Special Report

February 2002

Tax Reform Proposal's Claims Questionable
Revenue Neutrality: Just an Illusion?

The tax reform debate is raging. The Florida Senate's plan to reduce the sales and use tax from 6% to 4.5% and expand the tax base (mostly by adding services) has bitterly divided opponents and proponents.

The initiative to lower the tax rate and broaden the base has given new life and a heightened visibility to the debate over how to modernize Florida=s tax system. However, while a comprehensive, informed tax debate would be good for Florida and its citizens, this has given way to a climate of acrimony and sound-bite mentality. The true impact of the proposal has yet to be determined. The economic assumptions upon which the claims for revenue neutrality and changes in tax incidence on households and businesses need more clarification, consensus and verification. The long-term, far-reaching economic impact of this major shift in tax policy has not yet been assessed.

Revenue Estimates and Revenue Neutrality

There has been much talk about how the new tax proposal is to be "revenue neutral." That is, the new tax structure should raise no more revenue than the old tax structure would raise. CS/SJR 938 states: "To ensure revenue neutrality, general state sales and use tax revenue collected for state fiscal year 2004-2005, as estimated by the revenue estimating conference, must be no more than the amount of general state sales and use tax revenue collected during the prior fiscal year, adjusted by the average rate of growth in general sales and use tax revenues over the most recent five state fiscal years. The legislature shall enact general law, to be effective July 1, 2004 to implement this section and to ensure such revenue neutrality."

The term, revenue neutral, is illusive and its use in this debate largely disingenuous. Estimating the value of all the exemptions (and non-taxable items) from the sales and use tax is a difficult undertaking. While the state has been collecting taxes on the sale of tangible personal property since 1949, there is no historical data on taxing services. The estimates used in crafting the plan are likely "wide guesses" and should not be considered as any more than that. Devising such a major tax change to ensure revenue neutrality 2-3 years in the future--especially in these changing and uncertain times--may not be possible. Under the SJR, revenue neutrality will be predicated on the revenue estimating conference forecast as of July 1, 2004. This is, of course, before the first dollar of a new taxing scheme is collected. **If the estimates are wrong, and much more (or less) money is collected during the first year of the new**

taxing scheme, there is no remedy in the law. If there is any likelihood whatsoever that the proposal will result in a tax increase, then Florida voters should be so informed. Otherwise, the low level of trust and lack of confidence the public already has in public officials will be further eroded and take that much longer to regain.

Florida TaxWatch contends that the provision in CS/SJR 938 is not a true measure of revenue neutrality. Revenue neutrality should mean that the new tax structure should raise the same amount of revenue as the old oneCduring the same time period and under the same economic conditions. The proposal limits the revenue in the first year of the tax to the previous year adjusted for growth--not what the current tax would have been expected to raise. Changing economic conditions creating a large "blip"--up or down--in collections during any of the five years used to calculated growth, would have a significant impact on revenue neutrality, by tens or hundreds of millions of dollars. Using current estimates, the average growth during the first four years of that period is 3.6%, although the next Revenue Estimating Conference (REC) could assess higher estimates.

The state's Revenue Estimating Conference has generally done a good job in estimating annual general revenue. Since 1990, the average error (up or down) in estimated revenue compared to actual revenue has been 3% (2% since 1993). FY 2004-05 total sales and use tax collections (under current law) are expected to generate approximately $19 billion. A 3% error would equal $570 million. REC's largest error since 1990 was an overestimate of 9.2%. An error rate of 9.2 % could create a first-year tax revenue increase or tax revenue shortfall of $1.75 billion. Since 1971, there have been four instances of double-digit error. Add to the normal, expected error the difficulty of estimating the impact of removing exemptions and taxing services for which there is no reliable and consistent database, and a significant difference between estimated and actual revenue for FY 2004-05 is likely.

In addition, using the first year collections of such a major tax change to measure revenue neutrality does not fully reflect its revenue raising capacity. The new law will create significant compliance problems and costs, and a large amount of noncompliance should be expected. David Brunori writes in his book *State Tax Policy*, "Taxation of services would also increase administrative and compliance costs for both the government and taxpayers. Unlike products, many services do not leave a record of production and inventory. Tracking the quantity and value of services rendered is a daunting task." This will be the first time for many businesses to be collecting the tax, and experts have testified that there will be between 300,000 and 400,000 new sales and use tax vendors. The Department of Revenue will face additional challenges if the proposal passes: the hiring of new agents, new audits and new information systems.

It is expected that, after the first year, the proposed tax base will grow faster than the current one. As a result, revenue neutrality, even an illusory one, will certainly just be a one-year occurrence. This was borne out during debate of the proposed bill and joint resolution on the Senate floor, when claims of revenue neutrality were often followed by discussion of how the new revenue could help fund important government services.

Lastly, CS/SJR states that the sales and use tax changes do not depend on the enactment of implementing legislation to achieve revenue neutrality. If the tax revenues for the first year of the tax were forecasted to greatly exceed the revenue neutrality measure, the Legislature would have to decide which exemptions to add back. That would surely be a contentious issue, and one that could easily not find compromise. So, even if the 2004 Legislature did not pass a bill to achieve revenue neutrality, the tax changes would still take effect.

Economic Impact

The Senate President hired Fishkind & Associates, an economic consulting firm, to assess the impact of the tax proposal. The findings were presented at two committee hearings, January 8 (the original SJR) and January 24 (the CS/SJR 938 and the implementing bill). The presentation is posted on the Senate President=s web page.

This analysis concludes that Florida households will enjoy substantial tax savings and that most businesses will benefit as well. It estimates the total savings to Florida households at $1.4 billion ($227 per household) and estimates the savings to a Atypical small business@ of $375.

Florida TaxWatch has made repeated attempts to obtain or discuss the assumptions and calculations on which the findings are based, but to date, they have not been provided. Without such data, the findings cannot be judged "on the merits" and only have face value. Nonetheless, based on the limited information that generally was made available and other source information that Florida TaxWatch was able to identify, several points deserve further clarification

Impact on Small Business

Tax savings for a "typical small business" is estimated by Fishkind & Associates at $375. This is based on a business with $500,000 in expenditures and spending $175,000 on rent, utilities and supplies (currently taxable) and $50,000 on professional services (currently exempt.) Under the Senate plan, the analysis shows that business would save $2,625 on the 1.5% reduction in the tax on rent, utilities and supplies (6% to 4.5%) and pay $2,250 in new taxes on services. (4.5%). Therefore:

Total expenses	$500,000
Rent, utilities, supplies @35%	$175,000
Professional services @10%	$ 50,000
Reduced taxes on rent, utilities, supplies	$ 2,625
Increased taxes on services	$ 2,250
Tax savings	$ 375

Defining a Atypical business@ is difficult, and Florida TaxWatch has not been able to review the assumptions that resulted in the expenditure estimates

However, what is clear is that this analysis does not include the impact of local option sales taxes. These taxes, levied by counties, would also apply to the proposed tax base. Currently, 51 counties levy a local option sales tax, ranging from .5% to 1.5%. The majority levy 1%.

Even using the above assumptions, if the business in the analysis is in a county with a local option sales tax of 1% or more, that savings would be eliminated. That business would still save $2,625 from a 1.5% reduction in the total tax on rent, utility and supplies (7% - 5.5%) but the tax on professional services would now be $2,750 ($50,000 X 5.5%). **The result is a tax increase of $125.**

Reduced taxes on rent, utilities, supplies	$ 2,625
Increased taxes on services	$ 2,750
Tax increase	$ 125

A business in a county with a 1.5% local option (Escambia, Jackson, Monroe) would have a tax increase of $375.

CS/SJR 938 does require local governments to use increased sales surtaxes realized from the new law in 2004-2005 to reduce "ad valorem taxes or other local taxes or fees as provided by general law." Since such a reduction would most likely come mostly from property taxes, and since most of the savings in the Fishkind analysis comes from rent, that business would not benefit from ad valorem reduction (except on tangible personal property).

Since 51 counties have a local option sales tax, a lot of small businesses stand to have a tax increase under the plan, using the above assumptions. It must be noted that some large counties have no tax (Broward, Orange, Palm Beach) but many do (Hillsborough, Pinellas, Duval). Miami-Dade has a 0.5% tax. Approximately 59% of the population live in counties with a local option sales tax.

Another feature of local option sales taxes is a cap of $5,000 on the taxable price of tangible personal property, yet there is no cap on services. That too could reduce the tax savings a business might reasonably expect to receive.

Impact on Households

The Fishkind analysis estimates total tax savings for Florida households to be $1.4 billion, or $227 per household. It also shows savings in all income classes and age groups.

The analysis cites the Consumer Expenditure Survey (CSE), widely used data published by the U.S. Bureau of Labor Statistics, as the source document. The CSE contains average expenditures for "consumer units" in various categories, both for the nation and various regions. It appears that the analysis used year 2000 data and the national average instead of the southeast region (which may in fact be a more accurate choice). There is a number of limitations to using this data in such an analysis, but it may be the best source of readily-available data.

Using the CSE, Florida TaxWatch attempted to replicate the analysis results. Many of the expenditure categories contain both taxable and non-taxable items. Without the analysis=s assumptions or other data used in making the determination of what to include, one cannot determine if the estimates are reasonable.

For example, the analysis shows current sales and use taxes paid per consumer unit of $1,071. That implies taxable purchases of $17,850. In order to build a group of expenditures that reached that amount, one must include several categories that likely included non-taxable purchases as well.

It is important to note that any savings realized by individuals will be, at least partially, offset by higher prices. The Fishkind analysis acknowledges this fact, but does not quantify it. It states that most sales and use taxes incurred by business will ultimately be passed on to consumers in pricing but that pass-through is likely to be much less than 100% because businesses can deduct sales and use taxes and some purchases are made by out-of-state residents.

Another point that needs to be made is that a large portion of the expenditures in the CSE data come from vehicle purchases and other major non-frequent purchases such as appliances and furniture. Since the CSE uses averages, whether or not a household makes such purchases in a given year will impact the reduction in sales and use tax they will enjoy. Vehicle purchases alone provide more than $50 of the average tax savings. If a household does not buy a vehicle in a given year, it will not realize those savings. Of course, conversely, someone who does buy a car, particularly a new one will likely save more in that particular year.

Local option sales taxes will also impact household savings. No one should enjoy a reduction in local option sales taxes paid since there is no change in the rate. However, anyone who purchases items or services not previously taxed will have a tax increase. It is estimated the new tax system will increase local option taxes by $325 million. As mentioned previously, the SJR instructs local governments to provide tax relief to offset that amount. If that relief is provided through property taxes, the sales tax increase will be shifted to citizens and businesses that do not own real property.

Conclusion

It is highly unlikely that the Legislature can craft a new taxing scheme that is truly revenue neutral. In addition, the important questions of the fiscal impact and long-range economic impact of such a fundamental change in tax policy cannot be answered in confidence in just one legislative session. If all households and most businesses are going to benefit from tax savings, who is going to pay? It is now clear that tourists will also benefit.

There are also major concerns about using Florida=s Constitution as the vehicle for major tax reform (see Florida TaxWatch Special Report "A Tax on Services Does Not Belong in the Constitution," February 2002). The Legislature should not abdicate its responsibility on such a weighty matter nor tie the hands of future lawmakers who will face so many uncertainties in the new economy. Also, by setting in stone the rate reduction and the repeal of all exemptions except groceries, health services, prescription drugs and residential rent and then leaving it up to the Legislature to enact $9 billion worth of exemptions to make it revenue neutral is a dangerous course. One can only be sure of what is in the Constitution. Statutory exemptions may or may not pass and can change from session to session. But with the repeal of exemptions set in the Constitution, the people of Florida cannot be sure what tax reform will truly look like.

Florida TaxWatch will continue to study the proposal, and tax reform in general, regardless of what happens to the Senate plan during this session.

The Fifth in a series of *Special Reports* on Modernizing Florida's Tax System
By
The Center for a Competitive Florida

This *Special Report* was written by Kurt R. Wenner, Senior Research Analyst,
under the direction of Keith G. Baker, Ph.D., Senior Vice President and Chief Operating Officer.
Steven L. Evans , Chairman; Dominic M. Calabro, President and Publisher.

For more information on this or any TaxWatch report,

E-Mail: .

Return to the TaxWatch main page.