

FISCAL RESEARCH CENTER

FOUR EASY STEPS TO A FISCAL TRAIN WRECK: THE FLORIDA HOW-TO GUIDE

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Four Easy Steps to a Fiscal Train Wreck: The Florida How-To Guide

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Introduction

In early 2006, Florida state policymakers were still enjoying revenue prosperity – partially caused by hurricane-recovery activity – and temporarily-postponed spending stress. The governor's current budget indicates that fiscal years 2004 and 2005 featured significant revenue growth (9.2 and 14.5 percent respectively). Fiscal 2006 appears to have brought a relatively modest 5.8 percent growth and after adjusting for inflation and population growth, current-year revenue is flat or falling slightly.

The favorable budget climate produced several proposals for disposing of the surplus. The proposals featured a mix of tax relief and new K-12 spending. Ultimately, some of the surplus was used on these issues, \$715 million was used to temporarily bail out the state-run Citizens Property Insurance Corporation and \$6.4 billion was held in reserve.

Unfortunately for policymakers and residents, the climate ahead is very different and could easily consume the reserve balance. Nominal revenue projections for 2007 are \$30 million below the expected yield for 2006. The decline for the total will be far worse if the projected sales tax increase of \$540 million does not materialize (and in Step 3, the reader will find reasons why it may not materialize).

Beyond the numbers, Florida policymakers and voters have taken four steps toward a fiscal train wreck. For the long-term budget, the ramifications will be significant and the specter of providing less services and/or raising taxes looms on the horizon. Beyond the budget, the steps also distort decisions in Florida and hurt economic welfare.

In this paper, each issue is introduced with a little history and analysis of the distortions that each step has created. Finally, proposed solutions are reviewed. The good news for Floridians is that forward-thinking policymakers and policy analysts have proposed solutions. The bad news is the proposals typically address one aspect of a larger, more complicated problem. Completely avoiding the fiscal train wreck will, in this author's opinion, require immediate and politically-unpopular changes.

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The steps to the train wreck are as follows. In step zero, a lax constitutional amendment process develops in Florida and this will be instrumental in creating the train-wreck environment. In step one, policymakers allow Medicaid spending to get out of control. The Medicaid spending aspect of the train wreck is not unique to Florida, but the other steps will exacerbate the Medicaid problem.

Enacting a Save Our Homes amendment is the second step, where homesteaders enjoy slow appraisal increases in active real estate markets. The third step is enhancing the structural flaw of the general sales tax with new exemptions. The fourth, and final step here, is enacting a class-size amendment to the state constitution.

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Step Zero: Lay the Foundation with an Easily Amendable Constitution

In March, 2006, the Florida Department of State reported approximately 50 active Constitutional Amendment petitions. The petitions reflect a general pattern where small groups of citizens hire consultants to gather signatures and then market the amendments. This route to a Florida Constitutional Amendment is known as the initiative-petition process.

The signature requirement that begins the process is remarkably easy. According to the Secretary of State's office, a group only needs 8 percent of the number of electors voting in the last Presidential election (611,009- based on the year 2004 numbers) to support putting the initiative on the ballot. Once the signatures are verified, the Florida Supreme Court issues a written opinion on whether the initiative is to be submitted to the voters.

With the assistance of "petition management" companies, a special interest group can easily submit the required number of signatures. Between the petition and the election, most purchase television and radio advertisements to convince voters to support their initiative.

Two interest groups that deserve specific mention are personal injury attorneys and physicians. The latter group convinced voters to add an amendment capping attorney fees from medical malpractice cases. The former successfully marketed amendments that gave potential clients more access to physician records and stop physicians with three or more incidents of medical malpractice from practicing in Florida. In essence, the groups fought each other through the creation of amendments that are now part of the constitution.

The author shares the view of others that a state constitution should not be a substitute for state statutes. As the reader will see below, two of the steps to the train wreck are constitutional amendments from the initiative-petition process and not from representative policy legislation.

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Reform

Two options have been widely discussed regarding this step in the fiscal train wreck. The first would follow Nevada policy in adopting a two-election process, where a proposed amendment would have to be approved both times.¹ Advocates of this option point to the precedent from two high-speed rail amendments. In the 2000 vote, Floridians approved an amendment that would force state construction of high-speed rail. In the 2004 vote, an amendment repealing the high-speed rail amendment was approved.

The second option – advocated by the Florida Chamber of Commerce – includes stricter standards on gathering petition signatures and a two-thirds approval requirement for most constitutional amendment initiatives. This would also reduce the likelihood of special-interest driven amendments.

Unlike the fiscal reforms described below, both amendment-reform options would move Florida toward a more efficient solution. Special interest groups would still be able to attempt amendments for their policy initiatives, but a higher approval threshold or a two-election process would make this strategy more difficult. Pritchett and McClure (2005) summarize a poll indicating the two-election process is slightly more popular.

¹ Pritchett and McClure (2005).

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Step One: Allow Medicaid Spending to Spiral Out of Control

By the standard measures, Florida Medicaid spending is relatively low. For example, per-enrollee spending was \$3,337 in 2002 while the U.S. average was \$3,947.² Spending on children and elderly enrollees were the lowest (as a share of the respective U.S. averages) while spending on non-disabled adults was relatively close to the national average.

Spending growth for the program, however, is extremely problematic as it has averaged 13 percent per year over the past six years. By fiscal 2005, Medicaid had increased to 24.4 percent of the entire state budget (Medicaid was 5.9 percent in 1980).³ Total expenditures exceed \$14 billion dollars and the program now covers 2.2 million Floridians.⁴

Clearly, unsustainable Medicaid spending growth is not unique to Florida. Scott (2005) finds two fundamental sources for rapid spending growth at the federal level. The first is prescription drug benefits where both price and usage have increased. The second is nursing home care. Scott finds the public share of nursing-home spending has climbed to 64.1 percent in 2002.

In Florida, policymakers identify two state-specific sources for the spending increase. The first source is complexity – Florida Medicaid participants can receive care through 11 contracted HMOs, a statewide primary care system (called the MediPass system) or three enhanced primary care systems.⁵ According to the approved Florida Medicaid Reform Application, the overlapping systems are both expensive to administer and dissatisfying to participants.

State policymakers also believe fraud is a cause for the rapid spending growth. With a program that generates about 140 million claims annually; inappropriate payments are considered to be a major problem. Although no fraud data appear in the reform application, several inappropriate practices have been

² Similar spending comparisons can be found in Weissert (2005).

³ Bond (2005).

⁴ Florida Agency for Health Care Administration (2005a).

⁵ Florida Agency for Health Care Administration (2005a).

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identified by the Florida Attorney General's office. "Pill doctors" and Viagra benefits for sex offenders were targeted in 2004 and 2005 respectively.⁶

Distortions

Blind and disabled Floridians account for 30 percent of enrollees, but 71 percent of spending.⁷ Thus, their benefits are an easy target for policymakers looking to shave spending growth from the program. One strategy was to halt cost-of-living adjustments. Another was to reduce payments to transportation-service providers.

The inefficiency from Medicaid spending growth is difficult to pin down. Legislation that tweaks the edges of program benefits probably adds minor inefficiencies to Floridians who now face a less generous safety net. Higher health care prices could have pushed Floridians to prefer dramatic cuts in the system, in favor of other spending or tax cuts, but we have no evidence on how residents view the program when faced with higher prices.

One Medicaid-induced distortion deserves special mention. An industry has developed that specializes in establishing Medicaid eligibility for nursing home bound Floridians. For example, Medicaid-friendly annuities are devices generally marketed to people who want to establish eligibility for one or both parents. This type of portfolio distortion is a clear inefficiency induced by the Medicaid program; and rising nursing home prices have both contributed to device popularity and driven more seniors into the Medicaid system.

Waiver

On October 19th of 2005, Florida policymakers received approval for a radically different Medicaid program. The plan is to begin in two counties with a structure that uses a cash (i.e., spending account) and counseling strategy to get participants to make their own healthcare choices, rather than fee-for-service reimbursement.

⁶ Crist (2004).

⁷ Florida Agency for Health Care Administration (2005b) and Aydin and Turcotte (2005).

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Ideally, the cash and counseling approach induces participants to either consume less healthcare or less-costly healthcare. Participants also have an incentive to help reduce fraud in the system as unspent account balances can be used for services that are otherwise not covered (e.g., certain vision and dental care).⁸

There are several disadvantages to the initiative. First, new state staff time will be dedicated to educating recipients and providers, as well as creating a risk-adjustment system to allocate larger account balances to higher-risk patients. Second, recipients will only receive emergency services until they enroll in (or a assigned to) a plan.

The final disadvantage is that recipients will be exposed to greater personal risk and the exposure will distort the consumption of healthcare. While the details of the Florida waiver are still being worked out, catastrophic care will probably be covered for participants even if they have used their allocated account balance. Non-catastrophic care probably will not be covered, meaning a recipient who has drained her spending account (i.e., a high-spending year) has an incentive to postpone healthcare consumption, even when the service is preventative.

⁸ More limited cash and counseling programs have been successful. According to Redmond and Soloman (2005), personal services for chronic health problems is an area where the programs work relative well.

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Step Two: Cap Homestead Assessment Increases Before a Real Estate Boom

“(Changes in homestead) assessments shall not exceed the lower of the following:

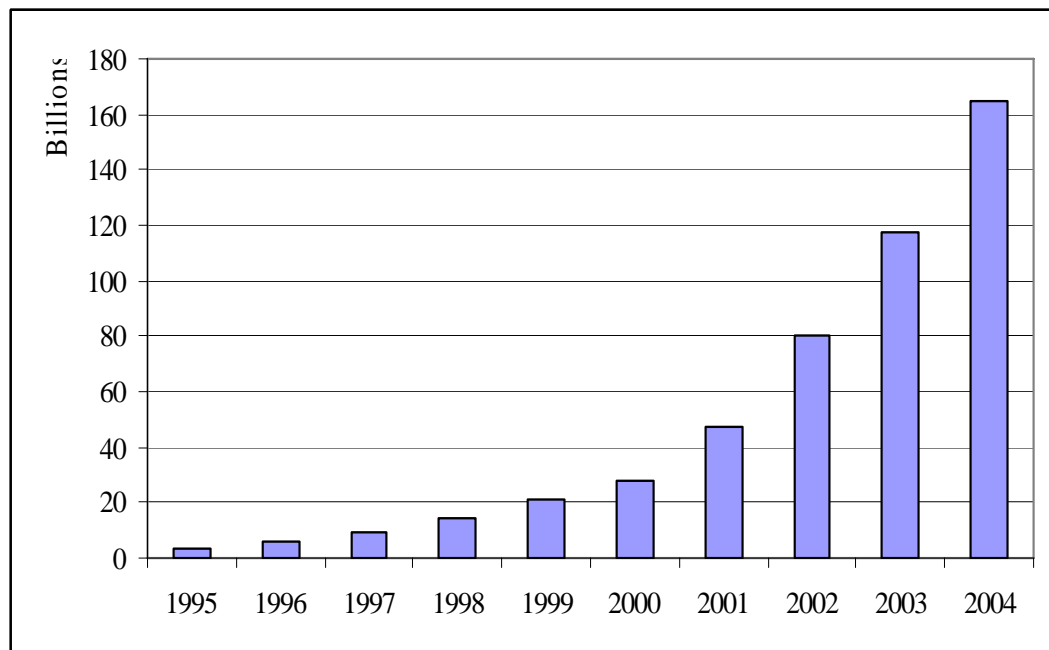
a. Three percent (3%) of the assessment for the prior year.

b. The percent change in the Consumer Price Index ...”

-- State of Florida Constitution, Article 7, Section 4,

The Save Our Homes amendment to the Florida Constitution was approved in 1992. According to a *Herald Tribune* feature on the program, part of the appeal was to protect older residents from losing their homes to escalating property taxes. The effect of the amendment can be observed in Figure 1 where over the ten year period since the amendment came into effect, the differential between assessed value and just value for capped Florida property increased 4700 percent. Using county and school millage averages, Florida homeowners saved roughly \$930 million for the

FIGURE 1. REAL PROPERTY ASSESSMENT DIFFERENTIAL (ASSESSED VALUE VERSUS JUST VALUE) FOR CAPPED PARCELS



Source: Florida Department of Revenue.

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former and \$890 million for the latter in 2004.⁹ Together, the two would account for 10.6 percent of countywide property tax levies.

The tax relief generated by the amendment is obviously very popular. This popularity may wane in the future – former Governor Lawton Chiles directed local appraisers to recapture under-assessed property in real estate slowdowns – but current real estate market conditions have prevented recapture and the savings to long-term homeowners have accumulated.

The Save Our Homes amendment has also created significant problems. In no particular order, they include:

1) *Lock In*

When a homeowner moves anywhere within Florida, they lose all Save Our Homes relief. For \$1000 in annual tax relief, moving means sacrificing \$15,372 (over 30 years at 5 percent). The lock in is generally more pronounced when the homeowner owns waterfront property or wants to purchase a larger house in a less desirable neighborhood.¹⁰

2) *Higher Millage Rates*

Real, per capita property tax collections appear in Figure 2 and they have obviously increased for five of the past seven years. Since assessment on existing homesteads cannot increase at this pace, the Save Our Homes cap is inducing local policymakers to maintain existing millage rates, or to only slightly reduce the rates, in a booming real estate market. In essence, property taxes on commercial and rental parcels have increased dramatically to fund services that homeowners desire, but do not have to pay for.¹¹

Tamman and Braga (2005) examined this issue by comparing millage rates over time. They found slight reductions in county rates, but sharp increases in total revenues. Since homeowners are less likely to notice the property tax effect of a booming real estate market, Tamman and Braga advance the idea that Save Our

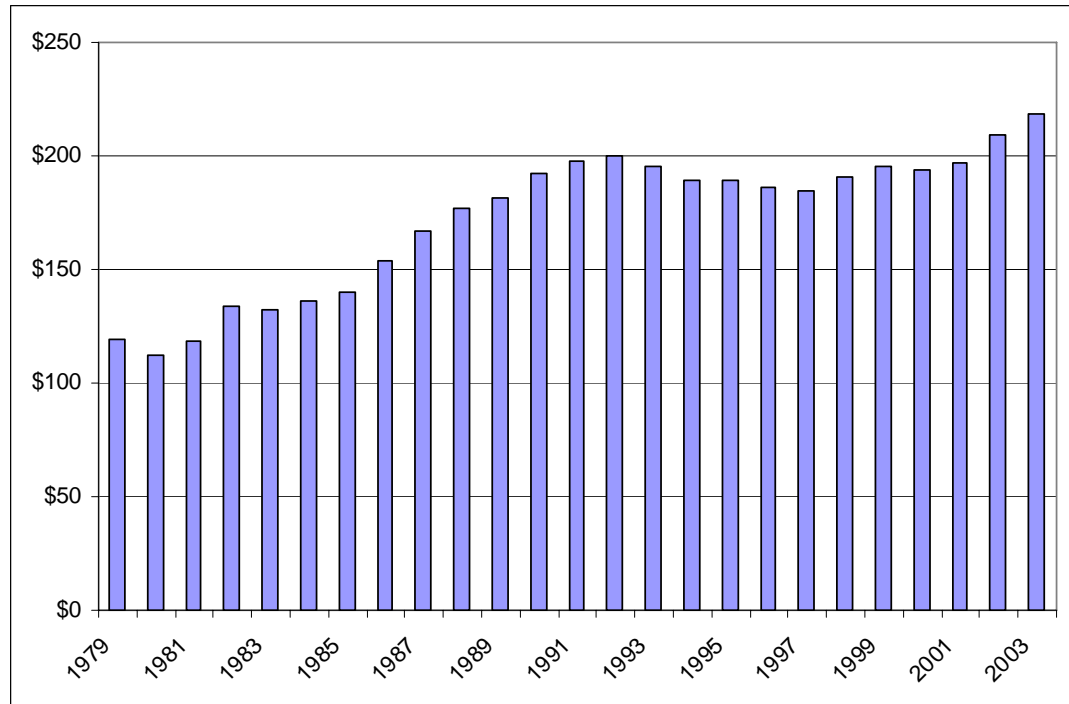
⁹ Total Florida savings would also include municipality property taxes, but this component is not estimated here.

¹⁰ Tamman and Braga (2005).

¹¹ Obviously, new construction is part of the tax revenue increase, but there is no evidence that new construction alone is driving the statewide trend.

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FIGURE 2. REAL, PER CAPITA COUNTY GOVERNMENT PROPERTY TAX REVENUE



Source: author's calculations on Florida Legislative Committee on Intergovernmental Relations data (<http://fcn.state.fl.us/lcir/fiscal.html>).

Homes has created a layer of protection for local politicians when property tax revenues are increasing.

3) *Inequities*

The most glaring inequity with Save Our Homes is horizontal as similar Floridians can live in identical houses but receive different tax levies. Tamman (2005a) illustrates this with Siesta Key condominium neighbors where the first pays \$5,700 in countywide taxes while the second pays \$2,300. The inequity also affects renters and seasonal homeowners who do not receive a Save Our Homes preference. The latter are at a particular disadvantage as they consume less local services, but have faced dramatic property tax increases. Some have claimed that Save Our Homes is reducing the snowbird economy and hurting the state.

Turning to vertical equity, one can only find anecdotal evidence on disproportionate benefits. Tamman (2005b) estimates that Former ITT Chairman Rand Araskog will save \$145,000 in county taxes (on an \$18 million Palm Beach mansion) and indicted former Tyco International president Dennis Kozlowski saved

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\$40,000. The latter claimed Palm Beach as his official residence, but he is suspected of spending most of the year outside of Florida.

4) *Tax Evasion*

Homestead exemptions are a recurring tax preference and create an incentive to cheat. These exemptions plus a Save Our Homes preference create a larger incentive. Tamman (2005b) found a widespread problem, where appraisers were overmatched. According to the article, state officials have not taken steps to help local appraisers identify homeowners who claim more than one homestead. Tamman also found two counties that have recovered more than \$2 million a year in revenue by aggressively trying to independently identify illegal homestead claims.

Portability

Policymakers have recognized the lock-in effect from Save Our Homes. In fact, the two leading Republican candidates for Governor in 2006 have both proposed portability for the Save Our Homes preference. They differ in the distance where portability would apply – Charlie Crist has favored statewide portability, while Tom Gallagher endorsed intra-county portability.¹²

While the proposals attack the lock-in problem, portability would probably exacerbate some of the other problems. For example, horizontal inequity between old and new Florida residents would worsen if the former group could take the Save Our Homes preference with them.

Portability would put additional pressure on local officials to maintain (or even increase) millage rates. Under the policy, the difference between the taxable base and market value would grow as relocating homesteads keep their tax savings. For example, a new subdivision creates public-service demand (e.g., roads) and a stream of future property tax payments. With portability, the former would not change but the latter would diminish.

¹² Kaczor (2006).

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Step Three: Accumulate Sales Tax Exemptions

“Today, our sales tax code has about 440 loopholes. Food for your dog or cat is taxed, but food for ostriches and racehorses is not. Professional football game tickets are taxed, but skyboxes aren’t. Limousine services are tax-free. If you buy a lawnmower, you pay a tax. But people who hire lawn services don’t pay a tax.” -- Floridians Against Inequities in Rates (website)

Florida relies heavily on the general sales tax. In 2004, it accounted for 56 percent of total Florida state tax revenue versus 33 percent for all states. Local governments currently add a rate up to 1.5 percent (to the state rate of 6 percent), but the use of the funds is restricted and must be specified in a local referendum adoption process.

Like many other states, the Florida sales tax emphasizes goods. The taxation of services is mixed, heavy on admissions/amusements and fabrication, installation and repair, but light on personal and computer services.¹³ State policymakers have not been aggressive in joining the streamlining movement with neither full nor associate member status.¹⁴

Food and medicine have been exempt from the Florida sales tax for more than 35 years.¹⁵ Recently, however, newer exemptions have entered the state statutes. Many apply to business purchases and are less likely to draw criticism from tax analysts.¹⁶ However, these exemptions are often industry specific, meaning the purchase at one firm is exempt while another firm pays the tax on a nearly-identical purchase.¹⁷

Unlike many other states, Florida has enjoyed economic conditions that have temporarily postponed a revenue slump from base erosion. In Figure 3, one finds remarkable sales tax growth over the last eleven years. Even with the slowdown in fiscal 2002 and 2003, the state averaged 5.8 percent increases over the period.

¹³ Federation of Tax Administrators (2005).

¹⁴ Streamlined Sales Tax Governing Board (2006).

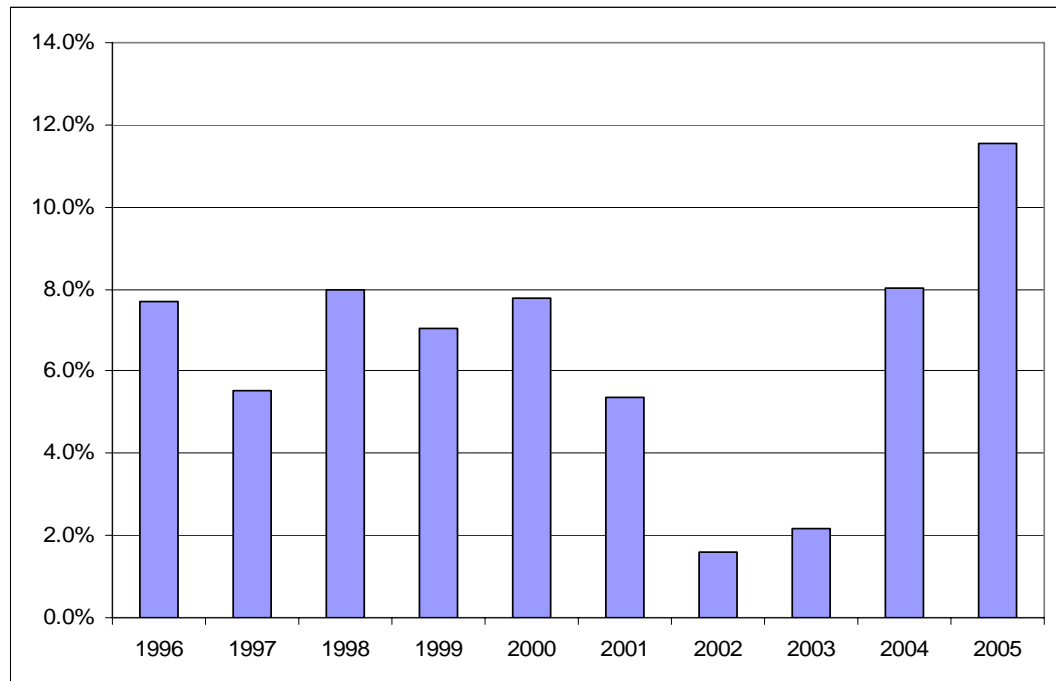
¹⁵ Both predate Due (1971).

¹⁶ The purchase of luxury boxes for sporting events is one that does not escape criticism.

¹⁷ For example, the purchase liquefied petroleum gas is generally exempt for agricultural firms, but generally taxable for other firms.

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FIGURE 3. GROWTH IN STATE SALES AND USE TAX COLLECTIONS



Source: author's calculations on Florida Department of Revenue data.

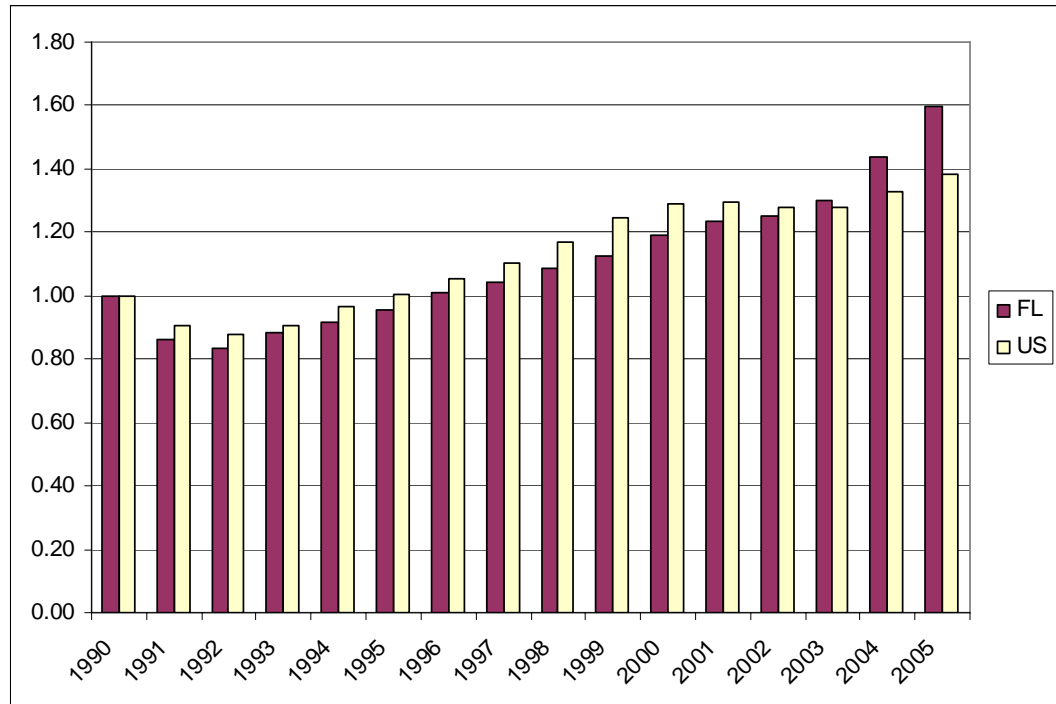
One likely cause for the Florida revenue increases – while the base is otherwise eroding – is a healthy construction industry and hurricane-recovery spending. For the former, construction employment appears in Figure 4 and the Florida industry has grown more rapidly than the same measure for the U.S. Regarding hurricanes, Harper and Hawkins (2006) found that recent collections were roughly 7 percent higher than pre-2004-storm forecasts.

In general, economic expansion (and the thriving real estate market) has prevented an erosion-driven decline in the sales tax base. In Figure 5, one can observe how increases in personal income have temporarily restored the taxable spending share of income.

The conditions have, however, increased Florida revenue reliance on durables. Figure 6 includes limited evidence on this change. Collections from automobile dealers and lumber and building retailers have increased to more than 20 percent of total general sales tax revenue. Obviously durables are sold by other

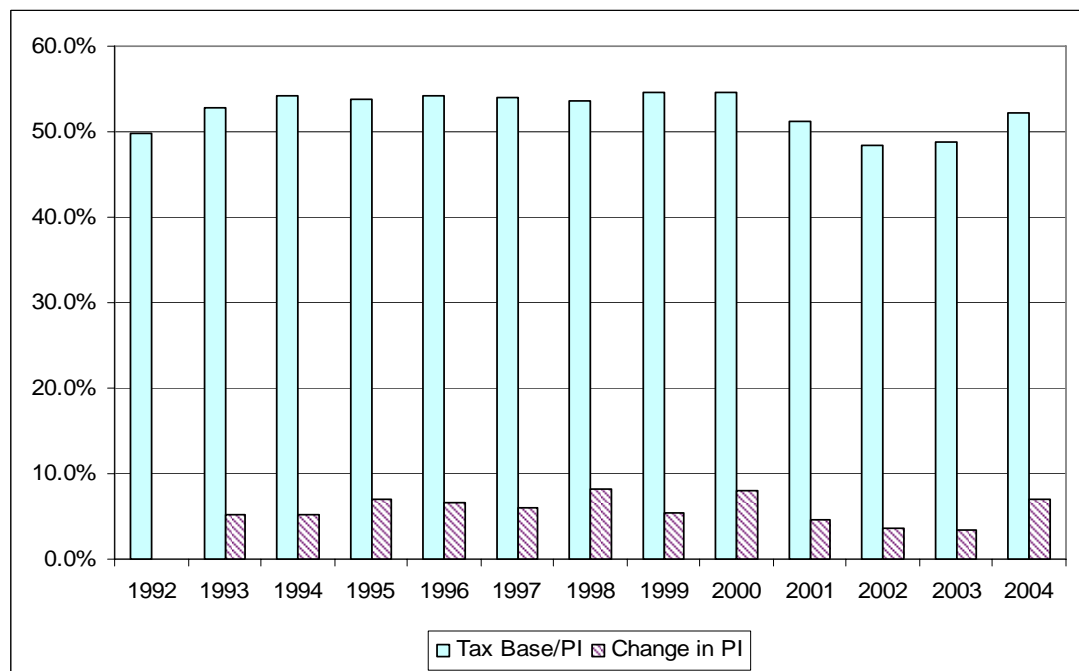
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FIGURE 4. CONSTRUCTION EMPLOYMENT INDEX



Source: author's calculations on U.S. Bureau of Labor Statistics data.

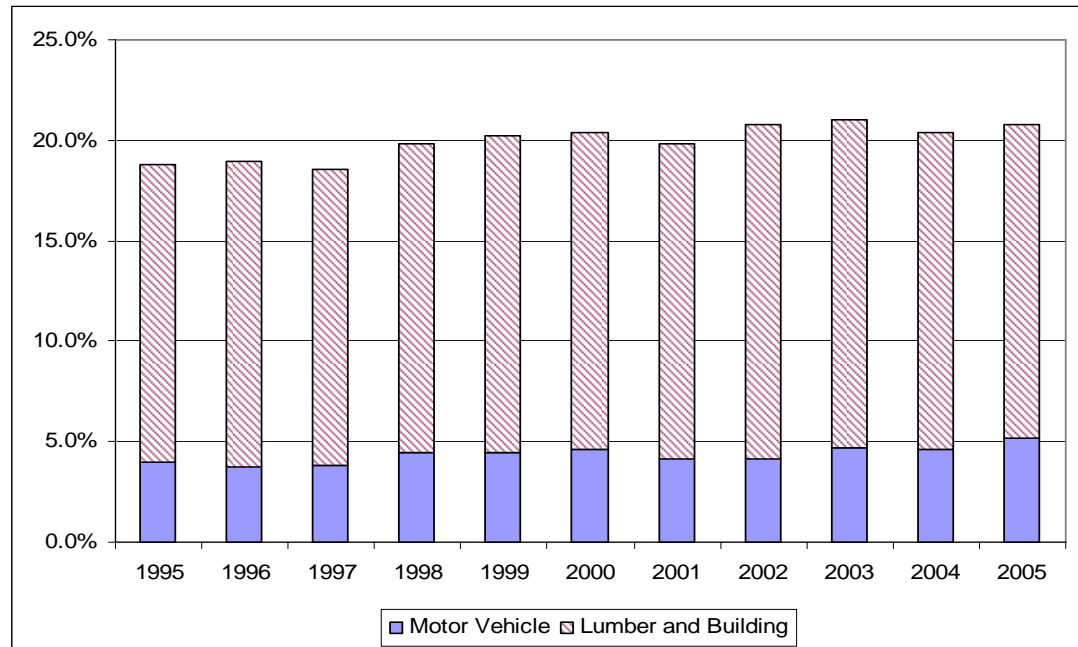
FIGURE 5. THE RELATIONSHIP BETWEEN THE SALES TAX BASE AND PERSONAL INCOME



Source: author's calculations on Florida Department of Revenue data.

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FIGURE 6. SHARE OF TOTAL SALES AND USE TAX COLLECTIONS FROM SELECT VENDOR TYPES



Source: author's calculations on Florida Department of Revenue data.

retailers as well, but the vendor types have changed over time and data consistency is suspect.

If one accepts the durable-reliance hypothesis, a sales tax slump will occur when spending on items such as automobiles and building materials slows. In the slump, policymakers should expect taxable sales as a share of personal income to fall well below 50 percent. The remaining questions are when will it begin, how sharp of a decrease will occur and when will revenue recover to somewhere near trend.¹⁸

Reform Attempt, Sort of

In 2002, State Senate President John McKay proposed lowering the general sales tax rate and dramatically expanding the base. The Florida Senate approved the measure, but the state house rejected similar legislation. A constitutional amendment approach was developed as a compromise between the two chambers.

¹⁸ Many believe the slowdown indicators are already evident. Kempner (2006) may have found one for beachfront condominium construction.

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Under the McKay amendments – there were three in total – most of the exemptions from the Florida sales tax would be scheduled to expire in January, 2009 unless the Florida legislature voted to renew them.¹⁹ Food, prescription drugs, health services, residential rent, electricity and heating fuel would be automatically exempt. According to Dunkelberger and Follick (2006), the McKay plan did not obtain the necessary signatures for the 2006 election and McKay has indicated that he will not pursue the initiative any further.

¹⁹ Floridians Against Inequities in Rates (2006).

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Step Four: Approve a Class Size Amendment

In 2002, 52 percent of voters approved an amendment that obliged the Florida legislature to provide funding for public school classes that would not exceed 18 students for grades pre-K to 3, 22 students for grades 4 to 8 and 25 students for grades 9 to 12.²⁰ Governor Bush's administration responded to the amendment with a four-stage plan. The first was to clarify how class sizes would be measured. The choice here was a district average requirement through the 2005-2006 school year, a school-level requirement for 2006-2007 and 2007-2008 and, finally, a class level requirement beginning in 2008-2009.²¹ Thus, in two years, every Florida classroom is supposed to satisfy the amendment specifications.

The second stage was to share information on flexibility such as methods to reduce construction costs. The creation of new state programs for districts to obtain funding was the third and the final stage was accountability measures for dealing with non-complying districts.

From 2003 to 2004, school district class averages indicated progress toward the caps. For example, the K-3 average had decreased from 23.07 to 20.54 (recall, 18 is the goal).²² Similar progress was found for the grades 4-8 average and the 9-12 average was in compliance. The district averages, however, were misleading. To paraphrase the Florida Department of Education (2004) presentation, 'Averages do not tell the real story – 72 percent of students are in classrooms over constitutional caps.' This means a significant spending requirement looms as the state approaches the 2008 deadline.

Like the Save Our Homes amendment, the class-size amendment has created two significant problems. In no particular order, they are:

1) *Production Inefficiency and Distorted Spending*

In an extreme case, education would follow something like a per-student Leontief technology where education per student could be determined by the minimum of (K, L) where K is the number of classrooms per student and L is the

²⁰ Brewer (2005).

²¹ Florida Department of Education (2006).

²² Florida Department of Education (2004).

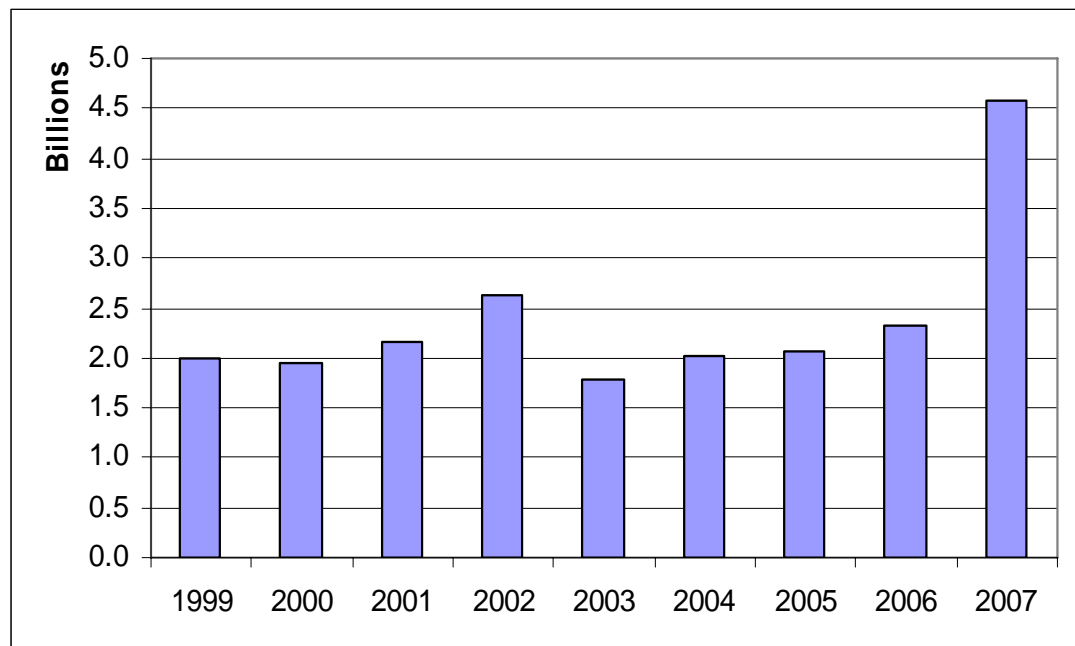
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teachers per student. If this framework actually characterized school production, a class size amendment could be justified as forcing an education enhancement policy on politicians.

Suppose, however, that other variables such as technology and labor quality affect production of education. Now, the amendment creates a potential inefficiency—where the state and the school districts are forced to purchase more K and L when the marginal return from the other factors might be larger.

One can observe the effect of larger K purchases in Figure 7, where state-level capital spending increases dramatically in fiscal 2007. The related budget stress could mean reduced spending elsewhere and actually sacrificing other education inputs. For example, new classrooms may be financed by postponing technology replacement. This type of spending substitution should actually drive up the marginal return of the foregone input.

FIGURE 7. STATE FIXED CAPITAL OUTLAY FOR EDUCATION



Source: The Bush/Brogan and Bush/Jennings Administration Budget Recommendations (various years).

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2) *Availability of Labor*

In the fall of 2004, Florida school systems needed 20,000 new hires. The 30 institutions in Florida with approved teacher education programs produced 5,400. In the fall of 2006, school systems are projected to need 32,000 new hires while the same institutions are expected to produce 5,600.²³

Policymakers have several policy initiatives to attract new teachers. They include higher salaries, a more general special education certification, easier rules for temporary certificates, a student loan forgiveness program and <http://www.teachinflorida.com>, a web site for drawing applicants. These measures help the structural shortage – in new teacher demand less new teacher supply – but there is no evidence they eliminate it.

Evolving Reform

The first response to the class size amendment by many in the legislature was a push for repeal. More recent efforts have focused on replacing the classroom cap with a countywide-average cap or an amendment easing the class size requirement while adding significant new funding for teacher salaries.²⁴

The effect of class size on student performance is a widely researched topic and the findings of researchers such as Eric Hanushek, Alan Krueger and Edward Lazear are beyond the scope of this paper. The policy problem is if Florida's class size amendment is replaced with something else, the goal should be a better return on education spending. The debate, however, does not center on return, but rather on the problems associated with reaching the class size caps.

²³ Florida Department of Education (2005).

²⁴ Solochech (2006).

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Conclusion

For the 2006 budget, Florida policymakers agreed to a remarkable \$73.9 billion budget. They argued over which tax cuts to approve and how to spend that which wasn't cut. Fast forward two, three, or maybe even one year and the picture will be very different.

Future budgets will be shaped by reactions to the four steps the state has already taken toward a fiscal train wreck. The first will be reacting to the unintended consequences of the Medicaid waiver. This could be new emergency-room funding for treating individuals who have drained their account or, perhaps, additional resources for the Agency for Health Care Administration to clear confusion about the system.

The second reaction will be to the other problems Save Our Homes has created after portability is, in all likelihood, the new statewide policy. This could be transfers to counties who promise to reduce the overall millage. Or, outside of the budget, we might find a Colorado-style initiative to cap local spending directly.

A vanishing sales tax base, as durable spending slows, will be evidence of the third step. The reaction might be to finally pass streamlining legislation or approve deep spending cuts. Another option is a McKay-style exemption review, but the lobbying that inevitably follows is probably distasteful to all concerned.

Finally, it is difficult to imagine every Florida public school actually meeting classroom-level class size caps. Therefore, the policy reaction has to occur before the deadline with a compromise that does not generate anger voters.

Overall, the Florida fiscal outlook is not promising. The four steps to the train wreck are going to eliminate the current surplus environment and force policymakers to make difficult decisions. Beyond the money, however, is the uncertainty on whether solutions to the train wreck are going to improve the public provision of goods and services and the policy-induced inefficiencies for Floridians. The train wreck itself will not be fatal, but the fiscal solutions may end up hurting the state. Unfortunately, that risk appears to be beyond the radar of many in the policy arena.

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Richard Hawkins is Principal Associate with the Fiscal Research Center and an Associate Professor of Economics at the University of West Florida. He did his undergraduate work at Emory University and received his Ph.D. in economics from Georgia State University. While at GSU he was a Research Associate in the Fiscal Research Center. His research interests include public finance, particularly the sales tax.

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