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A NEW LOOK AT EARMARKING

Mark G. Simkin

Abstract

Earmarking has been both praised and denounced as a fiscal tool of state government,¹ but there appears to be little scholarly research to either support or refute the arguments put forth in the dedication controversy.² This paper attempts to weigh the evidence both for and against special funding, and to suggest some long-run planning corrections which would serve as a remedy to some specific problems often encountered in the earmarking process.

Background

Earmarking may be defined as the device which ties revenue from a specific tax, or set of taxes, to the financing of a particular governmental function.³ The practice of earmarking is an old and common activity in state and local government, and was begun in the form of special assessments which local governments made in financing certain types of improvements to property. With the passage of time, however, a benefits principle of taxation motivated legislators to extend this practice to other functions of the state, as for example, in the building of highways, the maintenance of professional licensing offices, or the management of fish and game departments. In recent years earmarking has become extremely widespread, but the relationship between the recipients of a governmental service and those who pay the tax earmarked to finance that service has become increasingly tenuous.

Basically, states have two primary methods of earmarking tax revenues: a constitutional method and an appropriations method. In the former, the practice is defined in the state constitution and, usually, specific tax revenues are deposited in special funds from which expenditure appropriations may be made without legislative action. As such, little governmental control at either the executive level or the legislative level is exercised. In the latter case, however, earmarking is practiced by legislative directive. Receipts of designated taxes are often required to accumulate over some period of time and, in such cases, provide more flexibility in timing expenditures to needs. In some instances, even the transfer of surplus earmarked funds is permitted.

Importance Of State Earmarked Taxes To Business And Individuals

Despite negative pronouncements in earlier years,⁴ earmarking has continued to play an important, if ironic, part in the composition of the state budget. Studies conducted by the Tax Foundation in 1954 and 1963, which represent the most comprehensive surveys of earmarked taxes conducted to date, indicate that the average proportion of a state's budget earmarked in 1954 was 51.3% and in 1963, 41.1%.⁵ However, the relative decline in this ratio is misleading because it is mostly attributable to the relatively faster growth of the tax bases of general fund revenues and the enactment of nonearmarked taxes, rather than to the removal of earmarking statutes. In terms of dollars, the pervasiveness of earmarking is even more striking, total revenues having increased from \$5.7 billion in 1954 to \$9.1 billion in 1963. Finally, one notes that every state in the Union earmarks taxes and that in 1963, two-fifths of all states earmarked more than 50% of their total collections, and a few states reached figures of over 80%. Of the uses to which earmarked taxes are put, by far the most common were for highways (46 states), local general purposes (34 states), education (32 states), and welfare (15 states).

It is clear that all taxpayers have an interest in state and local financing since each is affected by the level, as well as the distribution, of the tax burden determined by the municipality. The fact that individuals and businesses do not contribute equally to the general tax revenues of the fisc makes the study of earmarked taxes particularly important to both since taxes which are assessed on a benefits principle obviously shift the tax computations away from an ability-to-pay principle and thereby affect this contribution ratio. Where one sector is believed to especially benefit from a particular governmental function and is taxed accordingly, the dedication process thus has the potential to drastically affect relative tax burdens and is consequently often a political question as well as an economic one.

A final point regarding the importance of earmarking is that earmarking affects both the expenditure as well as the revenue side of the ledger. Hence, to the extent that particular business interests or individuals believe that desirable governmental goods or services will "better" be provided with an earmarked program than with general funding, the parties have a vital interest in the earmarking process itself.

The purpose of this paper is to review the arguments for and against earmarking more thoroughly in order to permit a better understanding of the dedication process as well as to better as-

sess the efficacy of earmarking in particular cases. For situations in which earmarking appears appropriate, this paper also suggests certain long-run planning correctives for some of the common problems often encountered in practice.

Expenditure Allocation And The Welfare Implication Of The Earmarking Process

At the time of this writing, tax authorities and economists have not been able to agree on the usefulness of the earmarking process; and it is both surprising and paradoxical to find that a practice of such extensiveness, longstanding debate and, above all, dollar magnitude has been the subject of so little scholarly research. This dearth of investigation is perhaps best described by Sprenkle and Habacivch, who observe, "The literature on earmarking is notable mainly for its absence."⁶ Even the careful bibliographical research of the prestigious Tax Foundation concludes: "The literature on earmarking is surprisingly sparse. A careful check of standard references, as well as specialized taxation references, revealed only a few citations over the past decade."⁷

Some writers have argued that earmarking leads to a misallocation of funds in that, with a portion of state revenues dedicated to a particular function, the funded program will overexpand or become undernourished, depending upon whether the special fund tax sources yield revenues which are greater than, or less than, what would have been appropriated within the context of the general fund.⁸ Similar arguments along these lines are that earmarking will (1) "tie-up" the special fund revenue sources and thereby overwork the rest; (2) lead to undersupported functions which might compete more favorably under a general fund arrangement; and (3) substitute an indefinite revenue sum based on vague anticipations of tax collections for a calculated amount distributed on the basis of need.⁹

On the basis of such negative evaluations of the dedication process, standard texts in finance have, until recently, been almost universal in their condemnation of the earmarking practice.¹⁰ Leonard D. White provides a typical example when he states:

. . .the net result [of earmarking] is to reduce flexibility in the use of available funds, to disturb the balance between different programs, and to limit the authority of governors. . . . Earmarking reflects the power of special interests whose programs may be quite legitimate, and a distrust of both executive and legislative branches.¹¹

Other writers have not been so convinced of the wholesale removal of the special funding tool of government, as historical criticism has so forcefully advocated.¹² Among other things, they have been quick to point out that earmarking detractors have tended to treat earmarked taxes as an integral and ongoing part of the state tax system, whereas it has often been the case that only through the earmarking device that revenues have been generated, or encouraged, for the supported service.¹³ Hence, rather than "divert" state funds from other uses, earmarking may actually generate additional monies for state functions which would otherwise require general funds, or perhaps might not be provided at all.¹⁴

The dedication process has also been cited for its ability to inspire confidence in the state borrowing and the integrity of its construction commitments.¹⁵ Fredland and Scott point out, for example, that: "Relatively weak governments frequently set aside particular revenues for debt repayment. If the revenue source allocation is very certain, even a financially embarrassed government can borrow additional funds."¹⁶

But modern writers have gone further than this in promulgating the dedication process as a viable tool of state and local government. Perhaps the best known of such efforts is the work of James M. Buchanan whose analysis suggests that, to the extent that general funding does not permit an item-by-item decision on each major expenditure entry, earmarking may increase welfare by substituting a normative evaluation of personal choice for the "all-or-nothing" decision of the general budget. Thus the author suggests:

The earmarking of revenues must be reexamined in the context of individual participation in the formation of collective decisions. When this approach is taken, it becomes apparent that the restrictions that such practices as earmarking may impose on the independence of a budgetary authority need not produce "inefficiency" in the fiscal process. Some such segregation of revenues may provide one means of insuring more rational individual choice; under some conditions earmarking may be a "desirable" rather than "undesirable" feature of a fiscal structure.¹⁷

Buchanan's most important conclusion, however, is that general funding will not only lead to a larger share of the "favored" (more elastic) service, but total spending on both services may increase beyond the level that would have been reached had the accounts been segregated. To the extent that this increase in total spending is paid (consumer surplus captured) by a collection of individuals who purchase the high level "favored" service

only so that they may obtain an adequate level of less favored, but to them more desirable, services, general funding is observed to be suboptimal.¹⁸ For example, the bachelor who might vote against additional school district taxes (and expenditures) may vote for additional taxes to finance a bundle of services that includes education. Hence, in such cases, the practice of earmarking may lead to a more desirable level of expenditures which is commensurate with the various demands for public goods.

Charles Goetz extends the Buchanan argument by including not only an endogenous determination of the budgetary mix but the tax structure with which expenditures will be funded as well.¹⁹ It is demonstrated that, because of the utility structure for alternate expenditure levels and tax systems, a "prisoner's dilemma" develops in which suboptimal strategies dominate. Under these conditions, it becomes advantageous for some to renege from a commitment to the "best" (highest aggregate utility) tax-expenditure package. Thus, Goetz suggests that, in such instances, earmarking provides the ideal "enforcement" tool with which to restrict the choice of strategies, for only then will an optimal consensus be rationally determined. Hence:

Under certain conditions, the only possible budgetary adjustment which yields majority gains may require logrolling between members of the majority coalition on tax adjustment. General funds budgeting is a suboptimization process wherein incentive to chisel and lack of enforceability render cooperation between factions unlikely. By contrast, earmarking provides an enforceable "tie-in" between the tax concessions and expenditure concessions necessary to achieve a majority gain under certain circumstances.²⁰

The conclusions which may be drawn from these normative models of the dedication process go far to refute the earlier criticisms so often expressed in disapproval of special fund practice. An immediate result is a rationale which may "explain" why the various states continue to earmark sizable proportions of their budgets in the face of substantial negative pronouncement. More important is the discovery that earmarking need not universally lead to a "second-choice" budgetary allocation: the general welfare may be enhanced when (1) earmarking encourages needed public programs which would otherwise suffer,²¹ (2) when an "all-or-nothing" general fund budget does not accurately reflect an optimal mix of public commodities,²² or (3) when earmarking forces the majority opinion to weight the tax concession along with the expenditure decision in the overall tax program. Goetz concludes, for example:

Thus, while the consequences of permitting earmarking are dependent on a host of empirical factors, it is possible to indicate circumstances where the general funds method of adjustment may actually be inferior, either for a majority of the group or even by unanimity. There is certainly no a priori reason for economists to reject earmarking out-of-hand as an inefficient device within the context of a majority-rule decision process. . . . Earmarking may even meet the Paretian welfare criteria if it is evaluated as a long-run process.²³

The Benefits Doctrine

Most writers have not considered such abstruse theories of allocative welfare as a justification for earmarking but, rather, have cited a "benefits" doctrine of taxation. Although there are many bases of taxation, including ability-to-pay, allocation, ethical restraint, sumptuary, or even administrative feasibility, the benefits principle is most often advanced within the earmarking context because it rests on the presumption that those who receive the benefits from the goods or services provided by government should bear tax burdens in proportion to the amount of those benefits. Earmarking in this light thus has a distinct aura of equity.

The benefits principle is not a universal doctrine: it must always be weighted against other principles of taxation for a given situation, and its suitability ultimately decided by individual notions of equity and applicability. However, because earmarking is particularly easy to enact and may sometimes overcome resistance to new or increased taxes, this practice has demonstrated a lively potential for political expediency.²⁴ Undoubtedly, earmarking has gained its worst reputation from situations in which the benefits doctrine has been extended too far, or worse, has not applied at all. Even where exogenous budgetary controls are imposed, little can be said for special funding when other principles of taxation gain ascendancy, or when no relationship can be found between the revenue sources of earmarked funds and the expenditure programs by which they are financed.

A further case against the benefits justification has sometimes been made, however, where earmarked revenues are used to purchase capital goods, such as, for example, the construction of highways. In such instances, current expenditures are actually being made for a discounted stream of *future* benefits, and hence the relationship between them is much more complicated than would at first appear. Among other things, "it becomes ex-

tremely difficult in many cases to determine who receives how much benefit and how the tax is to be arranged so that he who receives the benefits pays the tax."²⁵

In the mind of this writer, however, this argument goes further in illustrating the difficulty of computing precise tax burdens under any proposed schema than in discrediting the benefits principle *per se*. If there is no such thing as the "best" principle of taxation, one can only search for one that, for one reason or another, seems better than the rest. If welfare is enhanced through the governmental provision of a good or service which the general public will not adequately support, but which immediate beneficiaries are willing to finance themselves if given the opportunity, an earmarked program would clearly appear better than no program at all.

A final argument against the benefits principle is that it "explains too much," or that the indivisibilities in the public good produce large "spillover" effects to those who cannot readily be priced for the benefits they receive.²⁶ "Thus, the greater the externality, the less the benefits-received principle applies."²⁷

The fundamental error with this logic is the importance attached to an exhaustive "search and capture" of benefits through tax imposts. It is of course highly likely that everyone who benefits from a specific governmental function cannot be assessed for the benefits they enjoy in its provision. Nonetheless, if a **primary** group of beneficiaries can be identified, then it does not seem sufficient to negate the benefits principle just because any reasonable tax cannot "chase" secondary or tertiary beneficiaries.

Stability

It has been noted that earmarking automatically links the expenditure and receipts sides of government budgets.²⁸ Hence, distrust of the budgetary process in general, or fear of drastic cutbacks in desirable programs in particular, has motivated interest groups to press for expenditure plans funded by earmarked revenues in the hopes that a minimal level of expenditure, as well as a more continuous flow of revenues, would thus be realized. Along these lines, one authority has concluded: "If public preferences are too fickle to guide suitable levels of expenditure, then perhaps in periods of declining demand, earmarking becomes a vital condition for adequate levels of outlay on important but minimally popular functions."²⁹ Also, to the extent that fluctuations in spending patterns may also be reduced, earmarking has sometimes been credited for its capacity to impart stability to the state's financial system.³⁰

Although the dividends from stability in the tax program are well recognized,³¹ scholars have found some reason to question whether earmarking achieves this desirable result. One reason for this is that the "normal" case will usually admit unequal revenue and expenditure elasticities which must eventually lead to disparities (or so-called "distortion") in the levels themselves. Further difficulties are found in the facts that (1) incentives and disincentives to raise earmarked tax rates are created by Federal and exogenous state aid to the special fund, (2) adjustments required to increase the contributor tax burden may prove inconvenient, (3) notions of equity in the apportionment of an increased tax burden may be neglected in the immediate need to generate greater revenues, and (4) *ex ante* demand for the agency good or service is probably not accurately reflected in the provision levels because the expenditure decision is made after tax receipts are determined instead of the other way around.

As regards the overall question of fund stability, the issue would appear to present a testable hypothesis. Empirically, however, there has not been much consensus on a suitable quantitative measure of "stability," and applicable studies have led to questionable results.³²

Control

Earmarking creates an autonomous spending agency. As such, some writers have contended that earmarking infringes on the policy-making powers of the executive, especially in the area of budgetary control and review. As a result, these critics have argued that earmarked programs will tend to outlive their usefulness because their termination is problematical,³³ that inflexibility is imparted to the revenue structure because a portion of governmental activity has been removed from periodic legislative appraisal, and that the annexed budgets of special funds may hide administrative wastes which are not auditable with general fund accounting tools.³⁴ In the strongest form of the argument, there is even the implication that earmarking may be indicative of non-representative government.

In the opinion of this author, these arguments hide more than they reveal. Unquestionably, the substitution of fixed appropriations for managerial discretion denies the fisc the flexibility afforded the general fund and hence further aggravates the distortionary characteristic of the dedication process. However, in defense of earmarking, it must also be said that there is nothing in the dedication process which precludes the implementation of sophisticated accounting procedures in the special agency paralleling those of the general fund. Moreover, even in the context of the general fund, auditing instruments are more efficient in veri-

fyng expenditure levels, as opposed to devising methods of setting them, so it is questionable how much real supervisory power is afforded by accounting controls in and of themselves.

A more important form of control may be found when it is remembered that the legislature still maintains the responsibility for setting the rates of the earmarked taxes contributing to the special fund. An immediate consequence is the indirect supervision afforded this governing body over the magnitude of the special fund's expenditure program. Then too, it is obvious that the relative "autonomy" of the earmarked tax agency becomes less insular and more responsive to legislative decision, albeit indirectly, when this control is properly exercised. Finally, this observation further suggests that the "distortion" often attributed to the earmarking practice may in reality be the responsibility of the legislature's own reluctance to effectively deal with the earmarked program's long-run commitments. If so, it would appear that legislative planning, rather than earmarking weakness, is the issue, and this clearly is controllable through a different set of remedies than a simple alteration in the fiscal organization of the tax structure.

Some Correctives For Earmarking Deficiencies

The primary conclusion is that earmarking is a budgetary tool which has been overworked. Where no logical relationship can be found between tax contributors and beneficiaries, it is difficult to justify earmarking on grounds other than precedence, expediency, or accident. In such cases, a cessation of such practices would appear to be proper, and the greater portion of general-fund earmarking, in which a stated percentage of general fund receipts are tied to expenditure functions, would be a likely candidate for such action.

For situations in which a benefits system of taxation is applicable, earmarking may remain viable. The question of fiscal integrity within the special fund, as discussed above, might be answered when it is realized that "earmarking" and a "loss of legislative control" are not necessarily synonymous. In particular, earmarking says **nothing** about the administrative budget of the tax agency, which may or may not be funded by earmarked revenues. Of course, even if the administrative budget of the special agency were supported with general funds, this corrective would still not necessarily result in an optimal expenditure pattern among beneficiaries. However, it would at least permit the state government to assume uniform accounting and management procedures and might also be expected to go far in deterring unwarranted management costs in the expenditure program. Tests for administrative efficiency are also available and applicable within the earmarking framework.³⁵

Perhaps the most important aspect of the earmarking process bearing corrective scrutiny is also the most fundamental — that of matching obtained tax receipts to desired levels of expenditure. Although this author would not go so far as to call such disparities "distortion" in the earmarking process, he would admit the necessity of recognizing the non-static nature of the earmarking program which causes them.

One answer would seem to lie in better tax **programming** through a careful analysis of the elements which determine required levels of spending and, of course, revenue growth in the earmarking process. In the opinion of this author, such an accounting would go far to alleviate erratic tax adjustment as well as reduce this characteristic feature of present day earmarking practice. A more continuous tax program could also be expected to reflect a smoother stream of revenues which, in contrast to the earlier conclusions cited, might well facilitate stability in expenditures and, hence, a more rational system of finance than might otherwise be achieved. In short, earmarking could appear to require long-term planning if it is to avoid problematic lags in rate adjustment resulting from the dynamic evolution of its tax bases.

A possible model for achieving this objective might be an intertemporal goal programming model formulation in which tax rates become the variables (x), and the tax bases become the matrix coefficients (A). The model would determine a rational tax program for the agency by calculating those tax rates which minimize the absolute error of difference between obtained revenues (Ax) and desired expenditure targets (t). In matrix notation, the model becomes:

$$\begin{array}{l} Ax - t = d^+ + d^- \\ \text{Min.} \quad ed^+ + ed^- \quad (e \text{ a row vector of 1's}) \end{array}$$

The success which this author has had in carrying out the computations for such a model for the California Highway program would recommend its more general application as a corrective to the problems alluded to above.

Conclusion

The review of contributions by modern writers has revealed that earmarking is not without justification or logical application. The two circumstances most favorable to this approach would appear to be: (1) situations in which a **direct** relationship can be found between the consumers of a public good or service and those who should pay for them and in which a "benefits" system of taxation seems appropriate; and (2) situations in which a

Pareto-superior total government expenditure may be anticipated if certain monies are allocated outside the legislative arena of the general fund.

It has been noted that compartmentalizing the tax funds from a specific revenue source and dedicating them to a specific function is disquieting to those who would fear a misallocation in governmental expenditures. Against this criticism must be placed the argument that, because of the political context within which the decision-making process is performed, the cooperation between interest factions required for a majority gain may not be forthcoming in general fund budgeting, whereas earmarking may provide the ideal enforcement tool by which to envelop the tax and expenditure decision in the manner necessary to obtain the most desirable conclusion. To this must be added the Buchanan argument noting the "independence" that earmarking fosters in divorcing the dedicated account from the "tie-in" properties of the general fund approach. At least in theory, therefore, there would appear to be limited situations in which the rationale for segmenting accounts may be established, thereby permitting a study of the earmarking process as a **closed system**.

Within this context, the difficulties inherent in the earmarking function would seem to be fundamentally a problem of **planning**, as noted in the previous discussions of "Stability" and "Control." The foremost recommendation would be for the legislature to plan a schedule of tax rates which would time the levels of the revenue program to coincide with the expenditures required by the special agency to fulfill its long-term commitments. It is contended that the presence of a carefully planned program of expenditures would then be coupled with a compatible tax structure which would not only balance the program budget in the long run but which could be environmentally flexible as well.

REFERENCE FOOTNOTES

¹Tax Foundation, **Earmarked State Taxes** (New York: Tax Foundation, 1965), pp. 24-7.

²*Ibid.*, p. 27.

³*Ibid.*, p. 8.

⁴See, for example, Philip E. Taylor, **The Economics of Public Finance** (New York: McMillan Co., 1948), p. 29.

⁵Tax Foundation, *op. cit.*, p. 7.

⁶Case M. Sprenkle and William Habacivch, "Earmarking,"

Report of the Commission on Revenue, State of Illinois (Springfield: 1963), p. 816.

⁷Tax Foundation, *op. cit.*, p. 27.

⁸Sprenkle and Habacivch, *op. cit.*, pp. 817-9.

⁹*Ibid.*, pp. 816-7. Also see Tax Foundation, *op. cit.*, pp. 24-5.

¹⁰See Bernard M. Sliger, **Public Finance** (Homewood, Illinois: Dorsey Press, 1964), p. 51; M. Slade Kendrick, **Public Finance** (Boston: Houghton Mifflin Co., 1951), p. 331; or Philip E. Taylor, *op. cit.*, p. 28.

¹¹Leonard D. White, **Introduction to the Study of Public Administration** (New York: MacMillan Company, 1955), pp. 249-50.

¹²For a comprehensive discussion on dissolving earmarked funds, see Sprenkle and Habacivch, *op. cit.*, pp. 832-4.

¹³See, for example, Earl Rolph and George Break, **Public Finance** (New York: Ronald Press Co., 1961), p. 62.

¹⁴The question of whether earmarking leads to greater total expenditures than would be found within the general fund context is discussed at length in James M. Buchanan, "The Economics of Earmarked Taxes," **Journal of Political Economy** (October, 1963), pp. 457-69.

¹⁵Tax Foundation, *loc. cit.*

¹⁶John R. Fredland and Ralston D. Scott, "Policies of Debt Management," in Richard W. Linholm (ed.), **Public Finance** (New York: Pitman Publishing Corp., 1959), p. 773.

¹⁷James M. Buchanan, *op. cit.*, p. 458.

¹⁸An implicit assumption is the absence of the item veto which could possibly overcome such a possibility.

¹⁹Charles M. Goetz, "Earmarking Taxes and Majority Budgetary Processes," **American Economic Review** (March, 1968), pp. 128-36.

²⁰*Ibid.*, p. 135.

²¹This conclusion is also supported by the empirical studies of Elizabeth Deran, "Earmarking and Expenditures: A Survey and a New Test," **National Tax Journal** (December, 1965), pp. 354-61.

²²i.e., the social value (utility) per dollar of each last unit of purchase has not been equated at the margin.

²³Charles M. Goetz, *op. cit.*, pp. 135-6. The tax principle by

which the individual taxpayer would make private choices on governmental activities by comparing personal costs and benefits for each one separately is usually attributed to Knut Wicksell, "A New Principle of Just Taxation," in Richard A. Musgrove and Allan T. Peacock (eds.), **Classics in the Theory of Public Finance** (London: International Economic Association, 1958), pp. 72-118.

²⁴See, for example, Ellis T. Austin, **California's Special Fund Revenues**, a Report to the Controller of the State of California, 1968, p. 32.

²⁵Case M. Sprenkle and William Habacivch, *op. cit.*, p. 820.

²⁶*Ibid.*

²⁷Ellis T. Austin, *op. cit.*, p. 19.

²⁸Werner J. Hirsch, **The Economics of State and Local Government** (New York: McGraw-Hill, 1970), p. 50.

²⁹Elizabeth Deran, *op. cit.*, p. 361. See also Ellis T. Austin, *op. cit.*, p. 64.

³⁰Tax Foundation, *op. cit.*, p. 27.

³¹These would include an ability to facilitate long range planning, to generate confidence in the state's credit (and hence make bond issues relatively cheaper), to promote programs in which a continuity of effort and expenditure is particularly important, to encourage investment in capital equipment and manpower, and perhaps to stimulate a more efficient utilization of resources.

³²Sprenkle and Habacivch, *op. cit.*, p. 824 and Elizabeth Deran, *op. cit.*, p. 356.

³³As examples, the Tax Foundation reports that the state of Missouri continued to levy an earmarked property tax to pay interest on a state debt which had already been retired, and that two southern states continued to earmark taxes for Confederate war pensions despite the fact that there were no surviving recipients. See Tax Foundation, *op. cit.*, p. 25. For a discussion of the problems of dissolving earmarked funds, see Sprenkle and Habacivch, *op. cit.*, p. 832.

³⁴Tax Foundation, *op. cit.*, p. 25.

³⁵Marius Farioletti, "Tax Administration Funding and Fiscal Policy," **National Tax Journal**, March, 1973, pp. 1-16.

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