

BRIEFINGS

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Uncertainty Makes Amendment 5 a Bad Bet for Florida

The “tax swap” will likely be a tax increase

Amendment 5, if approved by Florida voters this November, would replace the required local effort school property tax set by the legislature with a combination of sources, relying mostly on increased sales taxes and anticipating a substantial increase in the base of what is not currently taxed. The constitutional amendment would also provide a 5% assessment cap for non-homestead property, lowering it from its current limit of a 10% annual increase.

Required local effort (RLE) is the property tax that the legislature requires school districts to levy in order to participate in the state’s school funding program. The amount of RLE is set each year by the legislature in the General Appropriation Act. The legislature mandated that the local school districts raise a statewide total of \$8.3 billion in RLE for 2008-09.

Amendment 5 is being brought to the voters by the Florida Taxation and Budget Reform Commission (TBRC), a constitutionally created commission that meets every 20 years to assess the state’s tax and budget policy. The amendment arose when the commission’s desire to do something about property taxes converged with the desire of some members to repeal many sales tax exemptions and create a services tax. The result was an amendment that would provide substantial local property tax relief for Floridians (25% statewide average) in exchange for an increase in other state taxes. It was envisioned to be a revenue-neutral “tax swap,” but a close examination of the amendment reveals that it is likely the legislature will have to raise taxes in excess of the property tax cut.

Since Florida TaxWatch had an important role in drafting the creation of the TBRC and encouraging the voters to adopt in 1988, it has closely followed the work of both the previous Commission and this one. This BRIEFING is the first in a series of reports on the proposed constitutional amendments offered by the Commission.

Required local effort has been a major contributor to the increased property tax burden in Florida in recent years, which has more than doubled since 2000. As Florida TaxWatch has noted for many years, the legislature has included an RLE property tax increase in every recent budget, and RLE has become an increasingly larger portion of school funding. The process of setting the RLE millage rate is also not as transparent as other local government millage rates. For these reasons and others, Florida TaxWatch has recommended reductions in RLE as the best way to give equitable property tax relief to all taxpayers; however, eliminating it all-at-once and

leaving a multi-billion dollar hole – to be filled in yet unspecified ways – raises significant concerns. Amendment 5’s proposed solution is worse than the problem.

It is difficult to truly evaluate the “before and after” of Amendment 5 because there is so much uncertainty. The swap does not take place for two more years and the dire economic challenges that Florida is experiencing put Florida’s economic future at greater risk when it can least afford it. Among significant unknowns are: the amount of taxes that the legislature would have to raise, what the tax package would look like, and whether there will be additional spending cuts on top of the billions of dollars worth of cuts to core services during the past two years. Enough is known, however, for Florida TaxWatch to conclude that Amendment 5 would not be in the best interest of the taxpayers and citizens of Florida.

Beginning with the FY 2010-11 budget, Amendment 5 would replace RLE funding through one or more of the following options: 1) eliminating exemptions from the sales tax; 2) raising the sales tax rate up to an additional one-cent (from 6 to 7 cents on the dollar); 3) state spending reductions or revenue increases resulting from economic growth due to property tax reductions; and 4) “other revenues identified or created by the legislature.” The requirement of taxing services was specifically amended out of a previous version of the proposal by the TBRC, although it still remains an option for the legislature to raise the needed revenue.

This proposal would affect only the RLE; other school property taxes, such as the constitutional voter approved millage or the discretionary millage authorized by the legislature, can continue to be levied by all of the 67 school districts.

How Much Needs to Be Replaced?

The precise amount of new revenue that the legislature will have to raise is unknown. While the amendment says that the legislature shall “replace the revenue impact of the elimination of required local effort,” that amount is not defined. More pertinent is the requirement for an “education hold harmless amount.”

The RLE is a component of the Florida Education Finance Program (FEFP), which is the primary funding mechanism for the operating costs of the state’s K-12 school districts. Revenue comes from both state appropriations and local property taxes. In the current FY 2008-09 budget, the state appropriated \$8.605 billion for the FEFP. While not an actual appropriation, the legislature also annually sets in the budget the total dollar amount of RLE property taxes that must be raised locally. This year, the amount of RLE is \$8.267 billion.

In an effort to help ensure that state dollars currently being used for the FEFP were not used to help replace the RLE, the TBRC added the “education hold harmless amount” to the amendment. It requires that the amount “appropriated and set” for FEFP in the 2010-11 budget be no less than the amount in the 2008-09 (current) budget, increased for growth in the previous two years.

The amount in the current budget for FEFP (total state appropriation and RLE) is \$16.9 billion. Adjusted for growth as specified in the amendment, the education hold harmless amount in

2010-2011 would be \$19.7 billion. The current state appropriation is \$8.6 billion, so if the RLE is eliminated, the state will have to find an additional \$11.1 billion in state revenues to fill the hole.

Normal general revenue growth in the next two years could help bring that amount down if the legislature increases the state's FEFP contribution; but nothing is assured in these very uncertain economic times. Florida has just gone through another series of multibillion dollar reduced revenue forecasts, leaving the state with less money to spend in two consecutive years – an unprecedented occurrence in the Sunshine State. The most recent estimate predicted growth of 7-8% to resume in the next two budget years, increasing revenues by \$1.76 billion in FY 2009-10 and \$2.17 billion in 2010-11 (the year the tax swap would take effect).

However, the forecasters warned there was considerable downside risk to the last estimate and it has already proven to be overly optimistic. After state economists reduced already-lowered revenue estimates for the FY 2007-08 and FY 2008-09 by almost \$3 billion in March 2008, actual collections during the next three months (March, April, May 2008) still came in \$263.9 million under these reduced estimates.

Then came more bad news. The state's Consensus Estimating Conference met recently (July 15) to adopt a new Florida economic forecast – which will be the basis for the next general revenue estimate. The Conference reduced estimates in every major area (income, jobs, housing starts, and population) throughout the period of the short-term forecast (through FY 2011-12).

Therefore, it appears likely that the next forecast will again reduce estimated revenues. The forecasters say that normal economic growth will not return to Florida until the second half of FY 2009-10; about the time the legislature would be making final decisions on how to replace the RLE. They further warn: “virtually all of the risks remain to the downside.” This means it is very doubtful that the future will be better than anticipated, but it could be much worse.

There will not be substantial additional revenues for the legislature to plug into the FEFP in the short-term. Even the current, optimistic estimated additional revenue would not be that much to work with, considering the overall size of the Florida budget (over \$66 billion in FY 2008-09). Furthermore, K-12 education will need to compete for funding in the budget with other core functions and essential state services – such as Medicaid, children and family services, services for vulnerable citizens, universal pre-kindergarten, universities and community colleges, public safety, and the state court system – which have experienced billions of dollars in spending cuts. The state budget passed by the 2008 Legislature is almost \$6 billion less than the one passed during the 2007 General Session.

Even if the current appropriation for the FEFP (which comes almost entirely from general revenue) increases by the same growth rate as estimated total general revenue collections during the next two years, it would still take \$9.7 billion in new revenues to reach the education hold harmless amount required by Amendment 5. Moreover, there is no guarantee anything in the state budget will receive significant funding increases in this difficult revenue environment. In fact, the state appropriation for the FEFP was reduced by \$1.2 billion this year (while RLE was increased by \$358 million). It must also be remembered that another reduction to total FEFP

funding would not reduce the “hold harmless amount,” meaning the amount of new revenue required by Amendment 5 would be even greater.

Clearly, the inclusion of the education hold harmless provision in Amendment 5 changes the plan from a “tax swap” to a probable *net tax increase*, which could reach nearly \$3 billion.

Where Will The Money Come From?

The need for as much as \$11.1 billion to meet the requirements of Amendment 5 raises the question as to whether the options specified in the amendment are sufficient to replace revenues currently raised by the RLE. The wording of the amendment basically leaves it up to the legislature to do whatever it decides. The amendment says that the legislature will replace RLE “with one or more of the following options” and one of those options is “other revenues identified or created by the legislature.” Despite this flexibility, it is clear the intention was to use the sales tax, by increasing the rate by (up to) one percentage point (one-cent) and eliminating billions of dollars worth of current exemptions.

The original math used by the proponents was simple: Replace the RLE – which was just under \$8 billion at the time – with (1) a one-penny sales tax increase worth almost \$4 billion and (2) \$4 billion from “closing some of the tens of billion of dollars of sales tax loopholes.”

However, the much larger amount of revenue required by Amendment 5, combined with a clearer understanding of the two sales tax increase options reveals that the legislature will have to find significantly more, yet unidentified, tax sources.

The TBRC used \$3.9 billion as the value of a one-penny sales tax increase in FY 2007-08, which comes from the *2007 Florida Tax Handbook* produced by the legislature. Revenue estimates have been revised since then and the current reductions in the state’s official estimates bring that number down to \$3.3 billion. Under current projections, the additional one-penny will not be worth \$3.9 billion until 2010-11. Furthermore, the additional sales tax would probably not produce that much revenue for the legislature to use since the *Tax Handbook* cautions that the estimate DOES NOT account for decreased demand and reduced collections due to a tax or price increase. It must also be recognized that a portion of sales tax collections are diverted to specific uses, including local governments through revenue sharing schemes. In fact, only 89% of the 6% Sales and Use Tax collections go to general revenue. Additional statutory changes would be necessary to have 100% of the sales tax hike go to replace RLE. How much a one-penny sales tax increase would bring in is uncertain, but it would likely produce far less than half of the needed replacement revenue, and perhaps as little as one-third.

The lack of sufficient revenue from the one-penny sales tax to satisfy the funding requirements of Amendment 5 would put a lot of pressure on the legislature to repeal sales tax exemptions and tax previously untaxed services. The amendment excludes most (in terms of dollar value) of the \$12.4 billion in exemptions from consideration, including food, prescription drugs, residential rent, and utilities. Using estimates from the *2008 Florida Tax Handbook*, removing the exemptions prohibited from repeal by the amendment leaves only \$4.1 billion of exemptions for

the legislature to consider for taxation. It is important to note, however, that the value of the various exemptions are just estimates. In fact, the *Handbook* cautions that there is overlap among the exemptions and that repeal of numerous exemptions may not produce the full value of the individual estimates.

The \$4.1 billion figure includes a significant amount of structural exemptions that are not likely to be repealed (and some of which cannot, by federal law, be repealed), not to mention exemptions for school textbooks and lunches, agriculture, and other popular exemptions. The estimate also includes \$100 million in credits, collection allowances, and subsidies that do not qualify as exemptions. Three of the largest exemptions remaining illustrate how difficult it will be to raise anywhere close to \$4 billion by the repeal of sales tax exemptions: the exclusion of purchases by governments accounts for \$468.2 million; metered water represents \$305.4 million; and the value of trade-ins and discounts (i.e., the value of trade-in vehicles applied to new vehicle purchase and coupons) is worth \$542.0 million. These exemptions are hardly “special interest loopholes.”

The remaining exemptions also include many important ones that promote economic development. Economists believe it is critical to employ a tax system that both encourages economic growth and generates revenue from economic growth. In other words, Florida’s tax structure should encourage productivity – not tax it – while generating revenue from consumption. Florida TaxWatch has found that a number of these exemptions, especially those for inputs-to-production and incentives for developing industries, are important for fostering a competitive and robust economy in Florida. These include exemptions for machinery and equipment for new and expanding businesses, electricity used in manufacturing, research and development, cogenerated energy, the space industry, and the film industry. These and other exemptions have been cited by the state’s economic development arm – Enterprise Florida – as being critical to successful economic development in Florida. Forcing the legislature to repeal a significant portion of current exemptions is likely to produce some counterproductive results. This forced action could harm Florida’s economy at a most inopportune time – as it attempts to begin to reverse a severe economic downturn.

A 2003 Florida TaxWatch Task Force found that there were less than \$1 billion (updated to 2008) worth of exemptions that did not fit into three categories that should not be repealed: (1) life’s necessities, (2) structural, and (3) economic development. The remaining exemptions include some that Amendment 5 takes off the table and others that may have tax administration or social considerations that may contraindicate repeal.

A close examination of the sales tax system highlights the fact that the assertion that there are billions of dollars of exemptions that are “unjustified loopholes” is incorrect. Because of this fact, the wording in Amendment 5 will make it difficult to repeal exemptions; the language of the amendment limits the repeals to those exemptions “which are determined not to advance or serve a public purpose.” This limitation sets a high bar and could provide a basis for legal challenges to the repeal of exemptions. Even the TBRC’s staff analysis of the proposal (Constitutional Proposal 02) that become Amendment 5 states: “One could argue that nearly all exemptions serve some public purpose.”

It must be noted that if the legislature raises the sales tax a penny, the estimated value of exemptions will increase by as much as 16.67 percent. Still, it is doubtful that the legislature will raise more than \$1 billion to \$2 billion from repealing exemptions, which means that, even coupled with a one-penny rate increase, the legislature will still have to find much more money – perhaps as much as \$5 billion to \$6 billion. The option of “revenue increases resulting from economic growth attributable to property tax reductions” is likely not going to help. It would be very difficult to identify such revenue with any reasonable degree of accuracy and, furthermore, no enhanced economic activity will have occurred when the time comes to make decisions on how to fund the “swap” (since any “revenue increases resulting from [the] property tax reduction” would be realized after the “swap” was already implemented and the necessary replacement funds already found). Additionally, the negative impacts on economic growth and revenues resulting from increasing other taxes should also be considered in determining any resulting net “revenue increases.”

Finally, while targeted state spending reductions should always be the first option explored, with billions in budget cuts already implemented and more potentially on the way, this option may not produce much more available money in the state budget. Moreover, the cuts made to date have dramatically affected the provision of services to the citizens of Florida. If additional spending reductions are necessitated by Amendment 5, and similar across-the-board cuts are made rather than targeted cost-savings measures based on a thorough and thoughtful consideration of government efficiency, these additional funding cuts to core services could jeopardize services provided to vulnerable citizens, actually reduce total education spending, and undermine the rule of law by slashing funding for the state court system.

Does Amendment 5 = A Services Tax?

The need for more revenue raises the specter of taxing services, something even most TBRC commissioners oppose. But taxing services was the intention of the proposal’s sponsor. The initial version of the tax swap required the legislature to replace the RLE by repealing exemptions and taxing services.

During the TBRC’s consideration of the proposal, there was significant opposition to taxing services from many members of the commission and the explicit mention of it was removed; but it was not prohibited. Some commissioners who voted for the amendment were convinced that revenue replacement could be accomplished with just a sales tax rate increase and repeal of some exemptions, which is a prospect that now appears unlikely. Other commissioners take the position that the current legislative leadership would never let a services tax happen. They are right that there is very little legislative support for taxing services, but they were wrong to assume that it could never happen.

If the legislature still finds itself in a multi-billion dollar hole after exhausting the options provided in Amendment 5, there are not many options for raising the additional billions of dollars that will be required. The \$22 billion sales tax dwarfs the state’s other tax sources. The next biggest tax is the \$2.4 billion on motor fuel, which has been historically reserved for transportation funding. Given the situation, it will be hard for the legislature to ignore the

potential for \$24 billion from taxing services (at 6%), which includes the \$7.6 billion in services that the state already tried taxing back in 1987 (a move which lasted only six months before being repealed and replaced with an increased sales tax rate).

Despite the significant opposition to a services tax, Amendment 5 undoubtedly puts this option into play. The amendment does not address taxing services, but due to the magnitude of the revenue required, the legislature would be compelled to consider taxing services. Thus, the prospect of a substantial services tax as a result of Amendment 5 is very real.

Economic Impact of Tax Swap

Proponents of Amendment 5 argue that a big property tax cut would be good for Florida's economy. By itself, it unequivocally would be; but Amendment 5 is not simply a tax cut. Past Florida TaxWatch research has shown that swapping property taxes for sales taxes dollar-for-dollar produces some negative economic impacts, due in part to the federal tax deductibility of property taxes. Since property tax payments reduce federal income tax liability, a dollar reduction in property taxes is not a dollar more in taxpayer's pockets.

Additionally, a lot of property in Florida is owned by non-Floridians; the TBRC economist conservatively estimates that 10-15% of residential property is owned by non-residents and that \$640 million of the tax savings resulting from Amendment 5 would "leak" out of Florida. These owners' reduced taxes will not benefit Florida as much as those of a Florida owner. While non-residents would pay a portion of an increased sales tax, the sales activity will occur in the state. The significant non-resident payment would apply mostly to the increase in the sales tax rate, which would only be a portion of the replacement revenue. The repeal of exemptions or the sales taxation of services would fall more heavily on Florida residents.

The TBRC economist's analysis of the tax swap supported this finding, predicting a significant loss of jobs (an average of 47,000 jobs annually), gross state product, and disposable income from this tax swap. At the request of the proposal's sponsor, another economist (who has consistently promoted a tax on services) was commissioned by the TBRC to do a subsequent analysis, which contradicted the first assessment, primarily by predicting an \$80 billion increase in property values. The Commission's original economist, while stating they could not find any empirical evidence that such a property value increase would occur, added it to their model. Even after making considerable, favorable adjustments, the revised economic analysis still found that Amendment 5 would harm Florida's economy.

If the taxation of services were added into the economic analysis, the negative impacts would likely be exacerbated. In 2003, the Florida TaxWatch Task Force on Tax System Modernization took a close look at sales tax exemptions and the potential taxation of services. Florida TaxWatch and Florida State University economists found that applying the sales tax to services was a questionable economic move and that taxing certain sectors would result in significant net losses in jobs, gross state product, and personal income of Floridians.

An important point to note is that both TBRC economists assumed a revenue neutral tax swap, meaning new taxes would equal the property tax cut. However, it now appears Amendment 5 would be a net tax increase, a development that would drive economic impact estimates in either analysis downward.

One more important economic consideration is the uncertainty that the passage of Amendment 5 would create within the business community, and the impact that uncertainty would have on Florida's business climate during the next two years. Business leaders and relocation experts have consistently noted that the most important feature of a state's tax system for an attractive business climate is stability and consistency – not dramatic uncertainty. Stability and consistency allow for good planning and the capital investment required to create jobs. Amendment 5 would add a lot of unknowns to business planning and investment in Florida. For the next two years, no one is going to know what Florida's tax system is going to look like beginning in 2010-11. All that is known is that property taxes will be reduced and Florida will be enacting the largest (by far) multibillion-dollar state tax package in its history. The 25% property tax reduction would be attractive to a business looking to relocate to Florida, a new or expanded Florida company, or even an individual considering moving to Florida; however, without knowing the alternative tax increases that will be implemented to finance the property tax reduction, they may very well not be willing to take the risk.

Other Concerns

Although Amendment 5 contains the “education hold harmless provision,” it nonetheless has significant implications for education funding. Most important, the FEFP must be held harmless **ONLY** in the first year after implementation of Amendment 5. After year one, K-12 will have to compete with other education entities, as well as other state priorities, for funding every year. Taking a dedicated funding source for public schools, like the RLE, and replacing it with general revenue would not be a good deal for Florida's school districts.

In the first year, the hold harmless provision could create serious budget woes for non-K-12 entities. This includes other education funding such as universities, community colleges, and early learning. Other budget areas, especially those that rely heavily on general revenue – Health & Human Services, Corrections, and the Courts – also face further cuts if legislators chose to use existing state dollars to help replace the RLE or if revenue collections do not meet estimates.

Since the decisions will be based on estimates and the amount of needed revenue is so large, it is unlikely that a package of \$11 billion in both state tax increases and budget cuts could be devised that has a high degree of reliability that it would raise the revenue necessitated by Amendment 5, especially in the first year. This puts school funding, and funding for the other functions of state government, at risk. This lack of reliability is especially true for new taxes that the state and taxpayers do not have as much experience collecting and remitting.

The difference between annualized estimates and first-year cash also means the legislature may have to enact tax increases with an annual value of more than what is needed to fully fund the FEFP in the first year of the swap. An example is a services tax. The *Tax Handbook* estimates

that annualized revenue from taxing services averages 33% more than the first-year cash receipts. This means the state would have to enact \$1.33 billion in annual services taxes to collect \$1 billion in the first year (when the hold harmless provision applies).

There are also concerns that the elimination of the RLE will allow for faster growth of remaining property taxes. After a big reduction in tax bills, county, city, and special district taxpayers may be more likely to accept, or at least be less likely to show up at the public hearing to object, when their local governments propose a property tax increase or even vote to override the recently enacted millage caps.

There is also nothing in Amendment 5 that prohibits increases in other non-RLE school property taxes or even the reestablishment of an alternate to the RLE. Sensing this omission, the TBRC amended the proposal to reduce the constitutional cap on school operating millage from ten to five mills. While this change ensures that nothing of the magnitude of RLE will reappear, there are still more than 2 mills of capacity that the legislature could tap for schools.

Lastly, having to enact as much as \$11 billion in new state taxes to simply replace a long-standing local revenue source will seriously reduce the flexibility the state has to meet any future revenue needs of its own. These new taxes will be several times bigger than anything the state has enacted before, but the new state revenues will not significantly enhance education, build more roads, provide better public safety, or insure more children.

What About the 5% Assessment Cap?

Almost lost in the growing debate on the tax swap is the fact that Amendment 5 would also create a 5% assessment cap for non-homestead property. This assessment limit would be similar to the 3% cap on homestead property provided by Save Our Homes (SOH), except that it would not apply to remaining school taxes and there would be no portability. If SOH is here to stay, a cap on non-homestead property is needed to slow the tax shift that has been crippling businesses, rental property, first time homeowners, snowbirds, and second homeowners. However, by itself, the same inequities and attendant legal challenges created by Save Our Homes for homestead properties would be created among non-homesteads. It would also result in a major shift of tax burden from the vast majority of taxpayers to properties not benefiting from this proposal – e.g., new construction, first time homeowners, new Floridians, businesses that relocate or expand, and non-homestead residential property owners who move. There would be no portability, so businesses that relocate would be responsible for taxes on the full value of the new property. These higher taxes on new construction and business relocations could have a negative effect on commercial real estate and result in significantly different tax bills for similarly situated businesses, which raises competitiveness concerns. Capping non-homestead property will also result in greater property tax growth for those who have been benefiting under Save Our Homes, since the tax shift from homesteads to non-homestead will slow.

A better approach, as previously recommended by Florida TaxWatch, would be to couple a non-homestead assessment cap with a significant standard minimum exemption for all property, thereby reducing the impact on those not immediately benefiting from the cap.

Conclusion

Amendment 5 is a far-reaching attempt to reduce the burden of required local effort (RLE) property taxes without reducing school funding; however, this approach could have serious consequences for taxpayers, the state's economy, Florida schools, and the state budget.

It now appears that it is not a revenue-neutral "tax swap," but will instead likely be a multibillion-dollar net tax increase. The \$8.3 billion reduction in property taxes could require as much as \$11.1 billion in new state revenue to satisfy the "education hold harmless provision."

The economic impact of replacing property taxes with sales taxes is at best debatable and at worst detrimental. Additionally, the uncertainty that the amendment will cause would discourage investment in Florida – at least until the details are worked out in 2010 (more than one year from its passage in November 2008).

Florida's history with making tax changes to raise specific revenue amounts, instead of because they are the right long-term changes, should give pause. The unitary tax, the services tax, and the alcoholic beverage surcharge are examples of what happens when only revenue considerations drive tax changes. In each instance, it was quickly realized that a mistake had been made and all three taxes were subsequently repealed.

The pressure to repeal exemptions could result in the state losing valuable economic development tools that better enable Florida's businesses to compete successfully in an increasingly global economy, thereby harming the business climate and hurting the state's economic competitiveness. Even with the repeal of most available exemptions, it is doubtful that the specified options for replacing the RLE would be sufficient. Even if the legislature employs other, as yet unspecified, options, it is unlikely that a revenue package of up to \$11 billion in new and added state taxes could be put together that has a high degree of reliability, let alone certainty, that it would raise the required revenue.

The magnitude of these new state taxes would dwarf any other revenue hike in Florida's history. Florida's economy is facing one of its strongest challenges since the Great Depression. The economic/fiscal future is uncertain. Forcing the legislature to make major unspecified changes to the state's tax structure at this time and in this manner is a very dangerous proposition.

Florida TaxWatch concludes that the passage of Amendment 5 in November would be detrimental to Florida's economy, future, and people.

This *Briefings* was written by Kurt Wenner, Director of Tax Research.

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Florida TaxWatch's research recommends productivity enhancements and explains the statewide impact of economic and tax and spend policies and practices on citizens and businesses. Florida TaxWatch has worked diligently and effectively to help state government shape responsible fiscal and public policy that adds value and benefit to taxpayers.

This diligence has yielded impressive results: in its first two decades alone, policymakers and government employees implemented three-fourths of Florida TaxWatch's cost-saving recommendations, saving the taxpayers of Florida more than \$6.2 billion -- approximately \$1,067 in added value for every Florida family, according to an independent assessment by Florida State University.

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