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Testimony of

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Thank you for inviting me to testify today on Florida's budget and the outlook for the state's future. Florida, like the rest of the nation, is weathering a deep and sustained recession.

As of today, the state faces a budget gap of at least $3 billion. Last year's $66.5 billion budget was balanced through a combination of quick fixes, including $2.2 billion in tax hikes, $5 billion in federal stimulus dollars, and $1 billion in cuts.

This year's $69 billion proposed budget takes a flawed approach: Expanding spending by relying on uncertain stimulus funds, pushing Florida closer to what Scott Pattison of the National Association of State Budget Officers calls "the stimulus cliff."

When federal funds recede, unless Florida institutes meaningful spending reforms, budgetary gaps will reappear. The choices Florida's government makes today are vital to Florida's future.

To bring Florida back to fiscal stability requires looking at how the state arrived at this point, while ensuring the state avoids the pitfalls responsible for the bankruptcy scenarios facing California, New York, and New Jersey. In these states, ever-escalating taxation to pay for out of control spending has produced a significant out-migration of people over the last decade.

I have spent the last several years studying the relationship between appropriations and policy implementation on the federal and state levels. And for the last 18 months, I've studied the fiscal collapse of New Jersey and the factors that brought it to its current crisis.

If Florida wishes to avoid the same fate it is imperative that the legislature get its fiscal house in order and not delay tough decisions until it's too late. This is what New Jersey did, and it is

[1] The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.

currently reaping the whirlwind of legislative malpractice, judicial interference with the appropriations process, and a tax structure that the non-partisan Tax Foundation calls the worst in the country.

As you know, the areas of greatest budgetary concern for Florida are the growth in spending in health care, transportation, and education. All three of these deserve careful study by the legislature. Today, I will focus on the relationship between fiscal policy and education.

Education

As you know, Florida's spending on education has risen steadily over the past 15 years. The question I'd like to frame my remarks around is: "Why does spending appear uncontrollable?"

For an answer I will discuss Florida's fiscal situation from the perspective of the fiscal "rules of the game." That is, the rules under which the state budgets and sets policy. These include the school funding formula and the revenue cap.

In 1973 the Florida legislature pre-empted the wave of educational funding equity litigation rolling through the states, creating the Florida Education Financing Program (FEFP). The goal was to equitably distribute state resources to Florida's 67 school districts.

The formula sets a base amount of funding for Florida's schools and then factors in a cost-of-living differential and other factors for each district. From this, state determines the "required local effort," or the amount the locality must collect on its own, which is based on property values and a required tax rate.

To receive state funds, school districts must levy the local property tax rate set by the Legislature. Districts with higher property values generate more funding than districts with low property values. Districts with low property values receive more state funding. Districts with high property values receive less.

This sets up a problematic relationship. Education is locally-delivered good but its financing is determined by the state. Through this formula, the state determines the local property tax. State and local revenue streams are co-mingled and redistributed.

The result of this approach is that fiscal accountability is blurred by the weakened relationship between the taxpayers and school districts.

The Tax Swap

The housing boom produced a period of double-digit growth in property tax valuations without reductions in property tax rates. This increased property tax burden led the state to consider alternative means to fund Florida's schools, proposing in 2008 Amendment Five, or the Tax Swap Amendment.

This amendment would have eliminated school property taxes and offset those revenues with a state-levied source such as an increase in the sales tax.

The amendment did not make the ballot.

It is important to review why this proposal would not have worked and how close Florida came to making the same fatal error New Jersey did 34 years ago.

In 1976, the New Jersey Supreme Court ruled in the first of a series of decision known as the *Abbott* decisions that state could not rely on the property tax alone to fund schools. The court ordered the state to find supplemental revenues. This set the stage for the takeover of the legislature's constitutional power of appropriations by the courts. The result is one of the highest rates of per-pupil spending in the country and an education system that in many urban areas graduates less than one out of every eight high school freshmen.

The New Jersey legislature complied with the *Abbott* rulings by creating a nearly flat income tax constitutionally dedicating all of the revenues to "indirect property tax relief."

Nearly 78 percent of the state's "Property Tax Relief Fund" is now spent on schools. The school portion is nearly equally split between 31 court-designated "poor districts" and the remainder of New Jersey's 605 school districts. A small portion of the fund is spent on providing homestead rebates and municipal aid.

The fund has failed on all counts. Today it is a leading driver of New Jersey's fiscal crisis, its ever-increasing income tax rates, and the outmigration of businesses and citizens.

Property taxes have risen in New Jersey every year since 1978, a mere two years after the first *Abbott* decision. Since 1976, the court has continued to issue more rulings. The most significant in 1997 mandated that poor districts spend as much per pupil as the wealthiest districts in the state. The result is one of the most progressive income taxes in the nation, with eight brackets and a top rate of 10.75 percent on those earning over a million dollars a year.

In spite of these massive transfers, outcomes in the *Abbott* districts remain abysmal. Since 1998, Camden has received $2.8 billion for its schools, with close to $24,000 spent per pupil per year. Last year, 18 percent of Camden's eighth graders scored proficient in math.

A tax swap, or any similar divorcing of education consumers from education producers, would put Florida on a similar path. There are fundamental flaws in dedicating more state revenue to providing a local good.

Replacing local revenues with state revenues does nothing to prevent property taxes from rising. In fact, the replacement of revenues may stimulate greater local spending. As more funding comes from the state, there is less "fiscal visibility" and accountability for how funds are spent on the local level.

Comingling and redistributing state and locally levied resources creates greater opacity for taxpayers, for the parents of schoolchildren, and for the state government. Accountability for spending and outcomes becomes obscured as the source of funding, and the place where spending takes place is separated, a concept known in economics as “fiscal illusion.” Taxpayers have a blurred picture of the true cost of funding education and are less likely to police such spending on the local level. The state government receives an incomplete picture of how those funds are being stewarded. And the local level loses its autonomy and flexibility in setting its fiscal policy and delivering educational outcomes.

In considering how to fund its schools Florida should adopt principles that give more, not less, autonomy to the localities to levy taxes to provide education. As funding is centralized, accountability on the local level is weakened. In other words, it’s important that Florida maintain as much link between taxation and outcomes as possible.

Revenue Limit

Another fiscal rule I would like to touch upon is Florida’s revenue limit.

Spending in Florida has continued to climb beyond what can currently be supported by state revenues, because the rules meant to constrain excessive spending are ineffective.

In 1994, Florida instituted a revenue cap. This cap increases each year according to the average annual growth rate in Florida personal income over the previous five years.

In effect, the revenue cap places no limit on spending. Appropriations are tied to growing incomes. When economic growth is robust, spending grows rapidly. Only own-source revenues are included (therefore federal funds are excluded), further weakening the cap.

In other words, this revenue cap has no teeth.

It is the fiscal equivalent of belonging to a gym but never going inside. It gives legislators a false sense of fiscal discipline, but does nothing to produce a disciplined budget. Reliance on this cap is a key reason that Florida is in its current fiscal position. To extend my metaphor, it’s like using a gym membership that’s never exercised as an excuse to eat dessert – night after night.

Florida should consider an effective spending rule. One such rule would cap spending to the sum of population growth and inflation.

Recommendations

I do not want to tell you that Florida’s fiscal picture is as dire as those facing other states, such as New Jersey, New York, and California. But at the same time, you are facing a significant gap between expenditures and revenues, and there is no choice but to close it.

The decisions that you as legislators make today will have ramifications for decades to come, just as New Jersey's poor fiscal decisions in the 1970s set the stage for one of the worst fiscal disasters in American state history. Florida's situation is not so dire that it cannot be fixed with the right policies. The decisions the state makes today will determine whether the state will remain competitive in the future. Florida can stay on track if it adheres to some basic principles in how it thinks about taxation, spending, and budgeting.

I have two key recommendations.

First, <u>apply the principles of decentralization in education financing</u>. Education is a local good. It is consumed and provided on the local level. When funding for schools moves further from this level, accountability is weakened. Fiscal opacity is built into the system. The best way to bring down costs in education, while increasing fiscal transparency is to continue to introduce competition, and pursue policies that provide more autonomy to local government, rather than less.

Florida's education landscape should be kept free from fiscal and regulatory obstacles that might limit flexibility and responsiveness in delivering a variety of educational goods.
Florida has been a leader in this area through its voucher programs and commitment to charter schools.

The perverse outcomes of the *Abbott* decisions in New Jersey fiscally centralized the provision of education, tying together the state's income tax and property tax regimes. This design is a leading driver in the state's fiscal and economic downward spiral as school costs skyrocketed and competition has been nearly shut out of the system.

On that note, it is worth mentioning the importance of the courts in setting this fiscal and educational climate. The New Jersey Constitution requires that students receive a "thorough and efficient" education. This language formed the basis of the court's multiple *Abbott* decisions.

Constitutional language is subject to a wide range of interpretations. Florida experienced this in 1998 when the state's Constitution was amended to include the "uniformity" clause, which mandates, "a uniform, efficient, safe, secure and high quality system of free public schools…." The court's interpretation of this clause became the centerpiece of the 2006 Florida Supreme Court ruling that overturned the A+ voucher program.

Secondly, <u>Florida should consider implementing an effective spending limit</u>. The current revenue cap is ineffective. Indeed, it is worse than ineffective because it merely provides cover for poor long-term budgeting practices. Florida should consider a limit with teeth that would tie spending increases to the combined annual growth in population and inflation. That would prevent future legislatures from having to make tough choices now facing this body.

Under such a cap, in cases where the state would like to spend beyond the cap, it must seek permission to override the cap from taxpayers. When revenues exceed the cap, these can be dedicated to a Budget Stabilization fund, up to a limit, with the remainder rebated to taxpayers.

Local governments should also be given the opportunity to institute similar spending limits if they choose.

Effectively designed spending limits with competition in the provision of education will have the combined effect of increasing accountability in school spending, lowering costs, improving outcomes, and enhancing prosperity for Florida's residents and economy.

Thank you for inviting me to testify, and I look forward to taking your questions.