

The Florida Center for Fiscal & Economic Policy

Proposed Constitutional Amendment 5 “The Tax Swap”

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The Florida Commission on Taxation and Budget Reform meets every twenty years and this spring it met for the second time since its creation. The Commissioners held public meetings around the state, heard testimony from experts and state officials, and examined and debated a number of member proposals in response to their mission. One proposal that was adopted after extensive modification from its original form, and will be voted upon in the November general election is a proposed change to the Florida Constitution called Amendment 5. Commonly referred to as “the tax swap” proposal, Amendment 5, if voted upon favorably by at least a 60% majority, will:

1. Eliminate the required local effort (RLE) for public school financing that is generated from ad valorem property taxes effective FY 2010 - 2011. The RLE is established and set by the Legislature as part of the Appropriations Act. The RLE in FY 2008 - 2009 is \$8.3 billion, or about 45% of all dollars funding K-12 schools.

2. Require the Legislature to substitute state revenues for the RLE using an unspecified combination of one or more of the following:

- Repeal sales tax exemptions (although a number of exemptions are off limits, such as exemptions for food, prescription drugs, residential rent, and utilities; and exemptions may only be repealed if they are determined “not to advance or serve a public purpose”).
- Increase the sales tax rate by up to one penny, from six cents to seven cents.
- Reduce or eliminate dollars from the state budget and reallocate them to the public school budget.
- Use other revenues, such as from repeal of the exclusion of services from the sales tax. Or use dollars that might be generated from economic growth “attributable to lower property taxes.”
- Institute new taxes.

3. Require the Legislature to hold the funding for education “harmless,” adjusted for potential growth, in FY 2010 - 2011, when the RLE is eliminated. This provision could require the Legislature to identify substitute state revenues of up to almost \$3 billion more than the \$8.3 billion RLE set in the FY 2008 - 2009 appropriation for a total obligation that could be around \$11 billion. It is important to note that the “hold harmless” provision for education funding is applicable to only one year – FY 2010 - 2011, the same year the RLE is permanently abolished.

4. Lower the cap on the ad valorem property tax rate for education not subject to a vote, which acts to decrease the dollars local officials can raise not subject to a referendum from property tax increases that may be needed for educational improvements financed through local dollars (i.e. the Discretionary Local Effort).

5. Restrict the annual growth in assessments of non-homestead properties for purposes other than funding education to a 5 percent cap which may act to reduce local dollars that can be raised for needs in other local public services.

Key Findings

- *Amendment 5 aims to reduce property taxes and instructs the Legislature to raise other taxes and/or reallocate the budget to replace them.*
- *Property taxes have been increasing in large part because the state has been cutting back on its share of its support for education and shifting education costs to the local property tax (RLE).*
- *Although Amendment 5 appears to guarantee funding for schools from state sources, it does so for only one year (Fiscal Year 2010 - 2011). The Legislature needs to increase its investment in public education instead of “holding education funding harmless,” which will actually cause harm.*
- *Moreover, the specifics of Amendment 5 are unclear as to how the Legislature will cover the approximately \$11 billion gap in property tax revenue that passage of the amendment will leave for financing Florida’s public education.*
- *If the Legislature chooses to not raise taxes and elects to reallocate the funds used for other state programs to fund the gap in property taxes Amendment 5 would create, the “cuts” will have to be extremely deep. In today’s dollars, if no new taxes were to be enacted, the Legislature would have to reallocate or “cut” approximately 44% of the total general revenue portion of the state budget to fund this gap!*
- *Amendment 5 is like “buying a pig in a poke” that may not contain a pig at all, but perhaps a snake or something else.*
- *More thoughtful, long-term approaches need to be undertaken to carefully examine the state’s tax structure and reduce its regressive impact on low- and moderate-income individuals, and at the same time, correct inequalities with property taxes.*

Discussion

In weighing the merits of Amendment 5 a number of questions should be considered and discussed:

- Have property taxes increased and what is causing the increase?
- Should property taxes related to the RLE be reduced and be replaced with other tax revenues, such as new taxes, an increase to the sales tax, repeal of sales tax exemptions and/or repeal of the exclusion of services transactions?
- Does the “hold harmless” formula in Amendment 5 truly hold education harmless?
- How much money will the Legislature have to add to its K-12 education expenditures to substitute for the RLE and the hold education harmless provision of Amendment 5?
- Will the Legislature be able to find other revenues (up to \$11 billion) through enacting new taxes without cutting the budget for state services beyond the amount it has already been reduced in the past three years?
- What will the effect be if the Legislature chooses to cut the state budget to find the substitute revenues?
- To the extent that the Legislature opts to repeal any sales tax exemptions or establish other taxes, what happens if there are legal challenges?
- Will lower property taxes really result in economic gains and, if so, will any increases to revenues be collected in time to use them?
- Will the replacement of local-state cooperative participation of public school financing to a system with mostly state financial responsibility have an impact on local control and oversight of public schools and move more authority to Tallahassee?
- Is a “swap” the correct solution for concerns about property taxes, or are there other alternatives that should be considered instead?
- Should Florida examine and reform its current tax structure?

Have property taxes increased and what is causing the increase?

Property taxes in Florida are on the rise because local governments — which are funding mostly by property taxes — have been picking up a rising share of the cost of providing services and meeting state mandates. Between 1999 and 2005, property taxes at the local level increased \$11.4 billion, or by about 78%. Tax collections for schools grew \$4.2 billion (about 37% of the total increase) during that period, the most of any category of local government. However, 64% of the increase for schools was attributable to the Required Local Effort; an amount established and set by the Florida Legislature.¹

The relative contribution of state dollars to local dollars for school funding has shifted over the past ten years to increase the local share. Since FY 1997 - 1998, the local share has risen from 40.5% to 50.5% in FY 2006 - 2007. Funding for K-12 schools increased by \$13.2 billion between 1997 and 2007, but only 29% of that amount came from state general revenue. Approximately 68% of the increase was derived from local taxes and the remainder was federal dollars.² The RLE has grown from \$3.646 billion to over \$8.267 billion (127%). This decline in relative state funding and shift to local dollars for school funding has forced an increase to local property tax obligations.

In addition, local governments have assumed more financial responsibility in other areas of public services, especially indigent health care, costs that have increased due to inflation and population growth. These factors also affect property tax increases. For example, law enforcement and corrections had a combined increase of almost \$1 billion between the years 1999 to 2005, which accounted for nearly one-third of the 78% increase in county property taxes.³

Should property taxes related to the RLE be reduced and be replaced with other tax revenues, such as new taxes, an increase to the sales tax, repeal of sales tax exemptions, and/or repeal of the exclusion of services transactions?

Impartial studies of Florida’s tax structure have found that it is very regressive because it relies substantially on consumption, or sales taxes. Consumption taxes are regressive because lower-income individuals consume a larger share of their income than higher-income individuals; individuals with higher incomes save more of their income and also spend more of their income out of state. In addition, Florida taxes primarily tangible goods, while higher-income individuals spend a greater proportion of their income on services rather than goods when compared to the spending patterns of those with less income. One revenue source that Amendment 5 “suggests” the Legislature consider as a replacement for the RLE - a one-cent increase in the state sales tax - would worsen the regressive nature of the state’s tax structure, thereby adding to the financial burden of lower and moderate income individuals.

It should be understood that increasing the sales tax rate may encourage tax avoidance which, coupled with uncertainties regarding

when Florida's economy and unemployment rate will improve, is likely to generate lower than estimated revenues. Current transactions exempted from sales taxes should certainly be examined. However, Amendment 5 excludes a number of categories and requires that any item considered for repeal first be determined to not "advance or serve a public purpose," which arguably is applicable to everything else or at least that will be the prospective of the special interests. Serious questions persist about the political will to repeal the exclusion of service transactions. New taxes can and should be considered, but such an examination should be based on a number of factors, including the merits and fairness of enacting a new tax, but not as a means to fill a revenue hole of such magnitude.

Does the "hold harmless" formula in Amendment 5 truly hold education harmless?

Funding for Florida's public schools ultimately should be increased rather than "held harmless" or at the same level (except for growth in student enrollment). A greater investment in education is needed to improve educational performance and outcomes.

The estimated per pupil expenditures for K-12 in FY 2006 - 2007 in Florida were \$8,493, compared to \$9,557 nationally for a ranking of 34th in the country. Only 60.8% of Florida's high school seniors -- 10% below the national average -- graduated with a standard diploma in 2005, the latest year for which complete data is available. This trend ranked Florida 44th in the nation. More than half (55%) of students entering college in Florida require remediation in mathematics, reading, and/or writing. Per capita state and local expenditures for education in Florida was \$1,807, compared to \$2,330 nationally for a ranking of 49th in the country.

Thus, over the next several years, it would be important for Florida's competitiveness to improve its funding of K-12 schools. But this is not what the "hold-harmless" provision of Amendment 5 does because it applies only to FY 2010 - 2011 and represents no increase to the state's investment in public education. After 2011, it is no longer applicable, and the K-12 budget will have to compete with every other state program for funding. "Held harmless" can easily become harmful to the funding requirements of the K-12 schools.

How much money will the Legislature have to add to the state's share of the K-12 budget in FY 2010 - 2011 to substitute for the RLE and the "hold harmless" provision for education funding in Amendment 5?

The Legislature set the RLE at \$8.3 billion for FY 2008 - 2009. But Amendment 5's "hold harmless" provision contains an adjustment for enrollment growth in Florida schools, which increases the amount the Legislature must replace to approximately \$11 billion.

It is important to recognize that beyond the revenue requirements directly related to Amendment 5; other factors may also influence a need to find much more than \$11 billion for the FY 2010- 2011 budget. There is reason to believe that budgetary requirements in other areas of the state budget that are essential and must be "held harmless" due to legal settlements, state priorities, new initiatives, etc., may also require additional dollars beyond levels known this year or the year after. Therefore, a more global view of budget requirements make predicting how much money will be really needed two years from now very uncertain.

Will the Legislature find other revenues for FY 2010 - 2011 (up to \$11 billion) through enacting new taxes without cutting the budget for state services beyond the amount it has already been reduced in the past three years?

Amendment 5 does not require the Legislature to replace the RLE with tax increases. Taxes are just one alternative that may be considered. Florida's economy is struggling and future estimates of revenue growth have been lower than forecast. With this uncertainty in the economy, now is not the time to place an additional burden potentially reaching \$11 billion or more within two years on the state's tax system without knowing exactly what tax exemptions will be repealed, and what, if any, new taxes will be enacted and how much must be collected. Amendment 5 fails to specify what tax exemptions, if any, will be repealed or what new taxes, if any, will be enacted. It is known that an increase in the sales tax will make the tax structure even more regressive which is undesirable and it will generate only a small portion (approximately \$3.4 billion) of the revenues needed.

The current political leadership and the governor have been silent on details. The voting public typically wants to know how any changes to the current tax structure will affect them. All Amendment 5 tells them is that their property taxes will decrease, but says nothing specific about what specific taxes, if any, they will be replaced with and how that could affect different groups of people. Therefore, it is very difficult to answer this question because no one knows what, if any, new taxes will be enacted for the replacement revenues, what the consequences will be from unknown alternatives, and whether budget cuts will also be undertaken.

The Legislature has found it very difficult to remove sales tax exemptions in the past. Is there any reason to assume that they will find it easier to do so with the adoption of Amendment 5? It should be kept in mind that the Legislature already has the authority to enact all the provisions in Amendment 5. The fact that they have not done so already speaks volumes.

What will the effect be if the Legislature chooses to cut the state budget to find substitute revenues?

The cuts will have to come from general revenue-funded programs. Recognize that the general revenue portion of Florida's budget is a little over one-third of the total budget with the remainder coming from trust funds and the federal government. Due to the requirement that education (K-12) be "held harmless," and adjusted for growth, about \$11 billion of the general revenue dollars are off the table if the Legislature decides to cut the state budget in FY 2010 - 2011.

The general revenue in the FY 2008 - 2009 appropriation is approximately \$25 billion. In today's dollars, this means that the education "held harmless" provision results in the need to cut approximately 44% of the available general revenue from other state agencies and reallocate the proceeds to the public schools budget (if the Legislature chooses to not raise sales or other taxes). In total dollars, a 44% reduction might imply eliminating general revenue funds for the State University System (\$2.2 billion), the State Community College System (\$1.0 billion), the Department of Corrections (\$2.6 billion), and all of the General Government agencies, including the Office of the Governor, the Legislature, and the State Court System. In addition, the Legislature could decide to eliminate funding for most services not required by the Federal government in the Medicaid program (e.g., adult dental services, hearing services, community mental health services, hospice care, prescribed drugs, and durable medical equipment) which cost \$9.3 billion in total dollars, or a little more than \$4 billion in general revenue. These examples are extreme, but there is no safeguard in the proposed amendment to exempt them from Legislative prerogative in the appropriations process.

In addition, it should be recognized that a significant portion of those general revenue dollars in the state budget are necessary to generate federal financial participation. Without matching dollars, the state does not receive federal funds in a number of programs. For instance, to reduce general revenue dollars used as match for Medicaid will not only impact the state's ability to meet health care requirements, but will also reduce federal dollars that create and sustain jobs and influence consumption that in turn result in increased general revenue collections.

Furthermore, the Legislature has already reduced appropriations for a number of state programs and services. Tens of thousands of people are on "waitlists" for services where there is inadequate funding to meet needs, including elder services (24,000), developmental services (17,000), child care services (53,600), and substance abuse services (17,692). In mental health services, there are approximately 190,000 adults with severe and persistent mental illness, and over 234,000 children with emotional disturbance who cannot receive services due to a lack of funds. Compared nationally, many health and human services programs in Florida are already ranked very low in terms of performance and outcomes. Services in which there already is a substantial amount of unmet need and sub par performance outcomes should not have to experience further funding reductions.

To the extent that the Legislature opts to repeal any sales tax exemptions or establish other taxes, what happens if there are legal challenges?

The provision in Amendment 5 that requires that sales or use tax exemptions may only be repealed if they are determined "not to advance or serve a public purpose" sets up a significant incentive for legal challenges. The implication is that the Legislature cannot be certain if action(s) it may choose to take to find revenues to substitute for the RLE and meet the "hold harmless" provision will, in fact, allow the revenue to be collected at all or for how long, depending on the outcome and duration of the litigation. This uncertainty may lead to the state failing to meet the revenue requirements of Amendment 5, such as the "hold harmless" protection for education. Further, it may influence the Legislature to choose not to address new taxes and instead force legislators to take an axe to the state budget for more cuts in state services.

Will lower property taxes really result in economic gains and if so, will any increases to revenues be collected in time to use them?

Lower property taxes are unlikely to result in significant or measurable economic gains. This is because reductions in services and/or increases in other state taxes that would be required to "pay for" the property tax cut would have a negative economic impact that would offset the economic benefits of reduced property taxes, so the net effect would be approximately zero. Even if there were any economic impact, it would be impossible to distinguish it from the normal economic growth that can be expected to occur when the current economic slowdown ends. Therefore, questions about Amendment 5's stipulations regarding the use of increased revenues from economic activity as substitute revenue for the RLE related to reduced property taxes are very difficult to answer with any reasonable sense of certainty and set the stage for another avenue for potential litigation, and certainly confuses and constrains the FY 2010 - 2011 legislature in the appropriations process.

Will the replacement of local - state cooperative participation of public school financing to a system with mostly state financial responsibility have an impact on local control and oversight of public schools and move more authority to the Legislature?

Yes, the level of government that contributes the vast majority of funding will expect to have a major influence on policy and operations, especially those that affect budget requirements. Amendment 5 is likely to lead to greater control of the state's schools by the "folks in Tallahassee" if not sooner than later. Keep in mind that the RLE was approximately 45% of the state budget for K-12, or almost one third of the total general revenue in this year's appropriation. If Amendment 5 passes, the Legislature will need to work very hard to find the substitute dollars.

Is a "swap" the correct solution for concerns about property taxes, or are there other alternatives that should be considered instead?

There are a number of issues and concerns with the state's property tax. Reasons for increases to property taxes have been explained above and are attributable to Legislative decisions in the appropriations process and trends in property value linked to inflation in the housing market.

In addition, Florida's property tax system is not equitable. The Legislature's Office of Economic and Demographic Research was required to examine the issue and findings from its report of relevance to this question regarding inequities in the application of the state's property tax and implications to school funding follow:

*Both local government officials and the county property appraisers feel that **the property tax burden is not shared equitably among all property owners or among owners of homestead property**. The impact of Save Our Homes varies considerably by county; however, the greatest differentials have generally occurred in the coastal areas of central and south Florida, and the extreme edges of north Florida. Because larger differentials lead to greater tax shifting, non-homestead residential and nonresidential property owners in those counties have increased tax burdens. The presence of the Save Our Homes assessment growth limitation has had a detectable impact on the distribution of the state-funded portion of the FEFP in Florida. While the total funding per student is not affected, the mix of local and state funding is altered between school districts. This in turn affects the local property tax burden. Approximately \$135 million or 1.8% of the total required local effort has been impacted. To the extent that the greatest differentials have generally occurred in the coastal areas of central and south Florida, and the extreme edges of north Florida (as previously found), these areas have disproportionately benefited from the interaction of the FEFP with the Save Our Homes protection, while **the other areas have experienced higher school property taxes than they otherwise would have.** ⁴*

In the fall of 2007, the Legislature passed a proposed constitutional amendment intended to address some of the concerns with the state's property tax policy. This proposal, Amendment 1, was passed in a special election in January of 2008.

It changed the property tax system as follows:

- **Tangible Personal Property Tax** - establishes an exemption from tax on the first \$25,000 in value of tangible personal property used in business.
- **Save Our Homes Portability** - allows a person to take up to \$500,000 in value of their Save Our Homes differential and apply it to reduce the taxable value of a new home. The estimated loss in revenue to K-12 schools is \$83.8 million in FY 2008 - 2009 and an overall loss in property tax revenue of \$2.67 billion over the next 5 years, including \$1.153 billion for K-12 schools.
- **Additional Homestead Exemption** - provides an additional Homestead Exemption of up to \$25,000 on homes valued over \$50,000. The estimated impact on other local governments (public school levies are exempt) is a loss of \$895 million for FY 2008 - 2009 and a loss of \$4.67 billion over the next 5 years.
- **Cap on Non-Homestead Assessments** - places a 10% cap on any increases to the assessed value of non-homestead properties. The estimated impact on local governments (public school levies are exempt) is uncertain in FY 2008 - 2009, but constitutes an estimated loss of \$1.1 billion in revenue over the next 5 years.

It is estimated that the impact from the reduction in property tax revenue from Amendment 1 on local government and public school revenues is a loss of \$1.075 billion to local governments in FY 2008 - 2009 (\$161.2 million for K-12 schools) and a loss of \$9.2 billion (\$1.4 billion for K-12 schools) over the following five years. Given the estimated impact of Amendment 1, and in view of the proposed new Amendment 5 that seeks to eliminate the RLE (up to \$11 billion in FY 2010 - 2011) and the numerous and serious uncertainties about it, poses the potential for dire consequences for the future financing of the state's school system.

Without expanding upon the process used to levy property taxes, it is also important to understand that methods involved in the process are also worthy of consideration for eliminating inequities in the system. A variety of exclusions, differentials, and exemptions are applied to determine the taxable value against which property taxes are levied.

It is well known that property values have increased dramatically over the last several years. For example, between 1997 and 2001, the fair market value of property in Florida increased each year by an average of nearly 7.3%. However, for the five year period between 2001 and 2006, the fair market value has increased each year by an average of more than 17.3%, far outpacing the growth in per capita personal income.⁵ The Save Our Homes differential greatly increased inequities associated with this increase in property values. Amendment 1 attempts to address this issue, although it is too early to tell whether the desired impact will occur, which has been complicated by the recent dramatic downturn in the values of homes throughout Florida.

Another area of concern with the state's property tax system is a component in the process that determines the highest and best use of their property which the property appraiser is required to determine by law. In most situations, the current use of a property is in fact the highest and best use. However, in some situations a parcel or home located in a thriving downtown commercial business district, which exists in many communities around the state, the highest and best use of the property would be commercial. As a result, the property owner is required to pay property tax based on the commercial use surrounding his property, rather than on its actual residential use which can significantly increase the home owner's property tax. This component of the property tax system should be re-examined.

Should Florida examine and reform its current tax structure?

The proposed Constitutional Amendment 5 is an effort that began with a reasonable public purpose and potential benefits for the state of Florida supported by many. Former Senate President John McKay's original concept, which he has championed for several years, called for requiring the Legislature to periodically examine all tax and use exemptions and exclusions and determine if they met an economic purpose and served the public good. Many times, when exposed to the political and legislative process, good ideas or bills are improved through compromise. This did not happen in this situation. The original proposal offered by former Senator McKay was modified significantly through the debate and process of compromise associated with its passage by the Florida Commission on Budget and Tax Reform.

The uncertainties inherent in Amendment 5 make it very difficult to judge completely. The old adage that it is unwise to buy a "pig in a poke" because it may turn out to be no pig at all is applicable to Amendment 5. The questions posed and answered above have sought to "let the cat out of the bag." There is very little likelihood that Amendment 5 contains a pig. Amendment 5 is unlikely to serve a reasonable public purpose at all, and, worse, it may result in very significant negative consequences. At the very least, the Tax and Budget Reform Commission should have specified what taxes and/or what specific budget cuts would be enacted to generate the revenues for a swap so that the voters would know if they were getting a pig, a snake, or something else with Amendment 5.

The Florida Center for Fiscal & Economic Policy would, however, encourage the leadership to continue the debate about the state's property tax situation, but also to examine the issue from a comprehensive perspective in light of the following facts:

- Florida is one of only nine states with no personal income tax.
- Florida's state and local tax burden is ranked the 47th lowest in the country.
- Similarly, Florida's corporate tax structure consists of a flat rate of 5.5% on all corporate income, which ranks 40th lowest among states that tax corporate income. By way of comparison, the corporate income tax in California is 8.84% and in New York it is 7.1%.
- Since Florida's tax structure is primarily based on sales and excise taxes, the structure is considered highly regressive. Florida's poorest residents pay 14.4% of their income in state and local taxes, whereas those with the highest incomes pay 3.0% -- effective 2.7%, after federal deduction offset. The national comparisons are 11.4% and 7.3%, respectively.
- In addition to being regressive, Florida's existing structure is unstable. The primary tax sources are adversely affected by any downturn in the economy.
- The major tax source, the Sales and Use Tax, has so many tax preferences that only about 40% of the potential tax base is taxed. Exemptions, deductions and credits reduce the Sales and Use Tax collections by approximately \$12.4 billion annually. This does not include the more than \$20.9 billion in state revenues lost to the exclusion of Service Transactions.

Attribution

Advice and consultation were provided by Michael Walsh, Senior Consultant; Karen Woodall, Director of Outreach and Education; Iris J. Lav, Deputy Director, Center for Budget and Policy Priorities; and Nick Johnson, also with the Center for Budget and Policy Priorities and Director of the State Fiscal Project.

Author's Note

Although a Florida Circuit Court recently ruled to remove the Amendment 5 proposal from the Nov. 4 ballot, an appeal will be heard by the Florida Supreme Court. Pending the outcome of this appeal and the potential for further consideration on provisions similar to those proposed in Amendment 5 if the Circuit Court's decision is upheld, the Center for Fiscal and Economic Policy research and findings in this paper are pertinent and help inform the future debate.

End Notes

1. "An Analysis of County Spending Patterns, 1999-2006, Where did the Money go?" by Fishkind and Associates, March 2007.
2. From Profiles of Florida School Districts, <http://www.fldoe.org/fefp/profile.asp>
3. "An Analysis of County Spending Patterns, 1999-2006, Where did the Money go?" by Fishkind and Associates, March 2007.
4. "Florida's property tax study-interim report," Office of Economic and Demographic Research. Bold added as emphasis by author.
5. Florida School Board Association

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