 1993, ch 48, § 16; 1994, ch 95, § 2.

Amendments.

The 1993 amendment added the last sentence.

The 1994 amendment substituted "less an amount deposited into the sales and use tax collection fund for the administration of the collection of sales, use, and contractors' excise tax as provided for in § 10-1-44, 56.80 percent of the remaining total revenue" for "56.25 percent of the total revenue" in the first sentence.

ATTACHMENT 2

§ 10-60-12. Revenues allocated for educational purposes.

Of the total revenue collected as a result of the tax imposed by this chapter, 56.25 percent of the total revenue shall be allocated for educational purposes as prescribed in the foundation program pursuant to chapter 13-13.

Source: SL 1993, ch 102, § 12A.

ATTACHMENT 3

§ 10-1-44. Establishment of sales and use tax collection fund.

There shall be established within the state treasury the sales and use tax collection fund for the purpose of administering the sales, use, municipal non-ad valorem, and contractors' excise taxes. Charges for the administration and collection of taxes collected pursuant to chapter 10-52 shall be deposited into the sales and use tax collection fund. In addition, the secretary of the department of revenue shall, on a monthly basis, deposit revenue collected as a result of taxes imposed in chapters 10-45, 10-46, and 10-58 in the sales and use tax collection fund. The total amount deposited in the sales and use tax collection fund may not exceed the amount budgeted for such purposes. All money in the fund created by this section shall be budgeted and expended in accordance with the provisions of Title 4 on warrants drawn by the state auditor on vouchers approved by the secretary of the department of revenue.

At the end of each fiscal year any cash balance left in the sales and use tax collection fund shall be transferred to the general fund.

Source: SL 1994, ch 95, § 1.

Commission Note.

Session Laws 1994, ch 95, § 3 provides, "At the end of each fiscal year any cash balance left in the sales and use tax collection fund shall be transferred to the general fund."

ATTACHMENT 4

§ 5-27-1. Establishment of state capital construction fund.

There is hereby established within the state treasury the state capital construction fund into which shall be deposited the net proceeds to the state from the sale of on-line lottery tickets...

Source: SL 1993, ch 48, § 1.

§ 5-27-2. Appropriations from the capital construction fund.

There is hereby continuously appropriated from the capital construction fund any interest owed to the youth-at-risk education trust fund pursuant to § 5-27-3. The capital construction fund shall be used to provide funding for ethanol incentive payments and public transportation, to conduct maintenance and repair on state-owned buildings pursuant to chapter 5-14, and to build, furnish and equip capital improvement projects, including the development and construction of projects on the state water plan.

Source: SL 1993, ch 48, § 2.

§ 5-27-3. Transfer of principal from youth-at-risk education trust fund.

The bureau of finance and management may transfer principal from the youth-at-risk education trust fund to meet cash flow requirements of the state capital construction fund....
Source: SL 1993, ch 48, § 3.

§ 5-27-4. Transfer of funds to ethanol fuel fund.
During fiscal year 1995 the bureau of finance and management shall transfer on a monthly basis two hundred eight thousand six hundred sixty-seven dollars from the state capital construction fund to the ethanol fuel fund...
Source: SL 1993, ch 48, § 23A; 1994, ch 57.

§ 5-27-5. Transfer of funds to public and special transportation assistance fund.
During fiscal year 1994 and each year thereafter, the bureau of finance and management shall transfer on a monthly basis thirty-three thousand three hundred thirty dollars from the state capital construction fund to the public and special transportation assistance fund...
Source: SL 1993, ch 48, § 25A.

§ 5-27-6. Transfer of funds to water and environment fund.
The bureau of finance and management shall transfer on a monthly basis two hundred ninety-two thousand dollars from the capital construction fund to the water and environment fund...
Source: SL 1993, ch 48, § 25B.

§ 5-27-7. Transfers from cement plant general fund.
Beginning in fiscal year 1995 and each year thereafter, the first two million dollars deposited into the general fund from the cement plant shall be transferred to the capital construction fund created in § 5-27-1.
Source: SL 1993, ch 48, § 26.

§ 5-27-8. Obligated transfer of money to captial complex maintenance and repair fund.
By July first of each year, the commissioner of the bureau of finance and management shall transfer five hundred twenty thousand dollars from the capital construction fund to the capital complex maintenance and repair fund...
Source: SL 1994, ch 58, § 1.

§ 5-27-9. Unobligated transfer of money for repair of department of human services, department of corrections and state veteran's home buildings.
After all obligations established in § 5-27-8 have been transferred, the commissioner of the bureau of finance and management shall annually transfer any unobligated cash up to two hundred seventy thousand dollars from the capital construction fund to the department of human services, department of corrections, and the state veterans' home maintenance and repair fund...
Source: SL 1994, ch 58, § 2.

§ 5-27-10. Transfer of money to special schools and agricultural experiment station maintenance and repair fund.

After all obligations established in §§ 5-27-8 and 5-27-9 have been transferred, the commissioner of the bureau of finance and management shall annually transfer any unobligated cash up to seventy-five thousand thirty-two dollars from the capital construction fund to the special schools and agricultural experiment station maintenance and repair fund.

Source: SL 1994, ch 58, § 2A.

§ 5-27-11. Transfer of unobligated money to state-wide maintenance and repair fund.

After all obligations established in §§ 5-27-9 and 5-27-10 have been transferred, the commissioner of the bureau of finance and management shall annually transfer any unobligated cash up to one million five hundred thousand dollars from the capital construction fund to the state-wide maintenance and repair fund established...

Source: SL 1994, ch 58, § 5.

§ 5-27-12. Vouchers for transfers to certain maintenance and repair fund.

Expenditures authorized by §§ 5-14-17 and 5-27-8 to 5-27-11, inclusive, shall be paid on warrants drawn by the state auditor on vouchers approved by the commissioner of the bureau of administration.

Source: SL 1994, ch 58, § 6.