

BRIEFINGS

Center for a Competitive Florida

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The FAIR Amendment Would Constitutionally Impose Billions of Dollars of New Taxes

The FAIR Amendment—a proposed amendment to the Florida Constitution that may go to the voters in November 2004—would turn the tables on taxpayers, fundamentally changing the way taxes can be raised and creating opportunities for dangerous, unintended consequences.

Under the Amendment, the Florida Legislature would, by July 1, 2007, have to review all exemptions and exclusions from the state's sales and use tax, and, if they are not individually re-enacted, they will be eliminated and currently exempt or excluded goods or services will begin to be taxed automatically. What's more, the amendment requires a three-fifths vote of the entire membership of each house of the Legislature to re-enact the exemption, and, if the Legislature never votes on re-enactment, the exemption is automatically repealed. This confusing and convoluted process will be repeated every ten years.

Current exemptions for food, prescription drugs, health services, and residential rent, electricity and heating fuel are excluded from the review and would remain exempt. This leaves the value of potential tax increases at approximately \$20 billion. This is more than 80% of the total general revenue currently collected by the state. While many exemptions may be re-enacted, this could easily be the largest tax increase in the state's history and could result without a vote from the Legislature, or even if a significant majority of legislators vote against it. Moreover, this opens the door for a tremendous number of products and services becoming taxable that should remain exempt.

Automatic and Indiscriminate "Sunsetting" of Exemptions Is Both Irresponsible and Unaccountable

One major problem with the way the amendment would work is the sunsetting of exemptions. Sunsetting would eliminate all but a dozen out of some 400 sales tax exemptions, unless the Legislature votes to reenact each individually. Ever since Florida's service tax debacle in 1987, Florida TaxWatch has been warning of the problems associated with sunsetting exemptions.

The Amendment, if approved, would turn the process of raising taxes around, putting taxpayers in a dangerous situation. Instead of the Legislature needing to state its case for tax hikes, this could result in a tax increase of billions of dollars, even if the Legislature does nothing. Taxes should never be raised without an affirmative vote of the Legislature. On top of this, it requires a three-fifth vote of both houses to re-enact an exemption. As we have seen in the last couple years—and a variety of special sessions—it can be very difficult to get the Legislature to come to an agreement, even with a simple majority. A 60% majority may prove difficult for even the most worthwhile exemptions. Basically, this requires a supermajority to defeat a tax increase—a drastic departure from current law and a bad precedent.

"Celebrating 25 years of improving taxpayer value, citizen understanding and government accountability."

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The amendment says that the Legislature shall reenact only those exemptions that serve the public purpose of: encouraging economic development and competitiveness; supporting educational, governmental, literary, scientific, religious, or charitable initiatives or institutions; or securing tax fairness. While this is a laudable goal, the individual categories are rather broad, thereby providing another bone of contention that could increase the debate over a certain exemption, the likelihood of a stalemate, and resulting in the exemption being repealed.

The proper course would be for the Legislature to take a careful look at each exemption and, only after it is sure that an exemption is not justified, specifically repeal that exemption and statutorily address how that item should be taxed. A wholesale sunset of exemptions without specifying exactly what should be taxed and how it should be taxed can present a myriad of problems.

Look back at what happened in 1987 with the ill-fated services tax. The taxation of services is a very complex issue as evidenced by the voluminous legislation that was passed and the mountains of rules promulgated by the Department of Revenue. It resulted in a tax that was not only unpopular, but also extraordinarily complicated and hard to administer. Taxing services raises difficult final point-of-service (nexus) issues and can result in pyramiding where essentially the same service is taxed multiple times.

Most Exemptions are Not “Loopholes” and Serve a Sound Public Purpose

One thing that must be remembered is that the contention that there are billions of dollars of sales tax “loopholes” and unjustified exemptions is just not true. Of the \$26 billion the state terms exemptions, \$17 billion are services, which are not exemptions at all but rather are not considered part of a sales tax. There is almost no sales taxation of services by other states and, remember, Florida tried taxing services once before and it lasted six months.

Almost two-thirds of the remaining exemptions are made up of six basic necessities of life: groceries, residential rents, residential power and heating fuel, drugs and medical supplies, hospital rooms and meals and water.

There also are numerous exemptions needed to maintain the nature of the sales tax as a tax on the final retail purchase of an item. These include exemptions to avoid pyramiding and duplicative taxation, such as materials used for packaging. Their cost is included in the price of the item being packaged and sold and is subject to tax at that time. Another example is separately billed utility charges to a tenant on which the landlord has already paid sales tax. Without that treatment, the tax would be collected twice. Other exemptions guard against the imposition of tax on tax.

Repealing some exemptions would also be in violation of federal or other controlling law. These include exemptions for Internet access fees, the taxation of which is prohibited by federal law. The credit allowed for sales tax paid in other states is required by the Commerce Clause of the United States Constitution. There also is an exemption for sales to governments, which are constitutionally immune from tax.

There also are economic development exemptions that help Florida businesses compete with those in other states and nations. These exemptions can more than pay for themselves in the long run, and repeal

would be counterproductive. Economists believe it is critical to employ a tax system that both encourages maximum economic growth and generates revenue from economic growth. In other words, Florida's tax structure should encourage productivity—not tax it—while generating revenue from consumption.

In fact, there is a need for additional economic development exemptions to be created, particularly on inputs to manufacturing such as research and development and manufacturing machinery and equipment. These exemptions would allow Florida to keep pace with other competitor states that offer similar exemptions.

Tax expert David Brunori, writing in the June 2004 edition of *Governing*, was critical of a proposal in Virginia to eliminate sales tax exemptions for many businesses. He writes:

But sales taxes are not supposed to be imposed on business purchases. When a business pays sales tax, the amount paid becomes part of its cost of goods sold. That cost is passed down the line until it falls on the consumer. The tax is hidden, and that violates all the principles of transparency — citizens do not know they are paying the tax, which is disguised as higher prices.

Brunori goes on to say that, if you are reforming a tax system today, you should be trying to expand the sales tax exemptions for business purchases, not eliminate them.

The point is: not all exemptions are bad. In fact, close examination shows that most are there for good reason.

Last year Florida TaxWatch established a Task Force on Tax System Modernization. Part of that effort was a close look at sales tax exemptions. The Task Force contracted with Florida State University to use the most sophisticated econometric modeling available to examine the impact of removing various exemptions. We found that applying the sales tax to services was a questionable economic move and that taxing certain sectors would result in significant losses in jobs, gross state product and income. The new revenue the state would take in would be far exceeded by the loss to gross state product.

The Tax Force created three categories of exemptions that should be retained: life's necessities, structural (retaining the nature of the sales tax as a tax on final purchase), and economic development. Outside of these categories, the Task Force found that there were over 100 exemptions and exclusions worth over \$1 billion that could be considered for repeal. These should be carefully reviewed and eliminated only by an affirmative vote of the Legislature.

Florida's Tax Structure has Served the State Well

Another myth is that Florida's tax structure is too volatile, and revenue collections change wildly as the economy changes. When the discussion about wholesale review of exemptions got serious in the 2002 Legislature, this was often raised as the reason for needing to broaden the sales tax base. In reality, in terms of stability, Florida's tax structure does very well. During the recent recession, Florida's general revenue collections continued to rise, a feat that 31 states cannot claim. Without raising taxes, Florida's collections rose 4.3% from 2001 to 2003. Only eight states fared better and Florida was the only major state that did not have a decrease in revenue. Again, 31 states saw their collections drop, including 3.2% in Texas, 10.1% in New York and 15.3% in California. There are 41 states that would love to have the revenue stability of Florida's tax structure.

Another myth is that Florida's tax system is antiquated and doesn't reflect the transition to a services-based economy. The sales and use tax base has been expanded nearly every year since 1949, according to the *Florida Tax Handbook*, a publication of the Florida Legislature. The handbook states the most substantial increases were: in 1957, when inexpensive clothing, motor vehicles (1% rate), mixed drinks, cigarettes, and industrial machinery (\$1,000 maximum) were added; in 1968, when rates were increased from 3% to 4% on most items (2% on motor vehicles); in 1971, when rates on motor vehicles were made equal to the state rate; in 1982, when rates were increased from 4% to 5% and for the first time a portion of the receipts were deposited into a trust fund; (the trust monies, approximately 10 percent of total receipts, were distributed annually to eligible municipal and county governments); and in 1988 when the rates were again increased from 5% to 6%.

Sales Tax Exemption Review Does Not Belong in the Constitution

Moreover, this issue does not belong in the Florida Constitution. Florida TaxWatch has a long history of opposing attempts to legislate using the constitution.

The Constitution should be a fundamental document that contains the root guidelines of government. It should not be used to address statutory issues that the legislature will not take on. The Florida Constitution does establish taxation as a uniquely legislative function and the Florida Supreme Court has observed:

The constitution is the framework of the government containing the general principles upon which the government must function. It is not designed to provide detailed instructions for the method of its implementation. This must of necessity be left up to the legislature.

Johns v. May, 402 So. 2d 1166 (Fla. 1981).

Instead, the Constitution in Florida is being demoted to the status of statutory code. The United States Constitution has been around for over 200 years and it has been amended only 27 times. The Florida Constitution has been amended 95 times in 30 years--most of the amendments proposed by the Legislature. Of these 95, only eight of them were supported by more than 50% of the state's registered voters, and five passed with the support of less than 20% of those registered to vote. Also, the voters have not met many constitutional amendments they don't like—over the last ten years almost 90% of amendments have been approved.

Tying future Legislatures' hands is not a good idea. Some constitutional tax restrictions already exist that limit flexibility. The proposed Amendment would create another one if it gets on the ballot and is passed.

Conclusions

The FAIR Amendment must still obtain the required number of signatures and withstand Supreme Court scrutiny before it makes it to the ballot. A thorough review of sales tax exemptions is justified and overdue. But any fair review would be careful, thoughtful and mindful of the potential deleterious impacts the so-call FAIR Amendment's arbitrary and automatic sunseting of exemptions would have on Florida's economy. It must be done without constitutionally making it difficult to avoid raising taxes. Exemptions should only be repealed or modified by a majority vote of the full Legislature.

A genuinely fair process would allow for sufficient review and ensure that an exemption is repealed only after the Legislature has determined that it is the right thing to do. The Legislature must carefully consider the long-term economic impact of all exemptions before it makes any decisions.

Unfortunately, the FAIR amendment does not provide that most important safeguard, and a barrage of unintended consequences could be the result.

This *Briefings* was written by Kurt Wenner, Senior Research Analyst, under the direction of Keith G. Baker, Ph.D. Senior Vice President and Chief Operating Officer.

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About Florida TaxWatch

Florida TaxWatch is the only statewide organization entirely devoted to protecting and promoting the political and economic freedoms of Floridians as well as the economic prosperity of our state. Since its inception in 1979, Florida TaxWatch has become widely recognized as the watchdog of citizens' hard-earned tax dollars. The nationally distributed *City and State* magazine (now *Governing* magazine) published a poll of the nation's statewide taxpayer research centers. Based on this poll, the publication cited Florida TaxWatch as one of the six most influential and respected government watchdogs and taxpayer research institutes in the nation.

In recent years, news stories about Florida TaxWatch have run in all Florida newspapers, *The Wall Street Journal*, *The New York Times* and *The Washington Post* and *Fortune* magazine. In addition, Florida TaxWatch has been featured on the prestigious *MacNeil/Lehrer Newshour*.

Florida TaxWatch is a private, non-profit, non-partisan research institute supported by voluntary, tax-deductible membership contributions and philanthropic foundation grants and contracts. Membership is open to any organization or individual interested in helping to make Florida competitive, healthy and economically prosperous by supporting a credible research effort that promotes constructive taxpayer improvements. Members, through their loyal support, help Florida TaxWatch to bring about a more effective, responsive government that is accountable to the citizens it serves.

Florida TaxWatch is supported by all types of taxpayers -- homeowners, small businesses, corporations, professional firms, labor unions, associations, individuals and philanthropic foundations -- representing a wide spectrum of Florida's citizens.

Florida TaxWatch's empirically sound research products recommend productivity enhancements and explain statewide impact of economic and tax and spend policies and practices. Without lobbying, Florida TaxWatch has worked diligently and effectively to build government efficiency and promote responsible, cost-effective improvements that add value and benefit taxpayers. This diligence has yielded impressive results: through the years, three-fourths of TaxWatch's cost-saving recommendations have been implemented, saving taxpayers over \$6.2 billion (according to an independent assessment by Florida State University). That translates to approximately \$1,067 in added value for every Florida family.

With your help, we will continue our diligence to make certain your tax investments are fair and beneficial to you, the taxpaying customer who supports Florida's government. Florida TaxWatch is ever present to ensure that taxes are equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are more responsive and productive in the use of your hard-earned tax dollars.

The Florida TaxWatch Board of Trustees is responsible for the general direction and oversight of the research institute and safeguarding the independence of the organization's work. In his capacity as chief executive officer, the president is responsible for formulating and coordinating policies, projects, publications and selecting the professional staff. As an independent research institute and taxpayer watchdog, the research findings, conclusions and recommendations of Florida TaxWatch do not necessarily reflect the view of its members, staff or distinguished Board of Trustees.



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