

Taxing Simply

District of Columbia Tax Revision Commission

Taxing Fairly

Full Report

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Earmarking Tax Revenues in the District of Columbia: A Description and Evaluation

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Summary

The dedication (earmarking) of all or part of tax revenues for specific expenditures and/or programs is a common practice among jurisdictions in the United States. The District's experience is similar to that of the average state in the United States. The percentage of District taxes earmarked (23 percent in fiscal year 1996) is close to the 24 percent average for all states in 1993.

There are six major expenditure categories for which tax revenues are earmarked in the District. The six categories and a brief description of revenues earmarked to fund them follow.

General obligation bonds

Earmarking of real property tax revenues to make general obligation bond payments is mandated by District law and by bond covenants between the District and general obligation bondholders. Semiannual general obligation bond payments for principal and interest are provided by a calculated portion of the real property tax. The percentage of real property taxes earmarked for this purpose will be 75 percent in fiscal year 1998. This earmarked portion of the real property tax was 46 percent as recently as fiscal year 1993. If current trends continue, an additional revenue source will need to be identified for this expenditure purpose within the next five years. Any change in the earmarking for general obligation bond payments will require a revision in the District's bond covenants.

Washington Metropolitan Area Transit Authority

The District is part of the Washington Metropolitan Area Transit Authority (WMATA), a regional body charged with operating the mass transit system in the Washington area. Several different tax sources are allocated to WMATA. Earmarked revenues for WMATA are almost \$150 million above actual expenditure needs for this fund. Despite the legal authority to use unneeded funds for general fund purposes, the allocation of these tax sources may prevent other desired earmarking.

Convention Center fund

Portions of the sales tax, hotel occupancy tax, and corporate and unincorporated business franchise tax are earmarked for construction of a new Convention Center. There is a provision in District law that allows the executive to increase rates for these earmarked taxes in any year it is deemed there will not be enough to pay for the expected expenditure and reserve requirements.* The restaurant sales tax component of the earmarked taxes is exempt from this provision. The potential administrative difficulty if this provision is required is difficult to overstate.

New sports arena

The Arena Fee is a new tax imposed to finance site acquisition and development costs of the recently completed MCI Center. The Arena Fee is a tiered flat-rate tax based on District gross receipts. The required revenue is \$9 million per year. Arena Fee rates are required to be increased in any year in which \$9 million in collections will not be reached. Such rate increases are to be made administratively and do not require Council approval. The Arena Fee bond covenant limits the use of Arena Fee revenues to payment of bonds for site acquisition and development costs.

Convention Center promotion activities**

Sixty percent of the hotel occupancy tax is earmarked for the promotion of Washington Convention Center Authority activities in the District. Three different promotional organizations receive these funds. There is less specificity in the expenditure of these funds than for other expenditures supported by earmarked revenue sources.

Federal Highway Trust Fund

Federal law requires that the District motor vehicle fuel tax be deposited into a dedicated highway fund. This fund is used to pay for federal cost-sharing requirements and for special increased federal highway fund shares that were provided for the District in the recent past. This earmarking has resulted in an increased audit presence by the General Accounting Office and substantial staff time to provide the appropriate records for such audits.

**After this chapter was written, the Council amended the law earmarking taxes for the Convention Center. Effective fiscal year 1999, only portions of the sales tax will be earmarked, and only the sales tax on hotel rooms may be increased to compensate for tax revenue shortfalls.*

***After this chapter was written, the hotel occupancy tax was repealed, effective October 1998, and no other tax was earmarked for promotion activities.*

POLICY ISSUES

The major policy issue concerns the extent of future earmarking in the District. Earmarking can increase, decrease, or stay the same as current levels. The decision about future earmarking will be affected by the source of the earmarking recommendation (Congress, bond holders, the public). The trend in expenditure levels relative to earmarked revenue source levels also will affect the level of future earmarking.

A second policy issue is the communication of earmarking policies to the public and policymakers. There is currently no budget requirement to separate earmarked revenue sources from those available to finance the general budget. No annual reporting is available on the extent of earmarking within the District.

Finally, there are few explicit annual or lifetime dollar limits on earmarked tax revenues. Ideally, an earmarked revenue source should grow at a level comparable to the expenditure for which the revenue source is dedicated. There should be some annual or lifetime limit on the amount of tax revenue earmarked for each program or expenditure.

RELATED POLICY ISSUE

While this report focuses on the earmarking of tax revenues, there is movement among District agencies to earmark fees and fines for agency purposes. Such earmarking will, of course, reduce general fund revenues. Agencies earmark revenues to provide a reliable source of funds for automation and modernization expenditures. The D.C. Council has introduced legislation earmarking a portion of fee and fine revenue for agency use.

Introduction

Earmarked revenues (or dedicated revenues) are an important part of the state and local government financial system. Every state earmarks at least some portion of its tax revenues for specific programs or expenditure categories. Purposes for which taxes are earmarked range from funding a snowmobile account (Minnesota) to state and/or local highway construction and maintenance (all states). The percentage of earmarked tax revenues varies from state to state, from 4 percent in Kentucky to as high as 87 percent in Alabama.¹ The District falls somewhere in between these extremes with 23 percent of its tax revenues earmarked for specific purposes. This is close to the national average for states, which was 24 percent in fiscal year 1993.²

By definition, earmarking is a designation of all or part of a revenue stream to specific programs or expenditure categories. The normal state government practice is to appropriate funds from a general fund pool, which is based on total revenues

Figure N-1

Historical Data on Earmarking Among States

Year	Average State Earmarking Percent	Highest State Earmarking Percent	Lowest State Earmarking Percent
1954	51%	89%	0%
1963	41	87	2
1979	23	88	0
1984	21	89	1
1988	24	89	5
1993	24	87	4

Source: National Conference of State Legislatures.

for a jurisdiction. In the earmarking process a specific part of a revenue source is set aside to fund a designated project or expenditure category. For example, a state may direct that a percentage of its sales tax on lodging be used only to promote tourism. This revenue is not available to fund any other programs or expenditure categories. The tourism promotion expenditure category in this example is subject to fluctuations of the earmarked revenue source from one year to another, unless augmented by revenue infusions from other general fund revenue sources.

There are several earmarking practices in current use. For example, a revenue source may be earmarked with a specific dollar maximum for an expenditure purpose. All revenues from the earmarked source above the specified dollar amount would be available for general fund expenditure. Another approach is to limit an earmarked revenue source to a specific time period. These approaches and others tend to mitigate the “drain” on general fund budgeting.

This chapter describes the earmarking practices for District taxes and budgetary and revenue implications thereof. It uses state earmarking practices as a reference point and provides a summary of earmarked District tax revenues. Finally, the report discusses options for changes to the District’s earmarking practices.

The national picture

Earmarking is widely practiced by federal, state, and local governments. State governments earmark a wide variety of taxes and revenue sources. Each of the 50 states dedicates some portion of its revenue stream for specific budgetary purposes. The

Figure N-2**Number of States Earmarking Specific Taxes**

Type of Tax	Number of States
Personal Income	17
Corporate Income*	17
General Sales/Gross Receipts*	33
Motor Fuel*	50
Motor Vehicle Registration*	32
Tobacco Taxes	27
Severance Taxes	24
Alcoholic Beverage Taxes	24
Property Taxes*	14
Public Utility Taxes	12
Pari-Mutuel	10

*Taxes fully or partially earmarked by the District.

Source: National Conference of State Legislatures.

leader is Alabama, which earmarks 87 percent of its taxes for specific purposes. The lowest percentage of earmarked taxes is found in Kentucky at 4 percent. In the average state, 24 percent of state taxes were earmarked in 1993, an increase from 21 percent in 1984 and the same as in 1988. The 1993 earmarking percentage represents a revival of interest in earmarking after a long fall from 51 percent of revenues in 1954 to 21 percent in 1984. This percentage would have been higher in 1993, except that collections from severance and motor fuel taxes, which are earmarked at a rate above the state average, did not keep pace with overall tax collections in several states.³ Figure N-1 depicts the percentage of state revenues earmarked over the years surveyed by the National Conference of State Legislatures (NCSL).

One of the earliest revenue sources earmarked for specific purposes in the United States was lottery revenue. Lottery funds were used for many purposes including funding the Revolutionary War; the founding of Harvard, Yale, and Dartmouth universities; financing specific construction projects; and waging campaigns in the French and Indian Wars.⁴ Such earmarking of revenue sources, particularly lotteries, was a fairly common practice in 19th century U.S. government finance.

The tax most frequently earmarked by states is the motor fuel tax, which provided 29 percent of all earmarked revenues for states in 1993. Figure N-2 indicates the

number of states that earmark all or a portion of each of 11 different revenue sources. All 50 states earmark motor fuel taxes, primarily using the earmarked funds for highways and other transportation purposes and for local government assistance usually associated with local transportation needs. Other frequently earmarked taxes include general sales taxes (33 states), motor vehicle registration (32 states), tobacco taxes (27 states), alcoholic beverage taxes, and severance taxes (24 states each). What Figure N-2 does not show is that a specific revenue source can be earmarked for a variety of different purposes. For example, portions of the general sales tax in Idaho are earmarked for cities, counties, water pollution, state buildings, and property tax relief, although no more than 10 percent of the sales tax is earmarked for any of the specific purposes noted.⁵

The tax sources used for earmarking noted in Figure N-2 will grow at different rates. The personal income and sales taxes will tend to grow at or above the level of inflation. Motor fuel taxes, registration, tobacco, severance, and alcoholic beverage taxes are all based on units of consumption and will normally grow more slowly than the level of inflation. Corporate income, property, and public utility taxes are likely to be more volatile. It is important to understand the nature of the selected revenue source when earmarking for a specific budget purpose. Earmarking a slow-growing revenue source for a rapidly growing budget expenditure can result in a mismatch in future years.

Some of the more common purposes for earmarking other than transportation include education and local government aid. As noted in the NCSL report, there is a geographical dimension to earmarking. Earmarking for educational purposes is prevalent in the southern and western states of the United States and not so popular in the Northeast.⁶

Many, but not all, earmarked taxes have a relationship to the purpose for which they are earmarked. Examples include earmarking a small portion of alcoholic beverage taxes for wine grape research (Washington) or earmarking a small portion of motor fuel taxes for snowmobile research (Minnesota). Some taxes are imposed specifically to fund a program. For example, Florida imposes a citrus tax, all of which is earmarked for citrus advertising. The District of Columbia Arena Fee funds the new sports arena.

A new tax or fee earmarked 100 percent for a specific program may be imposed in an attempt to ensure there is no shift in funds away from other programs due to the earmarked activity. For states with spending limitations however, this earmarking, whether of an existing or new tax, will result in a reduced general purpose budget.

Because earmarking often impacts general purpose budgets and reduces flexibility to solve local problems, the decision to earmark has consequences. Some of the advantages and disadvantages of earmarking are discussed below.

Advantages of earmarking

1. Earmarking can link a particular government service to taxes paid by users of the service. The most prevalent example of this linkage is motor fuel taxes and roadway construction and repair. Presumably, highway and street users pay for their use of roadways through motor vehicle taxes and related fees. The question remains, however, about who pays for the external effects of increased automobile use such as the costs associated with higher levels of air pollution.
2. Earmarking can guarantee that particular programs are funded at some minimum threshold level. For example, earmarking funds for education may be an attempt to “ensure” that some funds are available for this purpose no matter what happens to the local economy and tax collections. However, this may not be enough, and additional revenues from other sources may be necessary.
3. Earmarking can alleviate the harmful effects of a related service or substance. Examples include earmarking tobacco taxes for health programs and earmarking lottery proceeds to fund programs to assist gambling addicts.
4. Earmarking can support desirable purposes for which it is otherwise difficult to secure sufficient funding. Football stadiums and sports arenas may fall into this category. Such earmarking provides comfort for legislators who do not support financing the programs with general fund revenues.

Disadvantages of earmarking

1. Expenditures financed by earmarked revenue sources are not subject to the same level of annual or biennial legislative oversight as other items budgeted by state government. As one author noted, “... inertia — and the obstacles in the way of statutory or constitutional alteration — leads to the continuance of artificial earmarking.”⁷ Once a program is funded with earmarked funds, legislative expenditure review may become less rigorous than review of other programs.
2. Earmarking skews the budget process. Expenditure levels for earmarked programs can reduce funds available for other worthy programs. Distortions introduced by earmarking may be difficult to correct. This is most clearly illustrated by the situation in Alabama, where 87 percent of revenues were earmarked in 1993. According to Bradley Byrne of the Alabama Board of Education, “the General Fund is not big enough.”⁸ Byrne goes on to say that Alabama’s largest earmarked fund (education) is a target for any cause that can be remotely linked to education, including \$650,000 for a children’s museum within the headquarters of the Cattlemen’s Association.⁹

3. Separate accounting and audit scrutiny may increase the cost of administering programs financed by earmarked revenue sources. For example, the District's Arena Fee guarantees a level of sports arena funding that requires little annual legislative review. However, annual General Accounting Office (GAO) audits and a separate collection and accounting requirement increase administrative costs for the Arena Fee.

Specific District earmarked budget items

Earmarking in the District is best discussed in the context of state practices for at least two reasons. First, many of the earmarked revenue sources in the District are taxes normally found at the state level. Secondly, there is more information available on state earmarking than for any other level of government. However, the state comparison does not tell the complete story, because the District currently fulfills the responsibilities of several different levels of government (state, county, city, school district).

Congressional and bondholder requirements have played a major role in shaping the current District earmarking. The general obligation bond earmarking, Convention Center earmarking, Arena Fee earmarking, and Federal Highway Trust Fund earmarking all are based on the desires of Congress, bondholders or the combination of the two. Congressional approval of the District's budget provides a vehicle for congressional influence on earmarking. Bond counsel and rating agencies play a major role, because most District earmarked expenditures are bond-financed.

The District earmarks several revenue sources for a variety of budgetary purposes as discussed below. Figures N-3 and N-4 summarize earmarked revenue sources in the District and the purpose for which such earmarking is used.

GENERAL OBLIGATION BONDS

The District is required by D.C. Code 47-331(a) to:

provide for the annual levy of a special tax or charge, if the Council determines that such tax or charge is necessary Such tax or charge shall be levied ... in amounts ... sufficient to pay the principal of and interest on such general obligation bonds as they become due and payable.

The provision was enacted by the Council to meet requirements related to payment of general obligation bonds. The requirement is satisfied by setting aside a portion of the real property tax sufficient to meet the District's semiannual bond payment plus an additional 5 percent to cover delinquencies. Real property tax payments are

Figure N-3

**Summary of D.C. Earmarked Revenues
by Source**

General Tax Category	FY 1996 Amount Earmarked (\$ thousands)	Percent of Revenue Source	Percent of Total Tax Revenues*
Real Property	\$404,100	64.7%	12.07%
General Sales	221,500	47.4	6.61
Selective Sales**	71,500	75.5	2.14
Franchise Tax	3,700	2.4	0.11
Other Taxes, Fees***	73,800	100.0	2.21
TOTAL	\$774,600		23.14%

**Includes all taxes plus Arena Fee, Motor Fuel Tax, parking meters, traffic fines, and vehicle registration.*

***Includes alcoholic beverage, cigarette, motor vehicle fuel, motor vehicle excise, and hotel occupancy.*

****Includes Arena Fee, parking meters, traffic fines, and motor vehicle registration fees.*

due March 31 and September 15 of each year. The District repayment of general obligation bonds occurs in June and December of each year. The March 31 real property tax collections are used for the June bond repayment, and the September 15 real property tax collections are used for the December bond repayment.

As indicated in Figure N-3, the earmarked portion of the real property tax was 64.7 percent in fiscal year 1996. This percentage is set to grow to 75 percent in fiscal year 1998.¹⁰ The 75 percent earmarking in fiscal year 1998 compares to 46 percent as recently as fiscal year 1993. This rising percentage is due to the decline in the real property tax base over the last five years and a growing level of bond payments. If current trends continue, another revenue source may be required to be earmarked to cover the general obligation bond payments in the near future.

Real property tax earmarking has changed the way taxpayers make real property tax payments. Beginning in fiscal year 1995, all real property tax payments must be mailed to the lockbox bank (currently First Union) or paid in person at the First Union Bank. The first year of this procedure was difficult for some District taxpayers who were accustomed to bringing real property tax payments to a cashier at One Judiciary Square.

Surplus funds collected for bond repayment in one year can be used to reduce the required payment for a subsequent year. This procedure, used between the December

Figure N-4

**D.C. Earmarked Revenues
by Purpose**

Earmarking Purpose	Revenue Source	FY 1996 (\$ thousands)	Percent of Total Revenue*
General Obligation Bond Payment	Real Property (variable % of total)	\$404,100	12.07%
New Convention Center	Restaurant Sales Tax (1%)	11,300	0.34
	Hotel Sales Tax (2.5%)	13,200	0.39
	Corporate Franchise Surtax (0.2375%)	2,900	0.09
	Unincorporated Business Franchise Surtax (0.2375%)	800	0.02
	Hotel Occupancy (40% of total)	3,200	0.10
	Subtotal		\$31,400
Convention Center Promotion	Hotel Occupancy Tax (60% of total)	4,800	0.14
Federal Highway Trust Fund	Motor Vehicle Fuel Tax (100% of total)	31,800	0.95
New Arena Construction	Arena Fee	9,400	0.28
Washington Metropolitan Area Transit Authority	Restaurant Sales Tax (9%)	116,000	3.47
	Hotel Sales Tax (10.5%)	61,000	1.82
	Parking Sales Tax (12%)	20,000	0.60
	Motor Vehicle Excise Tax (all)	31,700	0.95
	Parking Meter Fees (all)	9,600	0.29
	Traffic Fines (all)	37,800	1.13
	Motor Vehicle Registration Fee	17,000	0.51
Subtotal		\$293,100	8.76%
Total		\$774,600	23.14%

**Includes all general fund taxes plus Arena Fee, motor vehicle fuel tax, parking meter fees, traffic fines, and vehicle registration fees.*

and June payments, eliminates the build-up of excess funds in the bond repayment account and ensures that the real property tax earmarking is providing no more than the required amount of revenue. A second procedure used by the District's treasurer is to "sweep" the account each August and return unused monies to the general fund.

WASHINGTON METROPOLITAN AREA TRANSIT AUTHORITY

The Washington Metropolitan Area Transit Authority (WMATA) provides mass transit for the District and surrounding jurisdictions. Each jurisdiction within WMATA charges fares and contributes local revenues to fund WMATA. The agreement to use federal funds to assist in mass transit in the Washington, D.C., metropolitan area requires each jurisdiction to allocate "stable and reliable" sources of revenue to pay for operating charges and the bond sinking fund. D.C. Code 1-2466 requires the District to allocate the following general fund revenues to the "Metrorail/Metrobus Account."

- Motor vehicle excise tax
- Parking meter fees
- 9 percent sales tax on restaurant meals
- 10.5 percent sales tax on hotel/motel rooms
- 12 percent sales tax on commercial parking services
- Motor vehicle registration fee
- Traffic fines

These revenues are allocated by the District to WMATA along with grant revenues provided pursuant to the *Urban Mass Transportation Act of 1964* to fund the Metrorail and Metrobus systems. D.C. Code 1-2466(e)(3) provides that funds not allocated to any other expenditures listed shall revert to the general fund. This guarantees that only the amount needed for the purposes enumerated is allocated from the above revenue sources. The earmarked fiscal year 1996 revenue sources including grant funds accounted for \$337.6 million.¹¹ Actual funds required for the account were less than \$200 million. Despite the reversion of unused funds to the general fund, the "allocation" of the above revenue sources appears to prohibit other potential earmarked uses for these revenue sources. There is some disagreement within the District Controller's Office about whether other earmarking is prohibited by the "allocating" of these revenue sources. D.C. Code 1-2466(c) also provides that personal property taxes are included as a backup funding source if "necessary to cover additional expenditures . . ." Personal property tax revenues have not yet been needed.

The allocation of revenue sources to WMATA became an issue when the new Convention Center funding was being discussed. The allocation of hotel and restaurant sales taxes to WMATA made it more difficult to write the legislation

earmarking a portion of revenues from the same sales tax for the new Convention Center. It was necessary to split the earmarked sales tax. The restaurant sales tax is split, with 9 percent earmarked for WMATA and one percent earmarked for the Convention Center. Similarly, the hotel sales tax is divided, with 10.5 percent earmarked for WMATA and 2.5 percent earmarked for the Convention Center.

CONVENTION CENTER FUND*

D.C. Code 9-809 provides for construction of a new Convention Center in the District to be funded partially by a series of earmarked revenue sources. The new Convention Center proposed for the Franklin Square site will be funded in part by the following earmarked tax sources:

- 1 percent sales tax on restaurant meals
- 2.5 percent sales tax on hotel/motel rooms
- 2.5 percent surtax on the 9.5 percent corporate franchise tax (0.2375 percent effective rate)
- 2.5 percent surtax on the 9.5 percent unincorporated business franchise tax (0.2375 percent effective rate)
- 40 percent of the \$1.50 hotel occupancy tax

The D.C. Code provides that the amount to be earmarked each month from sales tax and franchise tax collections may be determined based on a formula. This is an acknowledgment that it is not always simple to administer earmarking provisions. Because the District sales tax has five different rates, any other approach is very complex. A similar issue occurs with regard to the franchise tax, where taxpayers file returns once a year, although collections occur quarterly. Absent a formula approach, monies from the franchise tax would only be available when a taxpayer files an annual return.

D.C. Code 9-814(a) provides that if the Washington Convention Center Authority "... balance of cash and investments ... exceeds the balance of current liabilities and reserves, the excess shall be transferred, in cash, to the General Fund of the District." The determination of these balances is the responsibility of the

**After this chapter was written, the Council passed the Washington Convention Center Authority Amendment Act of 1998 (D.C. Act 12-402). Projected to become law in October 1998, this legislation eliminated the earmarking of the corporate and unincorporated business franchise tax surtaxes, returning them to the General Fund, and repealed the hotel occupancy tax. The overall sales tax on hotel and motel rooms was raised to 14.5 percent and 4.45 percent was earmarked for the Convention Center. A surtax on this last tax would be imposed if earmarked tax revenues are deemed insufficient. The earmarked 1 percent tax on restaurant sales continues and will not be adjusted to cover shortfalls.*

Washington Convention Center Authority. To date, no monies have been returned to the general fund from the Convention Center Authority.

The total revenues collected for fiscal year 1996 for the new Convention Center based on data from the Office of Tax and Revenue were \$31.4 million. Figure N-4 provides a breakdown of these amounts by revenue source. More than 75 percent of the Convention Center revenues come from the restaurant and hotel sales taxes, with only about 12 percent from the franchise surtaxes.

Section 305(b) of D.C. Law 10-188, approved August 2, 1994, provides that if the District Auditor certifies that

projected revenues from the [earmarked] taxes are insufficient to meet projected expenditure and reserve requirements of the [Washington Convention Center] Authority for the upcoming fiscal year, the Mayor shall impose a surtax, to become effective on or before October of the upcoming year on each of those taxes dedicated to the Authority, excluding the tax on sales of restaurant meals and alcoholic beverages ... equal to the pro rata share of the difference between [projected expenditures and revenues].

Up to now, the D.C. auditor has not made such a determination. However, there are serious administrative difficulties inherent in such a provision. If Convention Center costs escalate and additional funds are needed from the earmarked taxes, it is conceivable that the District could have different sales tax rates each year and different franchise tax rates each month. Due to the different fiscal years for corporations and unincorporated businesses, any change in the franchise tax rate must be allocated from the effective date for each different fiscal year period. The sales tax difficulties would arise from the difficulties of administering additional tax rates above the five already included in the sales tax return. Taxpayers would experience more difficulty in complying with District sales and franchise tax laws should such tax rate changes be made.

NEW SPORTS ARENA

Chapter 27A of Title 45 of the D.C. Code provides for a Public Safety Fee (now the Arena Fee) to finance site acquisition and development costs for the new sports arena. The Public Safety Fee was originally proposed as a general fund financing source. However, after one year the name was changed to the Arena Fee and was earmarked 100 percent for the new sports arena. The Arena Fee is a tiered flat rate tax based on a business taxpayer's District gross receipts. There are seven gross receipts classes, with flat rates ranging from \$25 for companies with gross receipts of \$0-\$200,000 to \$8,400 for companies with gross receipts in excess of \$15 million. Figure N-5 illustrates the rate structure of the Arena Fee.

Figure N-5**Rate Structure for Arena Fee**

D.C. Gross Receipts	Arena Fee
\$0–\$200,000	\$25
\$200,001–\$500,000	\$50
\$500,001–\$1,000,000	\$100
\$1,000,001–\$3,000,000	\$825
\$3,000,001–\$10,000,000	\$2,500
\$10,000,001–\$15,000,000	\$5,000
Over \$15,000,000	\$8,400

Note: D.C. gross receipts represent receipts allocated or apportioned to the District.

By law, the Arena Fee rates are administratively adjusted if it is determined that the collections from a subsequent year will not be sufficient to provide \$9 million. The rates may also be adjusted to make up for a shortfall in the prior year. The law provides that by December 1 of each year a certification is required that the Arena Fee will generate at least \$9 million in the subsequent year. If such certification cannot be made on the basis of current rates, the rates are changed so that \$9 million will be collected in the subsequent year and to make up for the prior year's shortfalls. This requirement sets a lower boundary on annual Arena Fee revenues. There is no provision to set an upper limit on annual Arena Fee revenues.

The Arena Fee is collected annually on or before June 15. As noted in Figure N-4 on page 544, collections for fiscal year 1996 were slightly above \$9 million.

CONVENTION CENTER PROMOTION ACTIVITIES*

Sixty percent of the hotel occupancy tax is earmarked for the purpose of promoting Washington Convention Center Authority activities in the District. Activities include promoting conventions and tourism in the District. The hotel occupancy tax is imposed at a rate of \$1.50 per room per night and is collected monthly. Fiscal year 1996 revenues earmarked for promotional activities were \$4.8 million. Funds for the current fiscal year are earmarked for promotional activities based on the estimated revenues for the hotel occupancy tax.

**In repealing the hotel occupancy tax, D.C. Act 12-402 provided another mechanism for financing convention and tourism promotion.*

Three different organizations receive these earmarked funds. The Washington Convention and Visitors Association receives 50 percent of the amount earmarked, the Mayor's Committee to Promote Washington receives 37.5 percent, and the remainder (12.5 percent) goes to the Washington Convention Center Authority for advertising and promotion.

The use of these earmarked funds is less specific than that for other District earmarked funds. The purpose of the earmarking is intended to be closely related to the industry paying the tax. Hotel owners will benefit to the extent that the activities of the three organizations cited above can attract visitors to Washington.

FEDERAL HIGHWAY TRUST FUND

Public Law 104-21, the *District of Columbia Emergency Highway Relief Act*, signed August 4, 1995, requires that the District motor vehicle fuel tax be deposited into

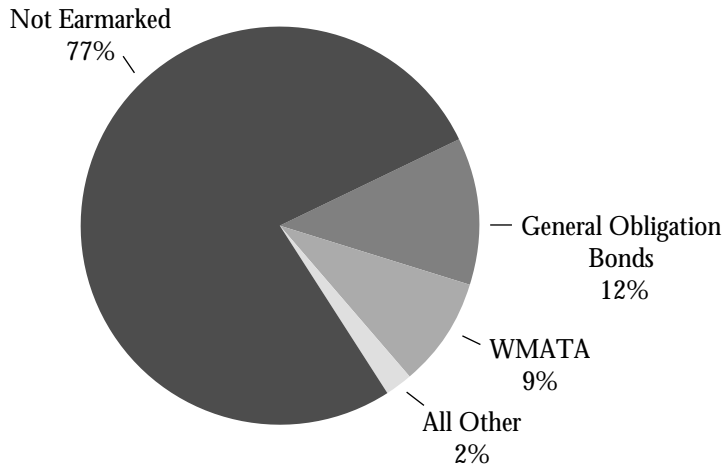
a dedicated highway fund to be comprised, at a minimum, of amounts equivalent to receipts from motor fuel taxes and, if necessary, motor vehicle taxes and fees collected by the District of Columbia to pay in accordance with this section the cost-sharing requirements established under title 23, United States Code and to repay the United States for increased Federal shares of eligible projects paid pursuant to section 2(a). The fund shall be separate from the general fund of the District of Columbia.

This earmarking is imposed by the federal government to ensure that the District is able to 1) cover the matching share of federal funds on an ongoing basis; and 2) reimburse the federal government for waiving certain local share requirements for District highway projects initiated between August 3, 1995 and October 1, 1996. The District enacted the appropriate legislation to implement the earmarking, and the motor fuel tax is now dedicated to the Federal Highway Trust Fund.

These actions removed the motor fuel tax as one of the earmarked revenue sources for WMATA. Prior to this action, the entire motor fuel tax was allocated to WMATA.

According to federal and District law, excess dollars from the motor fuel earmarking are reimbursed and can be used for local streets and transportation needs not eligible for federal aid. Prior to this earmarking, the District was one of only three state jurisdictions without a highway trust fund for matching federal transportation monies.

This earmarking results in an increased level of administrative scrutiny for the motor vehicle fuel tax. The federal legislation noted above calls for annual audits of the motor fuel tax monies and an annual report by the General Accounting Office. These audits consume staff time and resources within the Office of Tax and Revenue and the Department of Public Works.

Figure N-6**Fiscal Year 1996 District Tax Revenues*****Policy issues concerning earmarking in the District***

District earmarking is more prevalent than would be assumed at first glance. Figure N-6 indicates that 23 percent of District tax revenues are earmarked for several different purposes. The 23 percent does not include earmarking of nontax revenues such as solid waste disposal "tipping fees," which are earmarked for recycling costs. It also does not include the newly created business improvement districts within the District. These districts were created in response to business tenant demands and are designed to allow business tenants to tax themselves to create amenities within a specific business area.

District tax earmarking is primarily a response to congressional and bondholder concerns. Earmarked tax sources for general obligation bonds, Convention Center funding, arena site acquisition costs, federal highway funds and the WMATA fund are at the behest of Congress or bondholders. The District's options are limited with regard to such uses of earmarked funds.

Despite these limitations, the Tax Revision Commission has several earmarking options that can be explored as the District approaches the 21st century. Some of the Commission's options and examples of specific related issues are noted below.

Issue: How should the District approach earmarking?

Option 1: Maintain current system, but discourage additional earmarking.

Current District earmarking funds specific, well-defined programs and expenditures. Of the District's three largest tax sources, real property tax is 75 percent earmarked; sales and use tax is almost 50 percent earmarked (Figure N-3, page 543). The largest tax source, the individual income tax, is not earmarked at all. As the percentage of earmarked real property tax increases, pressure will build to provide a second earmarked revenue source for general obligation bond payments. Convention Center earmarking may also need to be increased as expected costs rise. One way to address these issues without increasing overall earmarking is to reduce the amount of tax and other revenues earmarked for the WMATA fund. As much as \$150 million in revenues earmarked for WMATA does not appear to be needed. Additional earmarking for other expenditure purposes should not be attempted until current patterns of earmarked revenues and expenditures are better understood.

Option 2: Expand earmarking beyond current levels to fund other needed programs.

Many local jurisdictions earmark revenue sources for school funding and other high-priority budget needs. The District should look to stabilize funding for these high-priority items by earmarking stable revenue sources for their use. Philadelphia, for example, earmarks its individual income tax for school funding. Earmarking "important" budget items emphasizes their significance to the community. There may be new projects and expenditures that individuals and businesses are willing to pay for with increased or new taxes. The Business Improvement District is an example of a self-assessed tax used for augmented public safety and other purposes as determined by the tenants of the business districts.

Increased earmarking within the District could act as a mechanism to funnel more money to the most important community needs.

Option 3: Reduce the District's reliance on earmarking as much as possible.

Earmarking reduces budget options available to the citizens of the District. Twenty-three percent of the District's current tax revenues are not available to fund general fund budget needs due to earmarking. A first step in reducing the reliance on earmarking would be to ensure that the earmarked revenue source is at or close to the required expenditure need. The WMATA earmarking, in which revenues are \$150 million above expenditure needs is an example of one problem in this area. Explicit annual and lifetime caps may need to be placed on Arena and Convention Center earmarked revenues. Earmarking for general obligation bonds and other future bond issues is more difficult to reduce. These earmarked revenue sources are not strong candidates for change in

the short term. Reduced reliance on future bond financing may be one way to reduce earmarking.

Issue: Should action be taken to ensure that District citizens have better information concerning earmarked revenues?

The Tax Revision Commission may wish to address concerns about the lack of public knowledge about District earmarking. It is likely that very few District citizens know that 75 percent of their fiscal year 1998 real property tax payments will be used to pay general obligation debt. Different options to address this situation are presented below.

Option 1: Change budget presentation to clarify earmarked revenue sources.

The current District budget does not separate the earmarked portion of tax revenues from the part that is available for general expenditures. The budget document could make this distinction apparent and could discuss the earmarking of each of the major tax revenue sources. Such clarification would be a useful tool for citizens, policymakers, and others interested in the District's financial well-being.

Option 2: Require an annual report.

An annual report detailing the extent of earmarking within the District could be used to disseminate information to policymakers and the public. Such a report could be structured to examine earmarking trends within the District. The proposed report could be required as part of the budget process. An examination of earmarking issues annually could be a useful tool in questions of tax policy and budgetary issues. The report could also be used as a benchmark to determine the District's earmarking compared to other states and municipal jurisdictions.

Option 3: Keep things the way they are.

Currently, there is no attempt to provide information to the public or to policymakers concerning the extent of earmarking of District tax sources. This system has worked in the past. It is possible that earmarking reports and general knowledge will inspire other interests to request that more revenue sources be provided for favorite programs. Until now, earmarking tax sources has been primarily in response to congressional and/or bondholder direction.

Conclusion

There is more earmarking within the District budget than appears at first glance. The extent of District earmarking is presented in Figure N-6. About 23 percent of

District tax revenues are earmarked for several different purposes. This does not include earmarking for such purposes as “tipping fees” to cover recycling costs within the solid waste disposal operations. Earmarking in the District is primarily for specific, well-defined budget purposes. In more than one case, a specific dollar amount of revenue is earmarked, rather than a percentage of a revenue source. This approach ensures that the correct amount of revenue is earmarked. In the example of the Arena Fee, the District imposes a tax for only one purpose — to provide earmarked revenues for specific expenditures (i.e., the new sports arena).

There are several ways the District could improve its current earmarking procedures. Ideally, earmarking should 1) include an earmarked revenue source sufficient to fund the expenditure need, including expected growth; and 2) be limited to the amount required for that budget need. These guidelines would suggest either a cap on the amount of earmarked revenue or a time limit (sunset) for earmarking revenue sources. Should the District decide to earmark additional revenue sources for programs and expenditures, these two rules should be incorporated.

There are pressures within the District to earmark additional revenue sources other than tax sources. Automation improvements and more operational funds are needed for many District agencies. Some of the agencies have suggested that retaining certain amounts of administered fees and charges would be an appropriate way to finance these needs. Legislation has been introduced to allow District agencies to retain revenues above certain baseline amounts. Fees and fines above a certain threshold would be earmarked for agency use, presumably for automation and operational improvements. Such proposals should be seriously considered. However, a plan of action needs to be provided before actual expenditures are approved from an earmarked revenue source. Many District agencies face a combination of inadequate funding and difficulty in budgeting for capital needs. Earmarking may be a way to avoid the difficult task of making a case for increased funding levels from the general fund.

If applied judiciously, earmarking revenues can serve a budgetary purpose. There are certain situations and circumstances in which earmarking is appropriate. Single purpose projects and bond funding fall into this category. It does not appear that the District’s practices are out of line with those of other states. For the most part, District earmarking is carefully applied with safeguards to ensure that the appropriate amount of revenue is earmarked. Further, much of the District’s current earmarking is the result of congressional or bondholder requirements.

The issues identified for the consideration of the Tax Revision Commission can have a direct impact on the citizens of the District. Earmarking and the “technical issues” surrounding the practice can affect citizens in several ways. For example, the practice of earmarking reduces budget options by declaring 23 percent of the revenue stream “off limits” when searching for funding sources. Earmarking can

prompt new taxes, such as the Arena Fee. The administration of earmarking can result in unlegislated tax increases and increased complexity for taxpayers. Earmarking can also be used to ensure the District's access to the bond market by earmarking a stable revenue source for bond repayment.

Endnotes

¹ Arturo Perez and Ronald Snell, "Earmarking State Taxes," 3rd ed. (Denver: National Conference of State Legislatures, 1995), p. 3.

² Ibid.

³ Ibid.

⁴ Robert D. Ebel, ed., "A Fiscal Agenda for Nevada" (Reno, Nevada: University of Nevada Press, 1990) p. 413.

⁵ Perez and Snell, op. cit., p. 61.

⁶ Ibid., pp. 5-6.

⁷ James A. Maxwell, "Financing State and Local Governments," rev. ed. (Washington, D.C.: Brookings Institution, 1969), p. 215.

⁸ Gene Owens, "The Trust Too Easily Taken," *Mobile Register* (August 5, 1997).

⁹ Ibid.

¹⁰ Conversations with Tax and Economic Policy Administration personnel indicate that the level of earmarking of real property taxes for general obligation bonds will reach 75 percent in fiscal year 1998.

¹¹ *District of Columbia Comprehensive Annual Financial Report, Year Ended September 30, 1996*, p. 43.