FLORIDA CENTER FOR FISCAL & ECONOMIC POLICY

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Florida's Fiscal Crisis: The Prescription

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Acknowledgements

The mission of the Florida Center for Fiscal and Economic Policy (FCFEP) is to perform and review research on state-level fiscal and economic matters, particularly in regards to their impact on low and moderate/middle income families and individuals and small businesses owned by, and employing, such families and individuals.

Florida's Escalating Fiscal Crisis: The Prescription was researched and written by Michael Walsh, Senior Research Analyst, and John Hall, Executive Director of FCFEP.

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Introduction

This is the second report on Florida's fiscal crisis. In **Florida's Escalating Fiscal Crisis: The Problem**[1]**,** we discussed the causes of the crisis (i.e. the economy and our antiquated tax structure); pointed out the very negative consequences that would result if the Legislature enacted additional substantial budget cuts to address the fiscal crisis; and recommended that reserve funds be utilized to address the shortfall in the current fiscal year.

The Center also recommended that a new approach should be adopted to address the shortfall projected for next fiscal year and future years. Overlooked in the debate over how to continue funding critical state programs and services, address unmet needs, reduce waitlists, and produce a balanced budget is the fact that the structure and nature of the state's tax policy is also a significant contributing cause of the problem. Florida's tax structure is problematic because it:

1. is heavily dependent on consumption taxes and is one of the most regressive systems in the country;
2. fails to affect the various components of the economy in an equitable fashion. Services and some categories of corporations are not taxed and others are subsidized;
3. treats income groups in a disparate manner. The affluent pay less of their income in taxes (2.7%) than do low income families (14.4%);
4. is subject to extreme variation in revenues raised (boom and bust) during the business cycle; and
5. has numerous exemptions and exclusions and subsidies that serve no reasonable public purpose.

Florida's Fiscal Crisis: The Prescription offers a structured approach to regain fiscal stability through modernizing our tax policies to align the system with today's economy and eliminating tax exemptions and exclusions that serve no public purpose. Our suggestions also seek to provide more balance, fairness and growth, seeking to trade a broader base of taxation for a lower rate. The recommendations are very interdependent and decisions to enact them should be considered in a comprehensive fashion to ensure the proper balance in tax policy.

The Center's recommendations will generate several billions of dollars in the coming fiscal years as they are phased in during the implementation process. In FY 2009 - 2010, approximately $4.3 billion in new recurring General Revenue can be generated. In FY 2010 – 2011, $4.6 billion in revenue is expected from enacting the Center's recommended changes to Florida's tax policies. Also, several recommendations not quantified offer additional potential for revenue: a forward thinking environmental issue (taxing plastic bags), efficiencies, and maximization of the potential of regulatory, licensure, and fee revenue to free up General Revenue.

It should be noted that the recommendations in this report and the resulting revenues are derived from an independent analysis of information contained in the "2008 Florida Tax Handbook" and from the November 21, 2008 General Revenue Estimating Conference. As more current information becomes available, the recommendations may be updated to reflect this new information.

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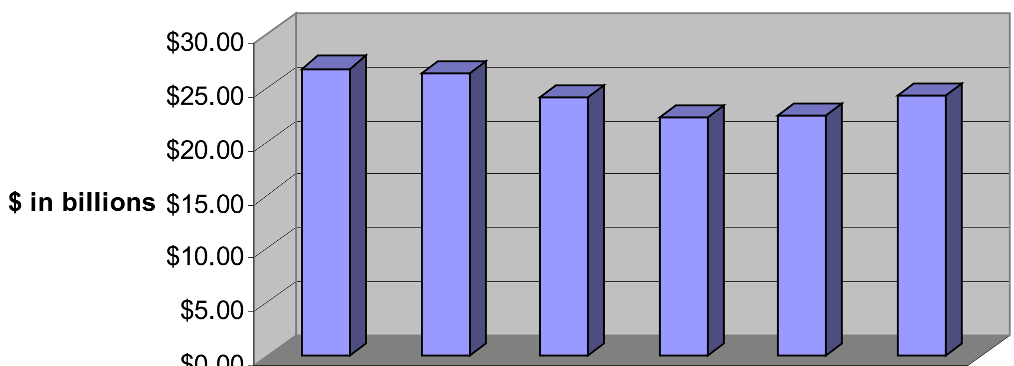
[1] http://www.fcfep.org/Documents/FiscalCrisis_112808_Summary.pdf

Considering current estimates of substantial future budget shortfalls along with requirements to replace dollars taken from certain trust funds in the recent special session of the Legislature, a balanced approach of cost reductions along with revenue enhancements is the best course of action. If the Legislature enacts these recommendations for revenue increases and cost savings, additional cuts to the budget would be significantly reduced particularly in light of the funds Florida will receive from the federal economic stimulus package over the next two years.

The dollars Florida will receive from the federal stimulus package will be substantial and will act to mitigate the need to enact further budget cuts as just mentioned. Caution must be exercised, however, because those dollars are non-recurring. Hopefully, Florida's economy will begin to recover by the time the stimulus funding ends, and with the revenues raised from the recommendations in this report, improved levels of recurring general revenues will be substituted for the loss of federal stimulus dollars. If Florida's tax system is modernized along the lines recommended by the Center, when the economy fully recovers, long overdue enhancements to funding critical state programs can be accomplished and waitlists can begin to be reduced.

Total General Revenue Collections
Current Law



	2006	2007	2008	2009 est.	2010 est.	2011 est.
Series1	$26.85	$26.33	$24.22	$22.23	$22.49	$24.36

Fiscal Year

Source: Florida Revenue Estimating Conference, Revenue Analysis, Volume 24, Fall 2008

Our research and recommendations were guided by three principles:

Equity: Persons (including corporate entities) that enjoy the benefits, opportunities, and security of living, doing business and visiting Florida should share equally in the costs associated with providing those benefits. A fair tax system taxes persons in similar circumstances on a like basis, and persons in different circumstances differently.

As a strategy to improve equity, the concept of a **broader base** will be employed. This will provide more stability and create a more balanced system because more entities will be included in the tax base. If all corporations and taxpayers pay taxes without any favoritism or special breaks and the economy improves, tax **rates could be lowered** as appropriate.

Progressivity: By depending on consumption taxes with many exemptions and exclusions, the tax burden in Florida has been shifted to lower income persons who spend a larger portion of their income on taxable items than do more wealthy individuals.[2] While it is difficult to have a progressive tax system without levying an income tax, there are ways to make Florida's system less regressive which the Center will detail in a subsequent report.

Stability: The primary source of General Revenue funds in Florida is the Sales and Use Tax. In an expanding economy, or when there has been an unanticipated stimulus (purchases to repair hurricane damage), the sales tax has produced sufficient and in some instances more than budgeted level of revenues. Conversely, in a declining economy when consumption contracts, sales tax revenues decrease. The goal of a fair tax system is to smooth out the highs and lows and make revenue collections more consistent and less volatile. This can be accomplished by establishing a broader tax base and reducing dependence on consumption taxes.

Recommendations to Modernize Florida's Tax Policy and Make the Structure Fairer

Sales Taxes

1. Temporarily increase Florida's sales and use tax from 6% to 6.75% to address the immediate revenue needs. During the next fiscal year, the Legislature would repeal sufficient exemptions, exclusions, subsidies and selected services making possible a reduction in the tax rate to 6.25%, a slight increase over the current rate but necessary to meet the state's needs for critical services. In addition, the Legislature should undertake a comprehensive review of all sales and use tax exemptions and identify items that should be eliminated. The Center recommends some that should be repealed as a starting point for review. (Revenues raised after increasing the rate to 6.75% = $2.2 billion in FY 2009 – 2010. After lowering the rate to 6.25% and eliminating the exemptions, exclusions and subsidies the Center recommends = $1.9 billion in FY 2010 – 2011)

In addition, the Center recommends the following additional changes to Florida's sales tax policy as a means to modernize its structure and create more fairness:

(a.) **Review and Remove Exemptions, Exclusions and Subsidies.**

[2] Institute on Taxation & Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," 2nd Edition, January 2003.

● **Remove selected Sales tax exemptions (Revenues raised = $207.9 million)**

Florida's sales tax has 246 exemptions and subsidies, costing the state more than $12 billion a year in forgone taxes. These exemptions and subsidies create inequities among different types of businesses and industries and require everyone to pay a higher sales tax rate than would be necessary if these special breaks were ended. Tax breaks that add no substantial economic value or create inequity among similar types of commodities should be eliminated. (See Appendix A for a listing of exemptions the Center recommends for elimination.)

● **Extend sales and use tax to many services that currently are excluded. (Revenues raised = $965.6 million)**

As the economy moves to one based more on services than goods, a number of states have or are considering ways to assure that their sales taxes are reflective of the new economy. Florida has not done so, and loses $20.9 billion from the exclusion of 121 services from the sales tax. While it is generally appropriate to retain exemptions for services that are exclusively sold from one business to another (for example, advertising), many other categories of household and mixed household/business services could be subject to a sales and use tax. (See Appendix A for a detailed listing of exclusions the Center recommends for elimination.)

(b.) Eliminate Sports Subsidies. (Revenues raised = $24.7 million)

Florida subsidizes highly profitable professional sports organizations that can afford to pay for the services the state provides to them.

(c.) Expand the Taxation of Internet Sales. (Revenues raised = not determined)

Although achieving comprehensive taxation of Internet, mail-order, and other interstate sales requires federal legislation, Florida can lay the groundwork for such legislation by joining a multi-state agreement to simplify its sales tax. It can also compel some Internet sellers with subsidiaries or representatives in the state to begin charging Florida sales tax through appropriate changes in the wording of the sales tax law.

(d.) Restrict the Dealer Collection Allowance to a maximum of five to ten retail outlets per business, and examine the justification for a higher allowance among Internet and mail order dealers. (Revenues raised = not determined)

There are significant economies of scale in the activities required for a retailer to comply with sales tax collection. Accordingly, a retail store chain with 300 Florida outlets should not receive 300 times the collection allowance received by a single, "Mom and Pop" store. The allowance for retail chains should be capped at a reasonable level; the much higher allowance granted mail-order and other "remote sellers" should also be reexamined.

Corporate and Business Taxes

The Center suggests several proposals to improve the equity of the corporate income tax. For example, the state should end the tax advantage now available to corporations that operate multi-state as compared to Florida corporations, and end the advantage of corporations that operate under some legal forms compared to others.

2. Remove loopholes and unwarranted exemptions in Corporate Income Tax.

. **(a.) Implement Combined Reporting. (Revenues raised = $376.3 million)**

Combined reporting is a policy adopted by 22 states that treats a multi-state corporation legally structured as one "parent" and numerous "subsidiaries" as if it were a single corporation. This would nullify numerous techniques that companies have devised to artificially shift profits earned in Florida into subsidiaries located in low-tax or no-tax states.

(b.) Remove the exemption of Limited Liability Companies and Subchapter S corporations from Corporate Income taxes. (Revenues raised = $1.1 billion by FY 2010 - 2011).

Limited Liability Companies and Subchapter S Corporations pass through their income to owners and shareholders and the shareholders pay taxes through the individual income tax. Since Florida does not have an individual income tax, these companies fully escape taxation of their profits. Most other states without an individual income tax require LLCs and Subchapter S corporations to file and pay corporate income tax.

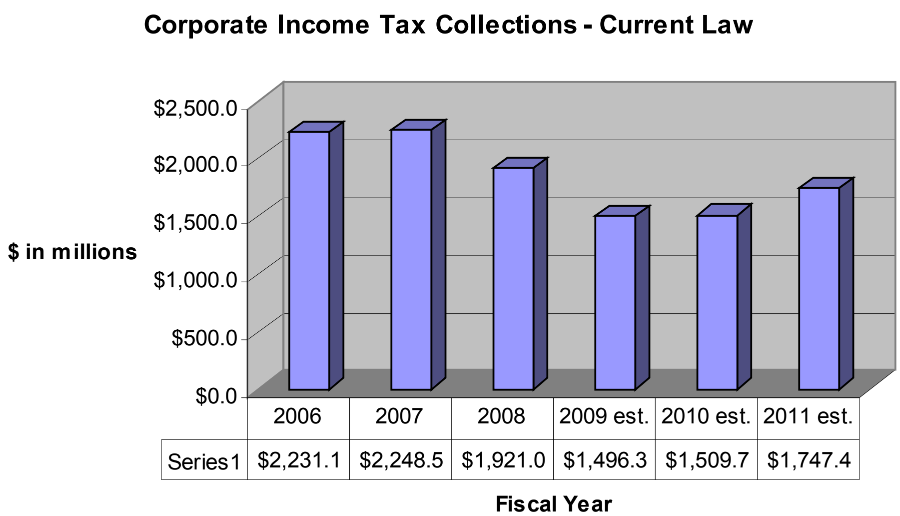
(c.) Decouple the state from the federal Domestic Production Deduction. (Revenues raised = $50 million by FY 2010 - 2011)

This is a federal tax break that some 20 states have decided not to allow. The domestic production deduction allows businesses to deduct — and hence pay no taxes on — a portion of their profits attributable to a broad range of "qualified production activities." Florida loses revenue by allowing this deduction, which often subsidizes job creation in other states. The main beneficiaries are large, profitable corporations. Struggling firms get little or no benefit.

(d.) Adopt the throwback rule. (Revenues raised = $38.4 million)

This is a policy adopted by roughly half the states with corporate income taxes that ensures that all corporate profits earned in the United States are subject to taxation by one — and only one — state. The throwback rule allows a state in which a corporation produces its wares to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales.

3. When these proposals are adopted, it should be possible to allow all corporations to enjoy a lower tax rate (potentially dropping the rate from 5.5% to 4.5%) and increase net revenue by about $648 million in FY 2009 – 2010 and over $1.3 billion in the following year.[3]



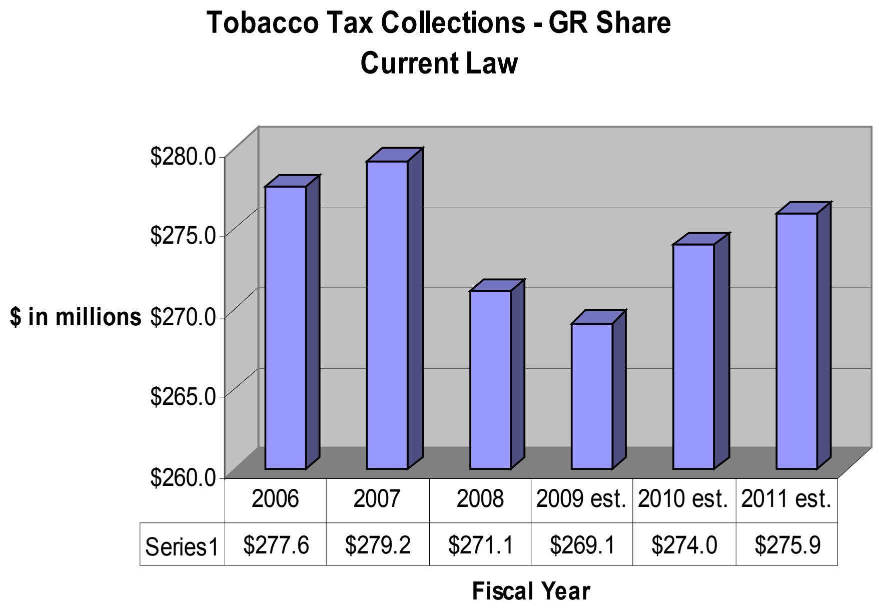
Source: Office of Economic and Demographic Research, General Revenue Estimating Conference work papers, the Florida Legislature, November 21, 2008.

Other Recommendations

4. Raise the cigarette tax by $1.00 per pack; increase the non-cigarette tobacco products tax to 100% of the wholesale price (Revenues raised = $1,000.8 million)

After the increase, Florida would still have the 20th lowest cigarette tax in the country. A tax increase would reduce the number of residents who smoke, potentially giving long-term benefits of lower health care costs. Although cigarette taxes are considered to be regressive – absorbing a greater share of the income of lower-income people than higher – improvements in progressivity from other elements of the package could offset that effect.

[3] Assumes policy changes would be implemented for ½ of fiscal year 2009 – 2010 and entire period of the following fiscal year. Revenues raised are estimates for FY 2010 – 2011.



Source: Office of Economic and Demographic Research, General Revenue Estimating Conference work papers, the Florida Legislature, November 21, 2008.

5. Reinstitute the intangibles annual tax with the same tax base prior to repeal, effective January 1, 2010. The personal exemption should be set at $250,000 (increased to $500,000 to include spouses). (Revenues raised = $250 million)

A tax on intangible personal property is the only property tax the state may collect but two years ago, it was repealed. Most states have a personal income tax which includes income derived from intangible property. A more progressive tax policy structure would reenact this tax particularly given the absence of a personal income tax and the regressive nature of Florida's current tax structure.

6. Close Loophole on Documentary Stamps Tax. (Revenue raised = $50.2 million)

Corporations that transfer property to subsidiaries or other corporations that are wholly owned by the transferring company currently do not pay the documentary stamp tax. Florida should generate documentary stamp revenue from these transactions as per the legal opinion on the Crescent Miami Center case.

7. Increase the charge on designated trust funds for general government services by 20%. (Revenues raised = $67.8 million by FY 2010 - 2011)

The service charge on trust funds is minimal and a 20% increase will not jeopardize attainment of the purpose of trust funds and will provide much needed recurring general revenue.

8. Grant authority to university Boards of Trustees (with approval of the Board of Governors) to increase base tuition by up to 15% each year.

Florida's universities charge the lowest tuition and fees of any state in the country. The Center concurs with the Governor's recommendation to increase tuition and at the same time provide supplemental dollars for need based financial assistance.

Other Value Added Suggestions for Consideration

9. Enact a fee on plastic bags. (Revenues raised = not determined)

Environmentally responsible and capable of generating additional general revenues in the short term, Florida should enact a modest fee on plastic bags provided by retail, grocery and other similar stores to their customers.

10. Maximize regulatory, licensure and user fees. (Revenues raised = not determined)

Florida has made considerable progress in maximizing revenues from its regulatory and licensure functions as a means to make them more self-supporting. Additional opportunities such as in AHCA, the Department of Agriculture and Consumer Affairs, and the Department of Health should be examined and implemented as appropriate.

11. Maximize efficiencies. (Revenues raised = not determined)

As the state examines the potential of streamlining governmental regulation over businesses as a means to improve our economic output, efficiencies that generate cost savings should be considered priorities, especially in functions that are a duplication of effort among interagency activities. In addition, efficiencies and cost savings can be generated from merging Medicaid waivers into a single agency as well as consolidating agency quality assurance functions.

12. Consider raising the tax rate on alcoholic beverages.

Although Florida's tax rate on alcoholic beverages is already one of the highest in the country, a modest increase should be considered.

13. Institute a Florida Estate Tax if Federal Estate Tax is reinstated.

If the Federal estate tax is renewed in 2011, and the Federal tax credit is reinstated, Florida again could collect Estate Tax revenues.

The following table summarizes the estimated fiscal impact over two years of the Center's recommendations for tax policy reform and modernization.

Estimated Revenue Generated
From Center's Recommendations
Total by Fiscal Year
$ in Millions

Revenue Source	FY2009 - 2010	FY2010 - 2011	TBD
Sales Tax			
Increase Tax Rate by 0.75%	$2,198.4	$2,198.4	
Lower Tax Rate by 0.5%		($1,465.6)	
Repeal Selected Exemptions	-	$207.9	
Included Selected Services	-	$965.6	
Eliminate Sports Subsidies	-	$24.7	
Expand Taxation of Internet Sales			TBD
Dealer Collection Allowance			TBD
Corporate Income Tax[4]			
Combined Reporting	$188.1	$376.3	
Subchapter S	$424.0	$848.0	
Limited Liability Companies	$129.0	$257.8	
Domestic Production Deduction	$25.0	$50.0	
Throwback Rule	$19.2	$38.4	
Reduce Tax Rate to 4.5%	($137.3)	($317.7)	
Other Recommendations			
Tobacco Tax	$1,000.8	$1,000.8	
Intangibles Tax	$250.0	$250.0	
Close Documentary Stamps Tax Loophole	$50.2	$50.2	
General Revenue Service Charge	$64.3	$67.8	
University Tuition	$72.0	$72.0	
Other Value Added Suggestions for Consideration			
Plastic Bag Tax			TBD
User Fees			TBD
Efficiencies			TBD
Beverage Tax			TBD
Estate Tax			TBD
Total	$4,283.7	$4,624.6	

Note: The recommendations in this report and the resulting revenues are derived from an independent analysis of information contained in the "2008 Florida Tax Handbook" and from the November 21, 2008 General Revenue Estimating Conference. As more current information becomes available, the recommendations may be updated to reflect this new information.

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[4] Assumes implementation on January 1, 2010.

Raise taxes in a recession rather than cut more?

Since FY 2007 - 2007, as shown in **Florida's Fiscal Crisis: The Problem**, the Legislature addressed the revenue shortfalls linked to an over 17% decline in recurring general revenues by "tightening the belt" with budget reductions exceeding $7 billion. *In real dollars per capita, the budget cuts over the past three years amounted to a 15.2% reduction. Yet, the demand for state services has increased as funded capacity decreased.* Thousands of people have gone without health and human services and continue to languish for years on waiting lists or queues. Funding for education has declined per FTE[5] over FY 2007 -2008 levels 1.9%, 5.1% and 1.4% respectively in public schools, community colleges and universities.[6] Yet funding for prisons has increased - an unintended consequence we suspect - which certainly is not the proper balance for our fiscal priorities if a well trained and educated workforce is to sustain and enhance Florida's economic growth.

A recession coupled with significant revenue shortfalls and the fact that the state budget has already been significantly reduced pose a major challenge for the Governor and Legislature. The Center recommended that reserve funds should be used for FY 2008 - 2009 and feels strongly that additional cuts to the budget should be balanced with revenue enhancements. The Center believes we should use the fiscal crisis as an opportunity to modernize our tax structure and increase revenue through removing unwarranted exemptions, exclusions and subsidies.

There is a school of thought that insists that tax increases in a recession are harmful, and that budget cuts are the only appropriate way to balance the budget. This position is not accepted by other noted economists.

Nobel Prize winner Joseph Stiglitz of Columbia University and Peter Orszag, former director of the Congressional Budget Office and now director of the Office of Management and Budget) sensibly argue that spending cuts could actually be more harmful for a state's economy during an economic downturn than tax increases.[7] This is because spending cuts result in layoffs of employees or contractors and thereby reduce demand for goods and services by at least a dollar for every dollar of spending cut, and thereby exacerbate the economic decline. According to the judgment of these highly regarded economists, tax increases, particularly tax increases on higher-income families, are a reasonable option to consider even in a recession. That is because some of the tax increases will be paid out of funds that otherwise would be saved or spent out of the state, and thus have a less draconian impact on demand in the state.

Although not always the case, the leadership in many states sees tax and fee increases as an acceptable alternative as recommended by Stiglitz and Orszag . Currently, 44 states face budget shortfalls. Survey data compiled by the National Governor's Association and the National Association of State Budget Officers shows that in previous recessions many states enacted tax and fee increases. In 1983, 33 states enacted permanent or temporary revenue increases to try to balance their budgets. In 1984, the number was 38. During the next recession, they increased taxes again - 30 states in 1990; 26 states in 1991; and 31 states in 1992. So far this fiscal year,

[5] FTE means full time equivalent student.

[6] Florida: An Economic Overview, December 10, 2008, Florida Senate.

[7] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2001.

states enacted net tax and fee increases of $1.5 billion, after enacting $4.5 billion in tax and fee increases in fiscal 2008. States also enacted $6.6 billion of other revenue measures that enhance general fund revenue but do not affect taxpayer liability.[8]

The Center intends to publish a series of follow-up reports to this publication that will focus on each recommendation and provide a much more detailed examination of our justification for the recommended change to current Florida tax policy, calculations used to develop the revenue estimates, and the consequences that are related to the adoption of the recommendation. These follow-up reports will be two to three pages and will be organized as follows: Corporate Tax Policy; Sales and Use Tax Policy; Tobacco Tax Policy; Intangibles Tax Policy; Documentary Stamp Tax Policy; and University Tuition Policy.

[8] The Fiscal Survey of States: National Governor's Association and National Association of State Budget Officers, (various years).

Appendix A

The Florida Center for Fiscal and Economic Policy
Recommended Repeal of Selected Sales and Use Tax
Exemptions, Deductions, Credits and Services

Florida Statute	Description	$ in Millions
	Exemptions, Deductions, Credits	
212.02(14)c	Materials used for packaging	$28.1
212.031(1)(a)6	Toll road charges	$67.9
212.031(9)	Highschool and college teams' stadium skyboxes	$0.9
212.08(4)(a)1	Bottled (except carbonated) water	$42.3
212.08(7)s	Alcoholic beverages used by businesses for tasting	$1.6
212.08(7)(w)	Subscription newspapers, newsletters & magazines delivered by mail	$21.5
212.08(7)(y)	Charter fishing boats	$71.3
	Sub Total	**$233.6**
NAICS Code		
	Services	
8121	Personal Care Services (including Beauty and Barber Shops)	$91.8
8123	Drycleaning and Laundry Services	$68.9
8129	Other Personal Services (Pet Care, Photo Finishing, Valet Parking, etc,)	$11.0
5412	Accounting, Tax Preparation, Bookkeeping and Payroll Services	$324.9
5615	Travel Arrangement and Reservation Services	$57.9
5617	Services to Buildings and Dwellings (includes Cleaning and Pest Control)	$98.5
4921	Couriers	$243.1
4922	Local Messengers and Local Delivery	$27.1
7111	Performing Arts Companies	$6.8
7112	Spectator Sports (sports Teams and Clubs, Racetracks, etc.)	$13.1
7113	Promoters of Performing Arts, Sports and Similar Events	$53.3
7114	Agents and Managers for Artists, Athletes, Entertainers, etc.	$12.8
7115	Independent Artists, Writers and Performers	$42.3
7139	Other Amusement and Recreation Industries	$33.4
	Sub Total	**$1,084.9**
	TOTAL	**$1,318.5**

Source: "2008 Florida Tax Handbook," the Florida Legislature