

August 1, 2002

## PAYING FOR SMALLER CLASSES: CONSIDERING THE OPTIONS

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In the November election, Florida voters will have the opportunity to consider a constitutional amendment that would mandate an upper limit on class sizes in public schools. If the amendment passes, class sizes would be reduced beginning in the 2003-04 school year until by 2010, classes for third graders and below would be no larger than 18 students, classes for fourth through eighth graders would be no larger than 22 students, and classes for grades nine through twelve would not exceed 25 students. The merits of mandating smaller class sizes is the main issue, and justly so, but a secondary issue is the cost of reducing class sizes. Smaller class sizes mean more teachers, more classrooms, and more overhead expenses to serve the same students. The state's economists estimate that to implement this amendment would require the construction of almost 30,000 additional classrooms and the hiring of more than 31,000 additional teachers. The cost of passing this constitutional amendment would exceed \$3 billion a year in additional educational expenditures.

The amendment does not specify how this money would be raised, so it is worth looking at the state's tax structure to see how smaller class sizes could be financed. When analyzing possible revenue sources, three things should be considered:

- 1.) Would it be possible to raise a sufficient amount of revenue to pay for the amendment?
- 2.) Is it reasonable to think that Florida voters and the legislature would approve revenue from that source?
- 3.) Would it be good policy to use that source of revenue to fund smaller class sizes?

The state's largest source of tax revenue is

the sales tax, which will raise about \$18 billion in 2003 at its current state rate of 6 percent. Most Floridians pay a higher rate than this because local sales tax is added to the state's 6 percent rate. The math is simple—if we assume that a higher sales tax rate would not reduce total taxable sales. Each one percentage point of the sales tax generates about \$3 billion in sales tax revenues, so the class size amendment could be almost paid for by increasing Florida's sales tax rate by 1 percent. But even this would fall short partly because the estimated costs are slightly above \$3 billion a year, but more significantly, because a higher sales tax rate would push more people to evade the tax, by buying out-of-state or over the Internet, where sales taxes are less likely to be paid.

Considering the three questions above, an increase in the state sales tax from 6 percent to 7 percent could raise most of the revenue necessary to fund the amendment; the remainder could be squeezed out of the budget in other places. Politically, increasing the rate would be a difficult sell to Florida's voters and would be difficult to get through the Florida legislature, so realistically, this may not be a politically feasible option. From a policy standpoint, Florida's sales tax rate is high enough now; further increases could seriously erode the tax base as taxpayers search for ways to evade it. Looked at in isolation, this does not look like a good policy choice, but reviewing the other options, it is better than most.

Florida's sales tax does not tax every purchase, so another way to raise the revenue to reduce class sizes would be to remove some sales tax exemptions. If groceries were taxed, that would raise about \$2.3 billion a year, and taxing

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residential rent would raise nearly \$1 billion, so extending the current sales tax to groceries and rent would cover the cost. Alternatively, Florida has flirted with extending the sales tax to services, but if all personal services were taxed, that would add only about \$1 billion to Florida's tax revenues, which would be inadequate to fund the education amendment. If personal services, prescription and nonprescription drugs, and all health services were taxed, that would raise slightly more than \$3 billion, which would just about cover the amount needed.

Extending the services tax to business and professional services would raise about \$4 billion in new revenues, but there are problems with this. Taxing business purchases results in double taxation because if, for example, a retailer purchases legal or accounting services or spends money on advertising, those costs become a cost of the retailer's final product. If those services are taxed, the sales tax becomes a part of the cost too, and is taxed again. The double taxation that results from taxing business services has several disadvantages.

Businesses that can afford it have an incentive to bring such services in-house, hiring their own accountants or attorneys rather than dealing with firms that charge sales tax. They can avoid the tax this way but by doing so, they are making decisions based on the tax consequences rather than on what is the most economically efficient way to do business. Florida's economy will suffer and obviously so will small accounting, legal, and other business service firms in the state. This also creates a disadvantage for small businesses that cannot afford to hire their own accountants and attorneys. The strength of Florida's economy lies in its small businesses, so Floridians should be careful about pursuing a tax policy that has a disproportionately negative impact on small businesses. Taxing the sale of business and professional services hurts Florida businesses relative to businesses in other states, and would push some of those professional service jobs to other states.

Taxing business and professional services is bad economic policy, but it also would surely face substantial political opposition. There was a strong push to tax business and professional services in 1987 and again in 2002, but both attempts ultimately failed. A services tax was

passed in 1987 and repealed less than a year later, and the 2002 measure did not get out of the legislature. (The legislature did approve putting a constitutional amendment on the ballot in November to revisit the issue, however.) Politically, taxing business and professional services does not seem feasible, and economically it is undesirable anyway.

The most feasible alternatives would be to remove the sales tax exemptions on groceries and residential rent, or those on personal services and health care expenditures. Going back to the three questions listed earlier, removing these exemptions could raise sufficient revenue to pay for the smaller class sizes. Politically, it would be difficult to convince voters and the legislature to do so, however. From an economic perspective, perhaps the strongest argument against removing these exemptions is that they would hit lower-income Floridians the hardest.

Another alternative would be to increase corporate income taxes, but the corporate income tax will raise only about \$1.3 billion if the economy stabilizes. The rate would have to be more than tripled to raise enough to pay for the class size amendment. But if the rate were raised this much, it would surely chase business out of Florida, so tripling the rate would not triple the revenue. Yet another possibility would be to look at Florida's intangible property tax, which raises about \$500 million. That rate would have to be six times as high as the current rate to pay for the higher class sizes the amendment would dictate. When one looks at the facts, these revenue sources are clearly inadequate to finance what the class size amendment would cost.

Increasing the corporate tax rate by 300 percent or the intangible property tax rate by 600 percent is not feasible. Doing so would cause taxpayers to leave the state, because both corporations and individual wealth are relatively mobile. Another problem is that both the corporate income tax and the intangibles tax tend to be cyclical. Revenues fall substantially when the economy declines, so when a recession comes along, those revenues decline and are not available to finance expenditures, which causes fiscal problems down the road. Florida should try to move away from tax bases that fall substantially during recessions, not move toward them. Going back to the three questions,

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neither the corporate income tax nor the intangibles tax could raise enough revenue to finance the changes in this amendment. Politically, it is unlikely that the voters or the legislature would be willing to entertain the massive increases in these taxes that would be required, and even if they would, such tax increases would be harmful to Florida's economy. These revenue sources look like poor alternatives on all three counts.

Florida's cigarette tax, now at 33.9 cents a pack, raises about \$450 million, so raising the cigarette tax to \$2.60 a pack would also cover the cost of the class size amendment, assuming smokers kept buying the same amount and did not smuggle them from lower-taxing states. Alcoholic beverage licenses and taxes raise about \$600 million a year, so raising them to six times their current rate would also pay for the amendment. Such huge tax increases are unlikely to be implemented. Again looking at the three questions, increased taxes on tobacco and alcohol could not raise enough revenue to finance the smaller class sizes called for by the amendment; the tax increases would be so large that it is unlikely they would be politically feasible; and from an economic standpoint, such substantial tax increases would encourage smuggling and tax evasion, which would harm Florida's economy.

Another possibility, even more remote, is to establish a personal income tax to pay for smaller class sizes. While the structure of personal income taxation varies among the states that use it, a personal income tax of 1 percent would probably be insufficient to fund the class size amendment. The rate would probably have to be between 1 and 2 percent to raise sufficient revenues. Personal income taxation is prohibited by Florida's constitution, so another constitutional amendment would be necessary to go this route. Getting voters to approve a personal income tax is even more unlikely than the unlikely scenarios just reviewed.

The proposed amendment says that the cost of smaller class sizes should be borne by the state, but what if, over time, state funding for education still fell and local school districts had to bear the cost? Floridians currently pay a total of about \$6.5 billion in property taxes to school districts and about \$13 billion in total property taxes. Looking at state averages, if the property

tax were used to finance the amendment's mandates, it would require a 46 percent increase in school district property taxes, which would be a 23 percent increase in overall property taxes. Because of differences in both the assessed value of property and class sizes among districts, property taxes would increase more than this in some districts but less in others. While using property taxes to finance the amendment's class size reductions would violate the amendment's intent, understanding that its cost would be equal to a 23 percent increase in property taxes helps see the potential financial impact of the amendment.

Looking at the options, it is apparent that the only tax substantial enough to finance this class size amendment is the sales tax, and to use the sales tax to finance this reduction in class size would require a 1 percent increase in the rate, or extending the tax to groceries and rent, or something of a similar magnitude. The political reality is that Florida voters and taxpayers will not support such substantial increases in Florida's sales tax to fund smaller class sizes.

Perhaps a combination of taxes could be used to fund the amendment but more likely, if the amendment passes, most of the cost will be financed by squeezing other parts of the state's budget. More than half of the state's general revenue spending goes to education, with the bulk of the rest going to health and human services, so without tax increases, those will have to be the areas to squeeze. The amendment says that the state would be required to come up with the revenues to finance the increased class sizes. But just as some people have argued that the lottery money supposedly earmarked for education has not increased education spending, the revenues to fund smaller class sizes could come from slower growth in other education expenditures. Education could be squeezed by raising college tuition and by reducing expenditures in other areas of school budgets.

A related amendment will also appear on the November ballot that would make pre-kindergarten education available to all Florida four-year-olds, and individuals sympathetic with the class size amendment may also be inclined to vote for this one. If both pass, the cost will be even higher. The state's economists estimate that the pre-kindergarten initiative would cost another \$300-400 million a year, and others

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estimate it might cost twice this much. The amendment specifies that it is to be financed "...through funds generated in addition to those used for existing education, health and development programs." Because those programs make up most of Florida's spending from general revenues, this seems to leave new taxes as the most likely revenue source. One would guess that because both of these amendments are likely to be supported by the same groups, they probably will pass or fail together.

If these education amendments pass, one of the important issues surrounding them will be how they will be financed. If they are financed through new revenues, the sales tax is the only tax the state has that could carry that financial burden. The amendment limiting class size could be financed by a 1 percent increase in the sales tax rate, an extension of the sales tax to groceries and rent, or extending it to business and professional services. Even if Floridians vote for the class size amendment, any attempt to raise taxes to pay for it would certainly meet resistance from both citizens and the legislature. Voters could support the class size amendment, but not the tax increases to finance it. It is poor policy to approve an expensive program without having a good idea where the money will come from to pay for it.

If the amendment passes, a likely result—even though it violates the stated intention of the amendment—is that it would be financed by reducing other school expenditures. Students would find themselves in smaller classes, but with fewer books and computers, reduced extracurricular activities, and more out-of-pocket charges to parents for school activities that are now paid for by the schools. Smaller class sizes would be paid for by cuts in existing programs, with most of the cuts coming from education. It may not make sense to cut education programs to fund smaller class sizes and pre-kindergarten for four-year-olds, but when one looks at the options, this is the most likely outcome.

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