

## THE EARMARKING OF STATE TAXES IN MICHIGAN

First in a series of occasional papers on issues raised by Proposal A of 1994.

### In Brief

- Nearly every tax imposed in Michigan since the early 1960s has had a portion of the resulting revenues dedicated to one or more specific functions.
- Proposal A of March 1994 increased the proportion of earmarked revenues from about 34 percent of total state tax revenues in 1993 to about 57 percent in 1995. Constitutional earmarking increased from 27 percent to about 35 percent and statutory earmarking rose from seven percent to about 22 percent of total state tax revenues.
- Michigan ranks high nationally in the percentage of state tax revenues dedicated to specific functions. While the results of Proposal A are likely to reduce the number of states that earmark more than Michigan, the final effect remains uncertain.
- Not since the adoption of the current Michigan Constitution has more than 55 percent of state tax revenues been removed from the budgetary process. This will make it more difficult to reallocate funding priorities, should that become necessary, and take decision-making responsibilities out of the hands of those elected to make such decisions.

### Introduction

#### What Is Earmarking?

**E**armarking, or dedicating, refers to the practice of reserving revenues from specific sources for specific functions. Earmarking may take two forms:

- A fixed dollar amount of the revenues from a given source, or
- A percentage of the revenues from a given source.

The common practice in Michigan has been to earmark a percentage of the revenues from a given source to a specific function. For the purposes of this paper, the concern is with the earmarking of the major state taxes levied to finance state government functions.

Provisions to earmark revenues may be included in a state constitution, or written into state tax laws. The relative mix of constitutional and statutory earmarking in Michigan has varied over the years. While policy makers need only go through the legislative process to alter statutory earmarking, a vote of the people is required to alter constitutional earmarking in Michigan.

In most cases, the use of earmarking runs contrary to principles of good budgeting. The legislative and executive branches must have strong control over revenues and expenditures. There must be adequate flexibility to react to changing conditions. They must be able to use the budget to set policy. These principles are best met through a budgetary process with all expenditures judged on their merits and income allocated accordingly. If any government function is important enough to warrant consideration for earmarking, based on its importance, it should easily pass the muster of the budgetary process. If not, perhaps it is not as important as its advocates might contend.

#### Earmarking In Michigan

The number of earmarked state taxes has tended to increase over time in Michigan, affecting the percentage of tax revenues available for allocation by budget makers. Many perceived the high level of earmarking, and the consequent inability to control the budget, as a contributing rationale for the calling of the 1961 Constitutional Convention. The new Constitution addressed the

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structural budget problems attributable to the low proportion of tax revenues deposited into the state general fund at that time. Proposal A of 1994 returns Michigan to earmarking levels not experienced since the 1963 Constitution was implemented. With the addition of new state taxes and government functions, earmarking stands to

have greater repercussions on control of the budget today than it did in 1960.

The relationship between some taxes and their dedicated purpose is clear. However, the relationship between the incidence of most taxes and the purposes for which the revenues are dedicated is limited or non-existent. Earmarking

reduces legislative and executive discretion over revenues and spending and therefore limits their oversight powers. This *Council Comments* will show how earmarking has changed since the 1960s and that earmarking may result in a more expensive Michigan government.

## Is Earmarking Good Public Policy?

### Justifications

States often earmark tax revenues specifically to benefit a taxpayer group, much like a user fee. The earmarking of fuel and weight

taxes collected from highway, air-space, or waterway users ensures that these taxpayers contribute to the construction and maintenance of the highway, airport, or port facilities and protects against the diversion of these tax revenues to another function. The high corre-

lation between the use of these facilities and the tax revenues generated brings a level of market orientation into the funding decisions. This is the most common type of state earmarking.

States also earmark as a means of stabilizing state finances and ensuring a minimum level of support and continuity of funding for specific projects or services. In some cases, this is done for political reasons, to support politically favored functions. Other earmarkings are for more pragmatic reasons. Capital investment programs and long-term projects would be more costly, and perhaps more difficult to get funded, without earmarking. Secure sources of financing allow higher bond ratings, thus reducing interest rates and costs.

Finally, earmarking has been used to gain political support for new or increased taxes. Most of the taxes that have been imposed or increased in Michigan over the past 30 years have included some earmarking, often as a result of deal making to win support for the tax.

### Taxation Principles and Earmarking

Dedication of tax revenues can frequently be defended on the grounds that a particular tax is paid by those who benefit from the services financed by the tax, and therefore it is not only legitimate, but desirable, to dedicate those revenues to the program financed by that tax. This justification for earmarking of taxes imposed on the users of specific government services highlights the distinction between the two basic principles of taxation -- ability-to-pay and benefit.

The *ability-to-pay principle* holds that, for taxes that support services consumed by everyone or nearly everyone (public safety, for example) or for which user charges are inappropriate (welfare, for example), taxes should be levied according to ability to pay. Although the determination of ability to pay is the subject of endless debate, it is generally considered economically undesirable to levy taxes that fall more heavily on those less able to pay.

The *benefit principle*, on the other hand, holds that there are certain governmental services whose benefits are consumed largely or totally by the direct users of those services and that, if those users can be identified, equity and efficiency will be promoted by taxing them in accordance with their use of those services. A corollary to this principle is that it is desirable to use the revenues from such taxes to finance only the services in question, not to use them to subsidize other services. For example, gasoline sold for use in vehicles driven on highways is a convenient, albeit not totally accurate, indicator of highway use. It is, therefore, justifiable to tax such gasoline sales and use the proceeds from the tax to finance highway construction and maintenance. It would make little sense, however, to tax highway users for general governmental purposes, because violation of this principle's corollary would cause this group of taxpayers to bear a greater burden for the financing of, say, correctional facilities than any other group of taxpayers.

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### Criticisms

There are three principal criticisms of earmarking. First, earmarking removes expenditure allocation decisions from the budgeting process. Earmarking tends to promote program funding at the level of revenues generated by the dedicated tax, rather than at a level based on need. Additionally, control over agency functions diminishes as earmarking reduces the incentive of the legislative and executive branches to monitor expenditures that come from earmarked revenues.

Second, while earmarking may be implemented to ensure a minimum level of support, in many cases it is not clear that additional revenues are provided to the function by earmarking. All money is fungible. The use of earmarking simply allows program funding at an amount that would have been provided in any event, while freeing money previously spent on that function to be spent on other functions. For example, the dedication of lottery revenues to the school aid fund did not proportionally increase the total level of school funding. It simply allowed general fund money previously used for school aid to be appropriated to other government functions.

Third, whether providing minimal support or additional funding, earmarking causes distortions in tax and funding levels when revenue growth is not related to changes in a function's funding needs. While a function might have required the full allotment of dedicated funds when earmarking began, often the same relationship does not hold true several years later. In some cases, revenues

grow faster than needs, typically resulting in expenditures growing to meet revenues. Program managers feel impelled to spend fully the revenues, even though this may be a wasteful use of funds at a time when other functions are in need of additional funding. In other cases, dedicated revenues may not grow at a rate sufficient to fund the needs of a function. Such occasions result in underfunding, the use of general fund revenues to make up the difference, or increased taxes. For example, at the initial incidence of earmarking, cigarette tax revenues bore some relationship to school funding needs. This relationship quickly eroded as the annual growth in revenues lagged growth in the school funding needs.

Earmarking can also distort the funding needs of the less politically appealing general fund functions. These functions include welfare, higher education, corrections, and general government administration. Unable to vie for earmarked tax revenues, these functions are left to compete for a smaller pool of funds. If the needs of these functions are greater than available funds, the result is either underfunding or non-earmarked taxes must be levied at artificially high levels to meet the needs.

Finally, budget makers' flexibility to adapt the revenue structure to changing economic times is reduced by earmarking. During the early 1990s, state revenue sharing from earmarked intangibles, personal income, and single business taxes was reduced to allow the state budget to adapt to the changing economy. This would

### Other Earmarking

In addition to the taxes discussed, other constitutional and statutory requirements result in the dedication of revenues in Michigan. Because unemployment insurance taxes are federally mandated, and the resulting revenues cannot be used for general-fund purposes, they were excluded from the major state taxes discussed in this study. Additionally, the state levies taxes that are solely dedicated to financing a local purpose, such as the accommodations tax earmarked to the convention facilities development fund and the airport parking excise tax earmarked to the airport parking fund. Lottery revenues are dedicated to the school aid fund. Section 35 of Article 9 of the Michigan Constitution dedicates revenues derived from leases for the extraction of non-renewable resources from state owned lands to the Michigan natural resources trust fund and the Michigan state parks endowment fund. Section 26 of Article 9 requires the state to return to personal income and single business taxpayers any tax revenues that exceed the state revenue limit by one percent or more. There are requirements such as Public Act 120 of 1994, which mandates the appropriation to state parks of at least the \$7.2 million, plus inflation, that was appropriated in fiscal year 1994. Finally, Section 30 of Article 9 of the Constitution requires 41.61 percent of total spending be paid to all units of local government taken as a group, a requirement that would apply even if all earmarking were eliminated. These earmarkings, while noteworthy, are beyond the scope of this study.

have happened with less political strife and would have been less difficult to accomplish had these

revenues not been earmarked. It would have been nearly impossible

had this earmarking been constitutional instead of statutory.

### Earmarking in Michigan

#### A Brief History

Earmarking in Michigan dates back to provisions of the 1850 Constitution dedicating specific state tax revenues to the Primary School Interest Fund. Additional state tax revenues became dedicated in the 1930s and 1940s when constitutional amendments earmarked motor vehicle gas and weight tax revenues to highway funding and sales tax revenues to school funding and state revenue sharing. Earmarking increased in the 1950s, primarily through statutory dedications. By 1960, 12 state taxes and over 60 percent of total state tax revenues were constitutionally earmarked to finance education, state revenue sharing, and highway maintenance and construction. Other state taxes were statutorily dedicated for other purposes. This condition contributed to the calling of the 1961 Constitutional Convention. The 1963 Constitution eliminated the Primary School Interest Fund, allowing previously dedicated specific tax revenues to flow into the state general fund.

#### Earmarking Trends

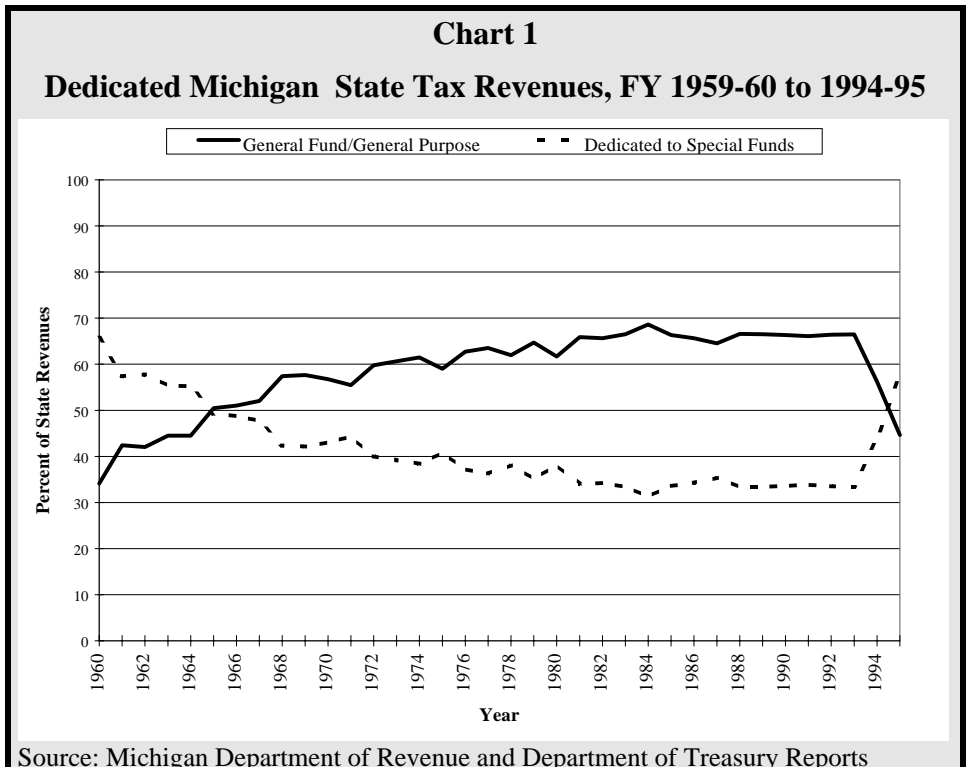
Over the 30 years between adoption of the 1963 Constitution and the passage of Proposal A in 1994, two seemingly contradictory trends occurred regarding earmarking in Michigan. First, five of the eight state taxes imposed during this time included some amount of earmarking.

Second, revenues earmarked to specific functions did not grow as a percentage of total state tax revenues (See Chart 1). Approximately 50 percent of total Michigan tax revenues were earmarked in 1965, when the state statutes were amended to reflect the elimination of the Primary School Interest Fund. Earmarked revenues declined to a low of about 31 percent in 1984. Earmarking remained about 35 percent from 1985 until the changes of Proposal A. The implication of these two trends is that while the proportion of state tax revenues dedicated to specific functions has not grown over the past 30 years, this lack of growth cannot be attributed to any conscious state policy to earmark fewer taxes.

#### Effects of Proposal A

In fiscal year 1993, about 34 percent of Michigan state tax revenue was dedicated to finance specific functions. About 27 percent was constitutionally dedicated and another 7 percent was statutorily dedicated. A major shift from local to state school financing resulted from Proposal A, replacing local property taxes with two new state taxes and three increases in existing taxes. The result was a \$4.4 billion increase in state tax revenues, completely earmarked to either the School Aid Fund or health care.

In fiscal year 1995, 20 of the 27 state taxes imposed for state purposes earmarked some portion of



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the revenues to specific functions. Earmarking comprised roughly 57 percent of total state tax revenues:

### National Trends And Interstate Comparisons

Interstate comparisons across a number of years indicate that earmarking has been a cyclical trend, with Michigan following the same pattern as most other states.

Year	U.S. Average	Michigan	Michigan Rank
1954	51%	67%	12th
1963	41%	57%	13th
1979	23%	38%	(t)11th
1984	21%	39%	(t)10th
1988	23%	35%	11th
1993	24%	39%	8th

Source: National Conference of State Legislatures, *Earmarking State Taxes*, 1995.

In 1954, the average state earmarked more than half of its tax revenues to specific functions. This average declined over the next three decades to a low of 21 percent in 1984. The period since

As can be seen in **Chart 1**, Michigan has returned to earmarking levels not experienced since the calling of the 1961 Constitutional Convention. Most of the increase is not attributable to a rise in user taxes, but to a rise in dedications to favored programs.

#### **Strong Relationships:**

#### **Benefit Principle Dedications**

In Michigan, as in many other states, several taxes are earmarked to specific functions because the

about 35 percent dedicated constitutionally and about 22 percent dedicated statutorily.

1984 has witnessed renewed use of earmarking, probably in response to increased taxpayer resistance to higher general taxes. In 1993, the average state earmarked 24 percent of total state tax revenues to specific functions. Alabama earmarked the largest percentage of its tax revenues, 87 percent, while Kentucky earmarked only 4 percent of its tax revenues. The most common purposes for state earmarking are local government, education, and transportation funding.

Michigan has ranked high relative to the other states in the percentage of state tax revenues earmarked to specific functions for as long as the National Conference of State Legislatures has been conducting its survey of the states, ranking eighth in 1993. The Michigan rank is likely to be higher in post-Proposal A earmarking comparisons, although not equal to that of Alabama.

### **Analysis**

tax base is highly correlated to the need for services. As previously noted, motor vehicle fuel and weight tax revenues, dedicated to highway funding, are examples of this type of earmarking. However, these taxes play a lesser role in the state budget than they once did. Transportation taxes comprised about 24 percent of total state tax revenues in the budgets of the late 1950s and early 1960s, but only about 8 percent of total state tax revenues in 1995.

State	Percent Earmarked
1 Alabama	87.0%
2 Montana	64.3%
3 Tennessee	60.1%
4 Nevada	56.9%
5 Utah	54.8%
6 South Dakota	47.0%
7 New Mexico	39.6%
<b>8 Michigan</b>	<b>39.5%</b>
9 Massachusetts	39.1%
10 New Jersey	38.7%
11 Illinois	32.3%
12 Washington	30.1%
13 Arizona	29.8%
14 Florida	27.6%
15 Missouri	26.5%
16 Indiana	26.4%
17 Mississippi	25.9%
18 Kansas	24.7%
19 Virginia	24.7%
<b>U.S. Average</b>	<b>24.4%</b>
20 North Dakota	21.9%
21 Iowa	21.8%
22 Nebraska	21.2%
23 Oregon	21.2%
24 Oklahoma	21.1%
25 Texas	21.0%
26 Idaho	20.8%
27 Colorado	20.4%
28 California	18.8%
29 West Virginia	18.7%
30 North Carolina	18.5%
31 Maryland	17.4%
32 Ohio	17.4%
33 South Carolina	17.4%
34 Wyoming	17.0%
35 Minnesota	16.0%
36 Louisiana	15.4%
37 Arkansas	12.8%
38 Vermont	12.5%
39 New Hampshire	14.2%
40 Maine	11.7%
41 Pennsylvania	11.0%
42 Connecticut	10.1%
43 Wisconsin	9.2%
44 Alaska	8.3%
45 New York	8.3%
46 Delaware	6.5%
47 Georgia	6.0%
48 Hawaii	5.1%
49 Rhode Island	5.1%
50 Kentucky	3.9%

Source: National Conference of State Legislatures, *Earmarking State Taxes*, 1995.

**Forced Relationships**

Sometimes the benefit principle is used to earmark where there is not a strong relationship between the tax incidence and the function. Such earmarkings may contribute

to higher taxes and distort the funding priorities of the budget. The incidence of some earmarked Michigan taxes bear some relationship to the service provided. However, unlike transportation

funding, were it not for earmarking these functions might not receive any state funding. This is the case with the dedication of the liquor specific tax to the liquor purchasing revolving fund, and

**Table 3**  
**Michigan Earmarking Trends for Major State Taxes, Select Years**  
(millions of dollars)

	1960	1965	1970	1975	1980	1985	1990	1995*
<b>Earmarked Revenues</b>								
<b>INCOME TAXES</b>								
Personal Income Tax	N/A	N/A	\$66.10	\$102.58	\$168.87	\$240.80	\$340.00	\$1,251.30
<b>BUSINESS PRIVILEGE TAXES</b>								
Single Business Tax	N/A	N/A	N/A	N/A	162.20	201.60	279.40	299.30
Corporate Organization Tax	0.41	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Foreign Insurance Company Premium Tax	20.66	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Horse Race Wagering Tax	1.67	3.25	4.39	6.05	11.15	9.34	8.44	7.37
<b>CONSUMPTION TAXES</b>								
Sales Tax	215.09	343.59	473.62	766.70	1,152.12	1,406.05	1,781.52	4,468.65
Use Tax	0.00	0.00	0.00	0.00	0.00	0.00	0.00	233.46
Cigarette/Tobacco Products Tax	17.94	21.15	24.54	24.65	25.67	137.42	62.26	440.93
Liquor Taxes	10.82	8.62	12.21	17.37	25.29	28.19	48.38	54.00
<b>PROPERTY TAXES</b>								
Intangibles Tax	9.50	9.50	9.50	31.90	9.50	9.50	9.50	0.00
Inheritance Tax	12.12	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Public Utility Property Tax	23.68	0.00	0.00	0.00	0.00	0.00	0.00	0.00
State Real Estate Transfer Tax	N/A	N/A	N/A	N/A	N/A	N/A	N/A	109.00
State Education Tax	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1,046.20
<b>TRANSPORTATION TAXES</b>								
Motor Vehicle Fuel & Weight Taxes	213.51	254.76	392.82	545.33	717.67	912.88	1,122.93	1,288.50
Aircraft Fuel & Weight Taxes	1.02	1.40	3.56	3.32	3.50	4.14	6.51	7.72
Watercraft Fuel & Registration Taxes	0.01	0.01	0.01	6.00	1.21	3.09	9.34	9.20
<b>Sub-Total</b>								
Earmarked Tax Revenues	\$526.44	\$642.27	\$986.75	\$1,503.89	\$2,277.19	\$2,953.00	\$3,668.28	\$9,215.63
<b>Percent of Total</b>								
Tax Revenues	59.1%	49.5%	43.2%	41.0%	38.3%	33.7%	33.4%	57.2%
<b>General Fund/General Purpose Revenues</b>								
<b>All Taxes</b>	\$363.84	\$654.96	\$1,295.15	\$2,166.21	\$3,662.36	\$5,814.09	\$7,321.44	\$6,895.91
<b>Percent of Total</b>								
Tax Revenues	40.9%	50.5%	56.8%	59.0%	61.7%	66.3%	66.6%	42.8%
Total Tax Revenues	\$890.28	\$1,297.22	\$2,281.90	\$3,670.10	\$5,939.54	\$8,767.10	\$10,989.72	\$16,111.54

\* Estimated tax revenues based on May 1995 Consensus Revenue Estimate figures.

Source: Various Michigan Department of Revenue and Department of Treasury reports.

the tobacco products tax to health care.

These earmarkings comprised less than one percent of total tax revenues in fiscal year 1995. However, because they are removed from the budget process, even during tight economic times when non-earmarked functions are subject to budget cuts, their continued funding seems to indicate a greater significance in the overall budget than, say, corrections or higher education.

### **When No Relationship Exists**

For the majority of the earmarked taxes in Michigan, a relationship does not exist between the tax and the purpose for which it is dedicated. Primary among these is the dedication of several taxes to the state school aid fund and to state revenue sharing. The 1946 sales tax amendment began both of these programs so that schools and local governments could enjoy a steady source of state funding. The intention was to remove state funding for these functions from the budgetary process, lest budget makers cut their funding.

Since that time, the state school aid fund and state revenue sharing have grown to become a major portion of the state budget. In the early 1960s, tax revenues earmarked to school funding and state revenue sharing comprised 37 percent of total state tax revenues. By 1995, these revenues had grown to 49 percent of total tax revenues.

### **School Aid Fund Revenues**

Over time, tax dedications have continued to ensure a minimal level of state funding of schools. Because there is no relationship between the tax revenues and the need for school funding, state school funding has been driven by a school aid formula rather than the level of dedicated revenues. As a result, new taxes have been imposed and general fund revenues have been used regularly to supplement tax revenues dedicated to the school aid fund.

Two conclusions can be drawn from these practices. First, it is possible that the amounts spent would have been spent with or without earmarking. Additionally, because there is still no relationship between the need for school funding and the incidence of taxation for the current taxes dedicated to the school aid fund, it is likely that additional taxes or general fund revenues, or both, will be needed in the future to fund schools. The reality of this fact is already evident. On November 11, 1995, Public Act 194 was signed into law, increasing from 14.4 percent to 23.0 percent the amount of personal income tax revenues earmarked to the school aid fund.

### **Unrestricted State Revenue Sharing Revenues**

The lack of a relationship between local government needs and the incidence of taxation is evident in two ways regarding state revenue

sharing. First, there is no relationship between the aggregate amount dedicated to state revenue sharing and the aggregate unfunded needs of local governments. If the amount earmarked from each tax bore some relationship to need when the earmarking began, such a relationship no longer exists. Second, there is no relationship between the amount of state revenue sharing distributed to an individual local governmental unit and the needs of that local government or to what that local government would have received if they levied the tax. Instead of a measure of need, distribution is based on population and relative tax effort.

### **Conclusion**

During the late 1950s and early 1960s in Michigan, there was a strong relationship between the incidence of the majority of the earmarked taxes and the purposes for which the revenues were dedicated. Currently, such a relationship exists for only about 25 percent of all earmarked taxes. Today, approximately 60 percent of state tax revenues are effectively removed from the budget process by earmarking. This will make it more difficult to reallocate funding priorities, should that become necessary. It also takes decision-making responsibilities out of the hands of those elected to make such decisions.

Table 4

## Michigan State Tax Earmarking Provisions, Fiscal Year 1995

**School Aid Fund***60% of original 4% Tax + 100% of add'l 2% Sales Tax Revenues*

100% of 4% Liquor Excise Tax Revenues

14.4% of Personal Income Tax Revenues<sup>1</sup>

100% of Real Estate Transfer Tax Revenues

*100% of additional 2% Use Tax Revenues*

63.4% of Cigarette Tax Revenues

94% of Non-Cigarette Tobacco Products Tax Revenues

100% of State Education Tax Revenues

**Unrestricted State Revenue Sharing***15% of original 4% Sales Tax Revenues*

6.91% of Personal Income Tax Revenues

\$9.5 million of Intangibles Tax Revenues<sup>2</sup>

About 13% of Single Business Tax Revenues

-----**Health Care Funds**-----**Health Care of Residents of Michigan***6% of Tobacco Products Tax Revenues***Health and Safety Fund**

4% of Tobacco Products Tax Revenues

**Local Health Departments**

1.3% of Tobacco Products Tax Revenues

-----**Transportation Funds**-----**Michigan Transportation Fund (Motor Vehicle Related)***100% of Gasoline Tax Revenues**100% of Liquefied Petroleum Gas Tax Revenues**100% of Motor Carriers Fuel Tax Revenues**100% of Diesel Fuel Tax Revenues**100% of Motor Vehicle Weight Tax Revenues**100% of Motor Carriers Privilege Tax Revenues***Non-Motor Vehicle Related Funds****Aeronautics Fund***100% of Aviation Fuel Tax Revenues**100% of Aviation Registration Tax Revenues***State Waterways Fund**

17.5% of Watercraft Registration Tax Revenues

**Harbor Development Fund**

33.5% of Watercraft Registration Tax Revenues

-----**Other Funds**-----**Liquor Purchasing Revolving Fund**

100% of 1.85% Liquor Specific Tax Revenue

**Local Governments**

27.5% of Horse Race Wagering Tax

**Convention Facilities Development Fund**

100% of 4% Liquor Specific Tax Revenues

<sup>1</sup> Personal Income tax revenues earmarked to school aid fund increased to 23 percent for fiscal year 1996.<sup>2</sup> Intangibles tax revenues have not been appropriated for state revenue sharing since fiscal year 1992.*Constitutionally dedicated tax revenues are italicized.*