Implementing a Just Tax System in Colorado & Strengthening Our Fiscal Constitution

Prepared by the Colorado Union of Taxpayers

Our Fiscal Constitution

Over much of our history Coloradans have successfully constrained the growth of government through our fiscal constitution. Our State Constitution embodied fiscal rules designed to constrain the power of government to tax and spend, rules requiring a balanced budget, debt limits, and voting and procedural rules.

Our fiscal constitution has served us well; our state prospered due in no small part to the fiscal rules embodied in our constitution. However, in the post-WWII period it was clear that our fiscal rules were not constraining the growth of government. Both state and local governments increased taxes and spending grew at rates far in excess of the growth of the private economy. This unconstrained growth of government triggered a tax revolt beginning in the late 1970's.

1. The Gallagher Amendment

In 1982, the voters of Colorado approved an amendment to the state constitution referred to as the Gallagher Amendment. The Gallagher Amendment required that taxable properties in Colorado be re-assessed every odd-numbered year, so that property values remain current. It also required that the percentage of actual value at which all residential property in the state is assessed be maintained at the same ratio to all other property. The intent was to stabilize residential property's share of the property tax base, and to constrain the growth of residential property taxes after several decades of rapid growth.

2. Statutory Tax and Spending Limits (TELs)

The first statutory tax and spending limit was introduced in 1978, after decades of rapid growth in state government. That TEL imposed a cap on the growth of general fund spending of **seven percent** per year. For several years that TEL constrained the growth of government. But by the mid nineteen 80's state government was again growing at rates in excess of the TEL limit, often at double-digit rates. Politicians found many ways to avoid and evade the TEL, shifting money off budget, hiding money in reserve funds, etc. In response to this unconstrained growth in government, new tax and spending limits were introduced in the early 90's. A new statutory TEL capped the growth of general fund expenditures at **six percent** per year.

3. The Tabor Amendment

A constitutional TEL, The Taxpayers' Bill of Rights, or TABOR, was introduced through taxpayer initiative, constraining the growth of state revenue and expenditures to the sum of inflation and population growth. TABOR also constrained the growth of government at the local level. Any increase in taxes and debt required voter approval. The expectation was that these new TELs would more effectively constrain the growth of both state and local government.

Constraining the Growth of Local Government

The tax revolt did have the desired impact on local government. By the mid 1990's we began to see some evidence that the tax revolt was constraining the growth of local government. Local government revenues and expenditures were growing at a lower rate than they had during prior decades, due in part to the tax and spending limits.

At the local level tax and spending limits work pretty much as they were envisioned. Mill levies are adjusted to conform to these fiscal constraints. If increased property values result in revenue growth in excess of the TABOR limit this requires a decrease in the mill levy and/or a temporary property tax credit.

As local governments began to face hard budget constraints they had more incentive to be efficient and to economize on scarce financial resources. The result was consolidation and downsizing that delivers government services at lower cost. There was incentive for privatization of a wide range of government services from garbage collection to recreation, where the private sector can provide the services more efficiently than local governments.

Local governments have the option of seeking voter approval for an increase in the mill levy. They also have the option of seeking voter approval to exceed the TABOR limits. Recent surveys show that the vast majority of these TABOR elections have passed. However, the voting on these ballot measures reveals that taxpayers are discerning, decreasing as well as increasing taxes depending upon the level of government and the quality of government services they receive.

Surveys show that Colorado citizens have more confidence in local government than state government, and least confidence in the federal government. The outcome of the tax revolt at the local level is that taxpayers are now better able to get the government they are willing to pay for, including public education.

Constraining the Growth of State Government

While the tax revolt was successful in constraining the growth of government and lowering the tax burden at the local level this was certainly not the case at the state level. Total state revenues and appropriations have grown more than eight percent per year in the 90's, about the same rate as they did in the 70's and 80's. How do we explain this paradox?

In Colorado we faced a unique opportunity as a result of the Reagan tax reform in 1987. Colorado would have captured about a $300 million windfall due to the broadening of the federal tax base. The legislature introduced a flat tax to replace the graduated income tax. However, they did not introduce a revenue neutral flat tax which, at that time, was estimated at about 4%. The legislature chose to set the flat tax at 5% and the results were exactly as predicted, an acceleration in revenue growth. That tax significantly increased the income tax burden, capturing about half of the windfall in revenue created by federal tax reform. Legislators promised that they would reduce the flat tax if this happened, but it is more than a decade and we are still waiting for those tax cuts. The modest reduction in the income tax rate to 4.63% over the last two years has still left us with a heavy tax burden.

Our TELs have failed to constrain the growth of government spending, so it is difficult to argue that state government now faces a hard budget constraint that creates incentives for efficiency and frugality, as has occurred with local government. But the problem goes beyond the fact that state government continues to face a soft budget constraint.

While the TELs have not constrained the growth of state spending they have changed the composition of that spending. The statutory TEL has resulted in shifting a larger share of general fund revenues into non-general fund expenditures, mainly construction and highway maintenance. That shift occurred in a sharp and discontinuous way with capital construction spending increasing almost 500% in one year. This was accompanied by great inefficiency in state government.

Reforming Our Fiscal Constitution

1. Bird/Arveschaug

Tax and spending limits have yet to slow the growth of state government revenues and expenditures. We can accomplish this objective by imposing more stringent limits on the growth of state spending. The statutory TEL called Bird/Arveschaug contains many loopholes that have allowed general fund expenditures to grow more rapidly than the six percent cap. The state government has continued to find ways to avoid that limit. The statutory TEL does not require the state to rebate surplus revenue above the limit. The Legislature simply accumulates the surplus in reserve funds and then transfers these funds into non-general fund expenditures.

Two bills have been introduced that would impose more stringent limits on the growth of general fund expenditures. They would reduce the Bird/Arveschaugh cap from 6% to 5% and limit the base used in calculating that limit. The second of these bills is less important today than it would have been a few years back when one time expenditures excluded from the Bird/Arveschaugh limit were a significant part of the total state budget.

The first of the bills is the most important because it would bring the growth of general fund spending into line with the TABOR limit. If general fund revenues then grow in excess of the TABOR limit, this would free up funds for construction and highway maintenance spending without depleting required reserves, and also provide for taxpayer refunds. At the same time total appropriations could increase at rates consistent with the growth of the private economy. If general fund revenues do not grow rapidly, as would occur in an economic slowdown or recession, then the state will be able to make a smooth transition from a high growth economy to a slow growth economy.

There is a more important reason for imposing these more stringent constraints on the growth of general fund spending than simply smoothing out fiscal policies over the business cycle. If we continue to allow state government to grow in excess of the growth of the private economy we will end up crowding out the private sector. People will have more incentive to attempt to transfer income and wealth through the public sector, than to engage in productive activity in the private sector. As we become a rent seeking or privilege seeking society we impose heavier burdens on the private sector. Our states becomes less competitive in attracting new business investment and jobs as compared to other states.

2. TABOR

The constitutional TEL, TABOR, was not triggered until 1997 when for the first time revenue growth exceeded the sum of inflation and population growth. The state is required to rebate surplus revenue above the TABOR limit, but has interpreted this to require a rebate in the year after the surplus is generated. This has enabled the state to finance a significant portion of current expenditures out of surplus revenue.

At some point, of course, the state will have to pay the piper. The state will exhaust reserves, and the growth of revenue will slow down. Indeed it is conceivable that during a recession the state could be in a fiscal bind. Having spent the surplus revenue from the previous year, the state may not have enough surplus revenue to finance required TABOR rebates in the following year. That would require the state to make some rather draconian cuts in spending. The solution is to require that the TABOR surplus be set aside in an interest earning account rather than used to fund expenditures. Given the profligacy of the state legislature this would have to be done over several years, and several bills have been introduced in the legislature to do this.

Perhaps the most problematic aspect of TABOR is the disposition of surplus revenue. Taxpayers anticipated that the surplus revenue would be rebated to the taxpayers who paid the excess taxes; but in fact that has not happened. When the first TEL was introduced in 1978 a modest amount of surplus revenue was rebated to taxpayers, but as mentioned those surplus revenues were quickly absorbed in increased government spending. The TABOR Amendment explicitly forbade the state from spending the surplus without a vote of the citizens. Not surprisingly the legislature immediately enacted a referendum to spend surplus revenue, but that referendum was defeated by the electorate. That suggests that Colorado citizens now have more state government than they want and are willing to pay for.

TABOR required that surplus revenue be rebated to taxpayers but left it up to the legislature to determine how the money would be rebated. Most of the surplus revenue is generated by excess personal income taxes, so one might expect the rebates to be tied to those taxes. What the legislature has chosen to do is to enact tax reductions and tax rebates that have little to do with the excess taxes paid. These tax reduction and tax rebate schemes have become more complex each year: twenty different bills have been passed to offset surplus revenue above the TABOR limit.

It was only a matter of time before the most powerful interest group in the state, the teachers' unions, would lay claim to what they perceived to be their share of the TABOR surplus revenue. Amendment 23 earmarks more than $11 billion for K-12 education over the next ten years, a significant portion of which will be taken from the TABOR surplus. It seems that every interest group with a lobbyist is trying to convince the legislature that they deserve part of the surplus revenues.

The privilege-seeking that now dominates the disposition of the TABOR surplus introduces inefficiency and inequity into the tax system in several ways. Targeted expenditures, tax cuts, credits and tax rebates are really loopholes in the tax system that create incentives for more lobbying activity to benefit special interest groups. Inefficiency is also created in the private sector as people respond to these tax loopholes.

If the tax revolt did not improve efficiency in state government, did it improve the fairness of our state tax system? The 1987 tax reform introduced more generous personal exemptions and standard deductions that removed low-income families from paying any income tax at all. A married couple with a less than $10,000 income pays no income tax. That tax reform closed loopholes and broadened the base of the state income tax shifting more of the burden of taxes to upper income families. The share of income taxes paid by families with less than $50,000 income decreased, while that paid by families with more than $50,000 income increased. The share of state income taxes paid by families earning more than $100,000 increased from 17% to 24%.

It is not surprising that the reduction in marginal tax rates would end up shifting more of the tax burden to upper income families, that is what supply side economics would predict. What is surprising is that our TELs have had a similar effect. Most of the TABOR surplus, about 74% is generated by the income tax. Yet only a small percentage of the Tabor surplus has been returned to the taxpayers who paid these excess taxes through income tax cuts. If the income tax cuts had been proportional to the excess income taxes paid this year, the total income tax cut would have been $548 million, more than double the actual income tax cut of $206 million. Because the legislature has chosen to offset the TABOR surplus with targeted tax cuts and tax rebates, they have redistributed income from taxpayers who paid the excess income taxes to special interest groups. Amendment 23 will result in even further redistribution of income through this disposition of the TABOR surplus for targeted expenditures.

Lessons From the Tax Revolt

What have we learned from the tax revolt in Colorado? Any consideration of fiscal reform in Colorado should begin with recognition of the importance of the fiscal rules embodied in our constitution. It is not easy to amend the constitution, and our representatives would do well to accept these constraints on fiscal powers. These include the recent constraints imposed on spending and taxes at both the state and local level. These rules reflect the will of the people to constrain the growth of government, in the same sense as the balanced budget provisions, debt limits, and budgetary procedures contained in the original constitution. To argue that these new fiscal rules somehow do not reflect the will of the people is to deny the last century and a half of our constitutional history.

We have had some success in achieving the goals of the tax revolt at the local level: constraining the growth of government, reducing the tax burden, and improving the efficiency and equity of the tax system. Citizens today are better able to get the local government services they desire and are willing to pay for. The outcome of the tax revolt is great diversity in which some communities choose higher taxes and levels of government service and other communities choose lesser taxes and less government services. Local governments face hard budget constraints and are more accountable to the citizens who pay these taxes. We should resist the socialist tendencies in our society that would remove the choices we make at the local government level, and that would mandate taxes and government services for us at the state and federal level.

While the tax revolt has had some success at the local level, we have not had much success at the state level. Indeed one could argue that some impacts of the tax revolt are moving us further from our goals. The TABOR surplus has created incentives for privilege seeking and politicians have been responsive to these special interests in the disposition of the surplus revenue.

The Reagan revolution taught us that a low broad based flat tax is the best way to achieve our objectives. In Colorado we missed a golden opportunity to introduce a revenue neutral flat rate income tax in 1987. With a TABOR surplus projected to reach more than $1 billion over the next five years, it is even more imperative to reduce the personal income tax rate to something close to 4%.

Unfortunately it will be much more difficult to accomplish this today than it was a decade ago. If we as taxpayers have learned nothing else from the tax revolt it is that when we pay excess taxes and the government gets its hands on our money they will find ways to spend it, redistribute it, or do anything other than return the money to those who paid the excess taxes. Privilege seekers rather than taxpayers end up with the surplus revenue.

We must return to the principles of limited government embodied in our state constitution. We must constrain the government to the core functions necessary to secure our individual liberty and property rights. We need an efficient and fair tax system capable of providing the financing for government to perform these core functions. The tax system should not be used to benefit special interest groups or to achieve an egalitarian redistribution of income.

REFORMING OUR FISCAL POLICIES

Constraining the Growth of Government

If there is one thing that we have learned from the experience in California, it is to not let our state government grow in excess of the growth in the state economy. In the boom years of the 1980's, California allowed state government to grow at double-digit rates. These levels of state spending and employment were unsustainable in the recession of the early 1990's. California was forced to make draconian cuts in state budgets, shutting down and curtailing many government programs. In higher education they were not even able to offer the courses and programs students needed to graduate. Such stop-and-go state fiscal policies are inefficient and inequitable, and they contribute to economic stagnation. More importantly, they are avoidable through more prudent tax and spending policies.

The growth of the Colorado economy was almost the opposite from that of the California economy. In the 1980's our economy stagnated and declined, with an out-migration of business, jobs and people. In the 1990's Colorado entered the longest period of high and sustained economic growth of the post-WWII period. Our growth has exceeded that of all but a few other states over the last decade. Colorado has attracted new business investment and created jobs resulting in a massive in-migration from other states, especially from California. As we enter the 21st century it appears that Colorado will continue to sustain a very high rate of economic growth at a time when the California economy is stagnating due to higher energy costs.

However, Coloradans seem not to have learned the California lesson. We have adopted a growth mentality that assumes that the only way our economy can go is up. While we may not experience the stagnation and decline we experienced in the mid 1980's it is a mistake to assume that we have eliminated the business cycle. In fact the current growth rate for the U.S. economy is zero, and it is not clear that we will avoid a recession. It will be impossible for the Colorado economy to sustain our high rates of economic growth if the U.S. economy experiences a slowdown or recession.

Over the past five years the Colorado economy has grown at an unprecedented rate. The average annual rate of growth in state income has been about 8 1/2% per year, ranking Colorado among the most rapidly growing states in the country. State revenues have been increasing at an even higher rate, almost ten percent per year, mostly due to a rapid growth in income tax revenues. Colorado’s tax and spending limits have kept the growth in state spending below the growth in revenue, resulting in the accumulation of surplus revenue in general fund reserves. Over the next five years those reserves are projected to accumulate to more than $1 billion.

Unfortunately our state fiscal policies are based upon the optimistic assumption that we will continue to grow at rates comparable to those achieved in the 1990's. Even if the state economy does not slow down, these fiscal policies will result in growth in state government in excess of the growth of the private economy. If we do experience a slowdown in economic growth or recession, these fiscal policies will leave us with levels of state spending and employment that are not sustainable.

All we need to do is look at the current state budget. Total state appropriations are projected to increase in excess of the projected growth in state income. While general fund appropriations are projected to grow about six percent, spending for construction and highway maintenance is projected to increase at a much more rapid pace, resulting in total appropriations growth in excess of eight percent.

If we look at non-general fund expenditures, the prospects are for even more rapid growth in state government. Semi-autonomous state enterprises are now increasing off-budget spending in excess of the TABOR limits. Amendment 23 will earmark more than $11 billion for education spending K-12 over the next ten years, partly financed from the TABOR surplus. A proposed amendment to the Colorado Constitution would earmark use of the TABOR surplus to finance new transportation spending. It seems that every interest group with a lobbyist is staking their claim to part of the TABOR surplus. If this continues, we will most likely eliminate the TABOR surplus altogether resulting in no refunds to taxpayers. If we earmark enough state funds, the government will be left with little discretion over spending.

A Window of Opportunity for Tax Reform

When Governor Owens took office he stated the obvious: it doesn’t make sense for the state to impose a high rate of taxation on Colorado citizens and then turn around and refund the surplus revenue. Governor Owens has taken the lead in advocating permanent tax reductions over the past two years, and also in supporting further tax reductions.

The rationale for these tax cuts is the same as it was when President Reagan launched his tax reforms two decades ago. Reductions in marginal income tax rates increase people’s willingness to work, save, invest and engage in entrepreneurial activity. The result is an increase in income and the tax base that can offset the reductions in marginal tax rates. These positive effects of reductions in marginal tax rates on tax revenues have yet to be built into the analysis of the fiscal impact of tax cuts, such as those conducted by our own legislative staff. As a result, those studies consistently overestimate the reduction in revenue that will accompany such tax cuts. High marginal income tax rates, on the other hand, create incentive for people to transfer income through the public sector and engage in other unproductive activity. We also have yet to incorporate these negative effects of high marginal tax rates in our studies of the state income tax.

Colorado must begin to pursue more prudent tax and spending policies that constrain the growth of government. The unprecedented growth of the Colorado economy has created a window of opportunity for tax reform. Colorado should enact tax reforms at this point because the window of opportunity for such reform is closing rapidly for several reasons:

1. A Slowdown in the Growth of the Colorado Economy

The rapid growth of the Colorado economy over the past decade is unprecedented, and is not likely to continue. The legislative staff projects somewhat lower rates of growth over the next five years. State income is projected to increase 7.5% per year, compared to 8.5% per year over the past five years; while state revenues are projected to increase 6.5% per year, compared to almost ten percent over the past five years. If the national economy experiences a recession, the state will not even be able to sustain these rates of growth.

2. The State Uses Surplus Revenue to Finance General Fund Expenditures.

The TABOR Amendment imposes a limit on the growth of state revenue and spending equal to the sum of inflation and population growth. The actual population growth this year is about 2.3%. Combining the population growth with the inflation rate of 3.6% would set the TABOR limit at 5.9%. Due to error in the Census Bureau estimate of population growth, the legislature will this year use a population growth rate of 6%, which when combined with the inflation rate will set the TABOR limit at 9.6%. Of course the Legislature could choose to limit the growth in spending to the lower limit, which would be closer to the growth in state income. But the state chooses to view the TABOR limit as a minimum rather than a maximum target for state expenditures. This decision will result in higher levels of state spending not only next year, but also indefinitely into the future, because it will increase the base level of revenue and expenditures against which the TABOR limit is applied. This decision alone will reduce the TABOR surplus and increase state spending by more than $ 2 billion over the next five years.

3. The State Uses Surplus Revenue to Finance non General Fund Expenditures

When the TABOR Amendment was passed the Legislature chose not to refund the surplus in the year in which it is generated, but rather, to refund these surplus funds in the following year. Further, the state does not accrue these funds in a separate interest-earning account, but rather, merges these funds with general fund revenues to finance current expenditures. Specifically, the state has interpreted TABOR to permit use of these general fund revenues to finance non-general fund expenditures, including construction expenditures. Recent increases in construction spending are, of course, not sustainable, but would deplete the reserve funds if continued into the future. Funding for construction should not be financed from the TABOR surplus, that money should be refunded to taxpayers.

4. Special Interest Groups Use Surplus Revenue to Finance Targeted Expenditures

As a result of Amendment 23, $160 million of the surplus revenue will be allocated to expenditures for K-12 education. This allocation of surplus revenue will increase to over $400 million over the next two years. Over the next ten years, Amendment 23 will cumulatively earmark more than $11 billion for K-12 education, much of it financed from surplus revenues. Apparently the teachers' unions want this money earmarked for education without any constraints on how the money is spent, despite the fact that they sold this amendment to taxpayers as a way to achieve very specific objectives in K-12 education. Other interest groups have learned this lesson from the teachers' unions and are now drafting initiatives and referenda that would target use of the surplus revenue to benefit their interests. Transportation groups now propose use of the surplus revenue to finance increased spending for transportation, despite the sharp increase in state transportation spending in recent years. For example, House Bill 1329 would place a referendum on the ballot to finance $1.35 billion in alternative transportation projects from the TABOR surplus over the next ten years. The TABOR surplus should not be used to finance such expenditures, but should be returned to taxpayers.

5. The State Exempts More Expenditures From the TABOR Limit

One of the most common ways for state governments to circumvent tax and spending limits is to shift more expenditures 'off-budget' so that they are exempt from those limits. Colorado has chosen to increase state enterprises whose expenditures are not subject to the TABOR limits. This year the legislature will exempt the State Division of Wildlife from the TABOR limits. Other proposals would exempt higher education and other state programs from the TABOR limits. To the extent that these state agencies are exempt from the TABOR limit, they face a soft budget constraint that will enable them to increase spending at a higher rate and which will reduce the surplus revenue that should be returned to taxpayers.

6. The State Uses the TABOR Surplus to Finance Targeted Tax Rebates and Reductions

More than 20 bills have been passed over the last few years providing tax rebates and tax reductions. Most of these tax rebates and tax reductions are targeted to special interest groups rather than reductions in broad based taxes such as sales and income taxes that benefit most Colorado citizens. Tax rebates and reductions have targeted such special interest groups as precious metals traders, purveyors of vending machines, and producers of bull semen. It seems that every interest group with a lobbyist is now laying claim to a portion of the surplus revenue in the form of tax rebates or reductions. This is no different than if the legislature simply gave these special interests a direct subsidy, except that it is hidden from taxpayer scrutiny when provided as a tax rebate or tax reduction. TABOR was specifically designed to preclude such targeted tax reductions and tax rebates and this original intent of our Constitution should now be enforced.

Tax Reform

1. Income Taxes

Since the income tax is the major source of surplus revenue, it should be the prime target for permanent tax reduction. Permanent reductions in the state income tax are widely supported by Colorado citizens. While the income tax rate has been reduced from 5% to 4.63% over the last two years, that income tax rate is still too high. When the Colorado legislature chose to set the rate at 5%, this captured a significant share of the windfall from federal tax reform and significantly increased the tax burden on Colorado citizens. The result of this increase in the tax burden was a rapid growth in state revenue, and a government that is too big, too expensive, and too intrusive in the daily lives of citizens. We should lower income tax rates to bring us to the revenue neutral tax rates we should have introduced more than a decade ago.

There is another important reason for Colorado to reduce income tax rates at this point in time, and that is to remain competitive with other states. Over the past seven years, the states have reduced taxes and fees totaling $33 billion. Reductions in personal income and corporate income taxes account for a significant share of these total tax reductions. Colorado's state income tax rates now rank among the highest in the nation, even after the modest tax reduction enacted over the past two years. Colorado's state income taxes have been increasing at rates twice the national average. If Colorado is to remain competitive in attracting business investment and jobs, we must continue to lower our state income tax rates to levels comparable to other states.

If the window of opportunity for permanent reductions in the income tax is closing rapidly it is imperative for the state to enact these cuts at this point in time. A bill introduced this year calls for a phased reduction in the income tax rate from 4.63% to 4.5% and 4.25% over the next two years. The fiscal note to this bill shows that such a phased reduction in the income tax can be implemented at the same time that other claims on the TABOR surplus are also met. It is in this sense that we can think of the current point in time as a window of opportunity for these tax cuts.

It is fair to say that in the absence of reductions in the income tax current trends in state finance will eliminate the TABOR surplus entirely. Further, those trends will eliminate the discretion the legislature currently has in deciding how those surplus funds will be allocated; all of the surplus revenues will be earmarked for expenditures, or for targeted tax rebates and tax reductions. If we fail to enact permanent reductions in the income tax at this point they will most likely never be enacted because that window of opportunity is closing very quickly.

If we fail to enact these permanent income tax cuts the ultimate losers will be taxpayers. Colorado citizens enacted the TABOR Amendment expecting that this would constrain the growth of government revenues and expenditures. When tax revenues exceeded these limits their expectation was that the surplus revenue would be refunded to the taxpayers who paid the excess revenues. In retrospect that was an unrealistic assumption. As special interests increasingly dominate state fiscal policies it should not be surprising to find that these surplus revenues are dissipated in increased state spending and targeted tax rebates and tax reductions. Permanent income tax cuts provide the ultimate solution for taxpayers by not permitting the state to get its hands on the revenue in the first place.

2. Sales Taxes

General sales taxes are taxes levied on the sales of goods and services and are collected from the consumer by the seller. Sales taxes are in use in virtually every state in the union, and have become the major source of revenue in a number of states. For these states, major reforms of the sales tax could significantly improve efficiency and equity and at the same time reduce the burden of the tax system.

The reform called for here is broadening the base of the sales tax while lowering the rate. Broadening the base of the sales tax is needed to reflect the significant changes from a commodity-based to a service-based economy. A broad-based sales tax has the same advantage as a flat tax on income; a low rate on a broad base can generate large amounts of revenue. If this is combined with the elimination of other taxes the result can be significant improvements in the efficiency and equity of the tax system.

General sales taxes are considered a relatively efficient form of taxation. Compliance costs are low because businesses rather than individuals or their employers collect the tax. Low sales taxes encourage compliance and discourage evasion and avoidance. Low sales taxes are also less likely to induce individuals and businesses to migrate to other states.

Perhaps the major advantage of sales taxes is their built-in incentive to save and invest. As a tax on consumption the sales tax discourages spending and encourages savings and investment. Since the marginal rate of a sales tax does not rise with income, this type of tax is superior to the income tax in terms of incentives to work and engage in productive activity. For this reason low broad-based sales taxes are conducive to rapid economic growth.

The major criticism of sales taxes is that they are regressive. In the terminology of public finance, sales taxes do not achieve vertical equity. Lower income households pay a larger fraction of their income in sales taxes than do higher income households. However, sales taxes do achieve horizontal equity because all households pay the same amount on a given purchase regardless of household income or wealth. Since high-income households consume more, they pay more sales taxes compared to low income households. Nationwide polls show that taxpayers tend to prefer sales taxes over income taxes. This suggests that people view sales taxes as fair precisely because the sales taxes they pay are proportional to the income they spend. In other words, their perception of fairness is closer to the economists' concept of horizontal equity than vertical equity.

Modifications are often introduced in the sales tax to improve vertical equity. Historically some states, including Colorado, have exempted food and drugs from the sales tax and provided vendor discounts. But the tradeoff here is that the more exemptions, the higher the rate must be to generate the same revenue. More exemptions also induce consumers to shift purchases to tax exempt items and to evade the tax.

The Colorado state sales tax of three percent is one of the lowest in the nation; the average state sales tax is five percent. However, local governments in Colorado rely heavily upon the sales tax; local sales tax revenues as a share of total state and local taxes are the second highest in the nation. The combined state/local sales tax in Colorado is about average compared to that for the U.S.

This sales tax policy was by design, as embodied in the state Constitution and statutes. Local governments rely primarily upon sales taxes because they are precluded from imposing income taxes by the Colorado Constitution. The state on the other hand relies primarily upon income tax revenues, since the state is precluded from imposing property taxes, and maintains relatively low state sales taxes. This specialization in tax bases as embodied in the state Constitution and statutes is consistent with the goal of a federalist system, i.e., to decentralize government, concentrating government at the local level rather than the state level.

Colorado should not attempt to centralize or standardize local sales taxes because this would remove the autonomy and independence of local governments. Local governments actually do a better job than the state because they use a broader sales tax base with few exemptions; also because they do a better job of auditing and collecting the sales tax. There are approximately 70 different exemptions to the state sales tax. Colorado should reform the state sales tax by removing exemptions and broadening the base to bring the state sales tax base into line with the local sales tax base. The state should also do a better job of auditing and collecting the state sales tax.

A little more than $100 million in surplus revenue is now refunded to taxpayers through state sales and use tax holidays. There are several reasons why this approach is inferior to income tax cuts in terms of our principles for tax reform.

With state sales taxes among the lowest in the nation it does not make sense to link tax refunds to the state sales tax. If local governments respond by raising local sales taxes this makes even less sense because local governments already impose high sales taxes compared to local governments in other states.

Most of the surplus revenue is generated by the income tax. Therefore, refunding the surplus through sales and use tax holidays involves some redistribution of income from one group of taxpayers who paid excess taxation to another group of taxpayers who did not pay excess taxes.

Some legislators defend the current rebate system in which rebates are linked to the sales tax, rather than the income tax, because this reduces the federal income tax liability. The problem is that the people receiving the sales tax rebates are not the people paying excess income taxes. The purpose of the tax reform should be to eliminate the surplus revenue, not redistribute income among taxpayers.

Reducing sales and use taxes creates more incentives for consumption spending. Cutting the marginal income tax rate, on the other hand, creates incentives for productive activity that increases income, and the income tax base. Thus, the latter approach is superior on grounds of efficiency.

Finally, the reduction of income tax rates is a simpler approach than the cumbersome process of determining each year if a sales and use tax holiday will be implemented. On efficiency, equity, and simplicity grounds we should favor the reduction in the income tax rate to 4.25%, rather than sales and use tax holidays, or tax rebates linked to the sales tax.

3. Property Taxes

Colorado has no state property tax, but is one of a number of states that rely heavily upon the local property tax. Property taxes are usually politically unpopular because they are paid directly by the taxpayer, often in single lump sum payments. In many states there is pressure to replace these property taxes with broad-based state income or sales taxes. Property taxes are often criticized in the public finance literature on grounds of both efficiency and equity. However, recent research suggests that property taxes are often superior to alternative taxes on both efficiency and equity criteria. States relying on property taxes often create a better business climate and successfully attract business investment and jobs compared to surrounding states relying on income and sales taxes. One of the most successful states in this regard is New Hampshire that relies primarily on local property taxes, and which has neither state income or nor state sales taxes. The experience of New Hampshire suggests that states can reduce their tax burden and improve efficiency and equity by relying more heavily upon local property taxes.

A criticism of property taxes on efficiency grounds is that their administration can be expensive and cumbersome. Yet compliance costs for property taxes are estimated to be lower than that for income taxes and higher than that for sales taxes.

Property taxes are clearly superior to income taxes in terms of their effects on incentives. Property is more difficult to move, and one form of property – land – is impossible to move. Therefore, property taxes tend to have less impact on the decisions of firms to invest or individuals to migrate, compared to alternative taxes. Property taxes are less likely than income taxes to discourage productive activity. Indeed property taxes on idle land may actually create incentives to invest and put the idle land to productive uses. This was, of course, the argument used by Henry George in support of his single land tax scheme.

Property taxes often have less negative impact on economic growth than either income or sales taxes. The experience of New Hampshire is particularly insightful for states attempting to promote economic growth. New Hampshire has successfully attracted business investment and jobs from surrounding states. An important factor has been not only lower tax burdens, but also reliance on property taxes rather than sales or income taxes. Most government activity in New Hampshire is at the local rather than the state level, and is financed by local property taxes. When taxes and spending are at the local level there is greater incentive for residents to monitor government programs and greater incentive for government to provide services efficiently. Despite the lower tax burden, New Hampshire provides government services that are equal to or better than surrounding states, and provides those services at a lower cost.

The success of New Hampshire's property tax system is especially evident in the financing of public schools. Local property tax-based funding of public schools is superior on both efficiency and equity grounds to alternative methods of funding relying on statewide taxes. Local property tax-based financing of education gives all the residents an incentive to monitor local public schools. The key is that better schools are reflected in higher property values. All homeowners are rewarded with higher property values, and therefore have an incentive to monitor schools whether they have children or not. When there is competition among school districts, students are attracted to better schools which means that tax dollars will flow to better performing school districts. School personnel have an incentive to provide education services efficiently because that attracts increased tax dollars.

Local property taxes are also a fairer method of financing education than relying on statewide taxes. Local property taxes based on property values reflect the quality of schools better than statewide taxes. When property tax rates are set locally and often by referenda, they reflect the ability and willingness of local taxpayers to pay for public schools. No statewide tax could be fairer than the local property tax, neither a uniform property tax rate nor an income or sales based tax.

Support for schools is stronger when control and responsibility for funding is in local hands. A family that wishes to invest a higher share of its income in educating its children is given a choice. That family will be willing to pay a higher price for a house in a school district with excellent schools. Shifting the funding of schools from the local level to the state level removes that choice. A family will pay the same tax for public schools regardless of where they live.

Substituting state financing for local financing might have perverse effects that will diminish the support for public schools. A family that wishes to invest more in their children's education may actually choose to live in school districts with low property taxes and average public schools, and move their children into private schools, spending more for tuition, computers, etc. In this sense, statewide funding undermines the support for the public schools, resulting in lower levels of funding and decreased enrollments.

The issue of public school finance is central to the debate over tax reform in Colorado. Several bills have been introduced in the Colorado legislature that would significantly change the way in which Colorado finances our public schools. These bills call for replacing the property tax with a state income or sales tax as the major source of funding for the public schools.

A number of arguments have been used as a rationale for this change in school finance. The major argument is that Colorado is not providing sufficient funding for our public schools. Reliance on local property taxes, it is argued, not only provides insufficient funds for the public schools, but also results in inefficiencies and inequities in school finance. The ability to raise money from property taxes varies widely among the school districts. Differences in tax bases (assessed property values) result in differences in revenue collected, using a given mill levy. Proponents of the bills before the Colorado legislature argue that substituting a state income or sales tax for the property tax as the major source of funding for the public schools will not only generate more revenues, but also increase the efficiency and equity of school finance.

These arguments in the debate over school finance in Colorado are fallacious. The first question is simply an empirical one: are Colorado public schools under-funded? To answer this question we need to understand recent trends in school finance. In recent years, state expenditures for education K-12 have increased rapidly, resulting in an increase in educational expenditures as a share of the total general fund. This rapid growth of state expenditures for education is shifting the burden of school finance from the local to the state government, and these trends are projected to continue in future years.

Historically Colorado has relied primarily on local government to finance most of the funding for public education. However, the Public School Finance Act of 1994 has shifted a large and growing share of funding of public schools from local government to state government. The Public School Finance Act of 1994 now provides the majority of revenues to Colorado's 176 school districts. Two local sources of revenue are incorporated into the Act: property taxes and specific ownership taxes. Funding for a school district is provided first by these sources of revenues which comprise the local share; if these local sources are insufficient to fully fund the total expenditures per pupil required under the Act then state moneys fund any shortfall. Payments of state money are made from state income and sales tax revenues. The Public School Finance Act has resulted in a dramatic shift in school finance from local governments to the state government, and a greater distribution of state moneys to school districts that do not fully fund the total expenditures per pupil required under the Act.

State spending for education K-12 will increase significantly as a result of Amendment 23. Amendment 23 earmarks more than $11 billion for education K-12 over the next ten years.

Amendment 23 created a new State Education Fund. The state is required to allocate 1/3 of 1% of the state income tax into the fund. In the year 2001, with the current income tax rate, the income tax revenue allocated to the fund will equal $313 million. Over the ten-year period until the year 2010 the income tax revenue allocated to the fund will total $4.58 billion.

That money must be paid from the surplus tax revenue collected above the TABOR limit. In other words, taxpayers must forego the income tax rebate they would have received without this amendment. For example, in the year 2001 each taxpayer would forego $113 in tax rebates in order to allocate this money to the teachers' union slush fund.

Some of the current surplus revenue allocated to non-general fund expenditures will not be available as a result of Amendment 23. The Director of the State Office of Budgeting and Planning projects that the state government programs most likely to be affected by the proposed amendment would be reduced capital construction, and depletion of the Highway Users Tax Fund used for highway repair and maintenance.

The amendment requires the state to increase current funding under the School Finance Act by 5% per year for the next ten years. Compared to current state school funding of $1.98 billion, funding will increase to $3.22 billion in 2010. Over the next ten years the cumulative increase in state school funding will be $6.35 billion with the amendment.

The amendment requires the state to increase state funding for Special Purpose Programs at the rate of inflation plus one percent for the next ten years. The current level of state funding for these programs is $140.5 million. If we assume an inflation rate of 3.7% per year, the annual state funding for these programs would increase to $222 million in 2010. Over the ten-year period the cumulative increase in state funding for Special Purpose Programs will be $330 million.

The total fiscal impact of the amendment is determined by summing the required increase in state funding in each of the three categories:

State education fund	$4.58	billion
School Finance Act	6.35	"
Special Purpose Programs	.33	"
	$11.26 billion	

The three fiscal impacts from Amendment 23 are additive. The reason is the clause in the amendment which states that "The state legislature can use money in the (*state education*) fund to pay for the required increase in the base under the school finance act, *as long as it is in addition to the 5% increase in state aid*." (Italics added)

There are several caveats to this estimate of the total fiscal impact of the proposed amendment. It is assumed that state revenues will continue to increase in excess of the TABOR limit over the next ten years, as projected by analysts in the state government. Under these assumptions the money allocated to the new State Education Fund will come out of these surplus revenues and at the expense of tax rebates. If those projections of state revenue growth are not realistic and the state encounters a recession such that surplus revenue above the TABOR limit is not generated, then these funds will have to be allocated from general revenue funds. In other words the money allocated to the new State Education Fund will come from other government programs, not from the TABOR surplus. Because the expenditures from the new State Education Fund are not constrained by the 6% appropriations limit, the most likely outcome is that spending for education would come at the expense of spending for other state programs that are constrained by the six percent statutory cap.

The disadvantage of earmarking funds for education in this way is that it removes discretion from the legislature in determining budget priorities between education and other state government programs. In short it gives the education lobby a privileged position in which they don't have to defend their spending programs along with other state agencies and interest groups through the regular budgetary process.

The education lobby did show at least some restraint in requirements for increased state funding under the school finance act. "The proposal requires the amount provided by the state to increase by at least five percent annually for the next ten years **unless Colorado personal income grows less than 4.5% between the two previous calendar years**." At least they recognized that the ability of the state to fund education depends upon the state of the Colorado economy, and available state revenue. But, given the projections for economic growth and state revenue growth over the next ten years, the state will likely be required to increase annual state funding under the school finance act by 5%.

A number of arguments were used as a rationale for this amendment, but a close examination of these arguments reveals that they are flawed. The argument that Colorado public schools are under-funded does not stand up to careful empirical analysis. The Public School Finance Act of 1994 has significantly increased state funding for public education, and the share of state funds allocated to public education is projected to increase significantly in future years.

It is argued that increasing state funding for schools and decreasing reliance on local property taxes will increase the efficiency and equity of school finance. However, there is now ample empirical evidence showing that these trends in school finance will result in less effective schools and less public support for public education

It is argued that allocating more money for the public schools will solve our education problem. But, the empirical evidence shows that throwing more state money into our public schools has not solved our education problems in the past, and there is no reason to expect that the increased spending required by this amendment will bring any better results.

One of the arguments used to support Amendment 23 was that the use surplus state funds to finance education would result in local property tax relief. We should point out that the state already provides substantial property tax relief indirectly through state funding of education K-12. The state share has increased to about 58% of total funding for education K-12 in recent years, and that share will increase significantly with Amendment 23. The state share of this education funding is even greater in school districts with lower average incomes, under the formulas used in allocating state education funds. Amendment 23 will decrease pressure on local school districts to raise property taxes to finance our schools.

We should repeal both the Public School Finance Act of 1994 and Amendment 23, and return to local property taxation to fund education K-12. One of the strengths of the Colorado fiscal system is that we continue to rely upon local governments rather than the state government to both finance and administer government programs. This is especially important in financing and administering our public schools. Reliance upon local property taxation to finance our schools introduces incentives to improve the schools that would not exist with state funding. Local property owners have an incentive to monitor how those property taxes are used by the local school systems, because poor schools mean lower property values. School districts that offer good quality public education are more successful in generating the property taxes required to maintain that quality. We should continue to give citizens this choice to live in schools districts where they pay higher property taxes in order to provide a better education for their children

4. Excise Taxes

Each of the following proposed reforms would eliminate inefficient and inequitable taxes. The major source of excise tax revenues is the tax collected on gasoline, alcohol and tobacco. Excise taxes have decreased as a source of government revenue. The reasons for this decrease explain why these taxes should be eliminated from the tax code altogether.

Excise taxes are sometimes referred to as user fees, but it is important to distinguish between excise taxes and user fees. A true user fee is paid when an individual is charged the cost of a government service which they choose to consume. For example, a fee to enter a state park imposes a cost on the individual who chooses to use the park. If the fee is related to the cost of providing the park service, then this form of user fee can be defended on grounds of both efficiency and equity.

Unlike user fees, however, there is little relationship between excise taxes collected on gasoline, alcohol and tobacco, and the provision of government services. At one time, when gasoline taxes were placed in a highway trust fund for the maintenance and improvement of highways, one could have made this argument for the gasoline tax. Today, gasoline taxes are used to finance a variety of government activities that have nothing to do with highway construction and maintenance. A number of studies now provide evidence that abolishing the gasoline tax and substituting true user fees for access to our streets and highways will improve both efficiency and equity.

In the case of excise taxes on alcohol and tobacco there is virtually no relationship between these taxes and the provision of government services. The rationale often offered for these excise taxes is not user fees, but rather social cost. The recent settlement between the tobacco companies and the individual states would seem to obviate the need for excise taxes on grounds of social cost. In the case of alcohol consumption this argument has a perverse outcome. Recent research shows that moderate users of alcohol are healthier than abstainers. Moderate alcohol consumption actually generates a social benefit in reduced health insurance costs. Recent studies find that these positive social benefits are greater than the social costs of alcohol abuse. The inference from these studies is that alcohol consumption should be subsidized not taxed. Eliminating excise taxes on alcohol will improve the efficiency of the tax system.

By every measure these excise taxes are very expensive to collect, and create incentives for avoidance and evasion. Because they are imposed on a relatively narrow base they require high rates to raise any significant revenue. Each of these commodities is now subject to high sales taxes in addition to the excise taxes. The result is that, in many states, the tax on gasoline, alcohol and tobacco now exceeds the pretax price. This makes transactions in the black market for these commodities highly profitable. Empirical studies document a significant increase in cross-border transactions in these commodities as excise taxes are increased.

Finally, excise taxes are the most regressive component of any state tax system. Consumption of gasoline, alcohol, and cigarettes accounts for a much larger share of the income of low-income families than that of high-income families. Nor is there much evidence that higher excise taxes have a deterrent effect on consumption of these commodities.

In the final analysis the explanation for continued reliance on excise taxes in many states is that this is the path of least political resistance. Politicians generate support from interest groups opposed to consumption of gasoline, tobacco and alcohol, while encountering little opposition from the groups who must pay these taxes. In the words of bank robber Willy Sutton, politicians impose excise taxes because that is where the money is.

The decision to abolish excise taxes in Colorado will be a formidable political task, and will require considerable education of the electorate on the importance of tax reforms to achieve efficiency and equity.

5. Personal Property Taxes

Many other state taxes fail to satisfy the criteria for an efficient and equitable tax system and therefore should be abolished. To illustrate this we will examine personal property taxation, which should receive top priority for reform. Of all our state and local taxes the personal property tax least satisfies these criteria. We can use the personal property tax in Colorado to illustrate the problem.

Personal property taxes do not bear lightly on production; indeed, of all our taxes the personal property tax falls most heavily on productive activity. Recent economic research shows that the burden of the personal property tax falls in part on property owners, and as a tax on capital equipment it has a disincentive effect on new business investment. Investors in new capital equipment will compare the anticipated tax burden from the personal property tax in Colorado with that in other states. To the extent that the personal property tax is considered onerous compared to other states, we expect capital to flee to those states

When we compare the assessment rates on personal property tax with that in contiguous states, Colorado appears to be competitive. All of the contiguous states except Wyoming have assessment rates equal to or higher than Colorado’s 29 percent. In Wyoming the assessment rate is significantly lower: 11.5 percent for property used for industrial purposes and 9.5 percent for property used for other purposes. With the exception of Oklahoma, all of these contiguous states exempt business inventories from the personal property tax assessment, as in Colorado.

The burden of the personal property tax also depends upon the effective rate that is determined by both assessment rates and mill levies. The evidence reveals that Colorado’s effective tax rate on personal property is generally higher than that in New Mexico, Utah, and Wyoming, but lower than in Arizona, Kansas, Nebraska, and Oklahoma.

If we broaden the comparison with other states we find a number of states in which all or most of the personal property tax is exempt from taxation, including Delaware, Hawaii, Illinois, Iowa, Minnesota, New Hampshire, New York, Pennsylvania, and South Dakota. In other states, the personal property tax is significantly lower than in Colorado. For example, in California, a state with which we compete for investment in a broad range of industries, the personal property tax rates are less than half those in Colorado.

Recently we have had a graphic demonstration of how the personal property tax affects business investment decisions in Colorado. Kodak chose to award a $200 million film manufacturing expansion to its Rochester, New York plant rather than to its Windsor, Colorado plant because of the state’s personal property tax. These taxes have been cited as reasons for the loss of investment in two large semiconductor plants to other states: Hyundai Electronics chose Eugene, Oregon over Fort Collins; and Taiwan Semiconductor chose Camas, Washington over Fort Collins. A wide range of capital intensive manufacturing firms in Colorado have encountered similar problems and have formed a coalition to reform Colorado’s personal property tax in order to remain competitive with other states.

Our personal property tax is not easily and cheaply collected, nor does it always bear directly upon the ultimate payers. The Colorado Republican Business Coalition notes that the $32.6 million in personal property taxes collected from small businesses in Colorado is extremely expensive to collect. They maintain that the time and effort and cost of preparing the detailed annual property schedules always exceeds the amount of the personal property tax collected. Not surprisingly, small businesses in the state are prime movers in efforts to reform the personal property tax. These small businesses account for almost half of all new jobs created in the state of Colorado.

The “traditional view” in the economics literature is that property taxes are passed along to consumers in the form of higher prices. As noted above, recent research suggests that a significant part of the burden is borne by the owners of capital. To the extent that the tax is passed along to consumers, it violates the principle that the tax should bear directly upon the ultimate payers.

The incidence of compliance with Colorado’s personal property tax is by no means certain. There are no empirical studies of avoidance and evasion of the personal property tax in Colorado. However, economic studies suggest that this problem is greater with the personal property tax than with other taxes, such as income and sales taxes.

The personal property tax does not bear equally upon all citizens in the state. The personal property tax falls exclusively on business – agriculture and homeowners are exempt. The personal property tax falls most heavily on capital-intensive business – manufacturing, milling, and refining. As a result the tax is biased against the creation of high wage jobs because those jobs are concentrated in the capital-intensive industries.

The burden of the personal property tax falls especially heavily upon small businesses in the state. Recent reforms exempt the first $2,500 of property from taxation. However, many small businesses that do not have qualified staff, must continue to file personal property taxes, and must rely upon expensive tax accountants and lawyers to comply with the law.

The elimination of our personal property tax would move us closer to an optimum tax system that satisfies the principles laid out by Henry George. If the tax is eliminated on new capital investment, the existing capital stock will be replaced by new capital over time while the tax is phased out gradually.

The business personal property tax is one of the most inefficient and inequitable taxes. For many small businesses this tax generates less revenue than the cost of administering the tax. Legislation passed in recent years offsets part of the surplus revenue with a business personal property tax rebate. We could improve our tax system by eliminating this tax altogether.

6. Gift and Estate Taxes

In polls and in practice, gift and estate taxes, or inheritance taxes, are opposed by a majority of people. Australia, Canada, and Israel have recently repealed their inheritance taxes. At the federal level, the Taxpayer Relief Act of 1997 raised the inheritance tax exemption level from $600,000 to $1,000,000 by 2006, and gave additional relief to family business owners. At the state level, California citizens in 1982 voted overwhelmingly to abolish their inheritance tax. There are good reasons why inheritance taxes should be abolished in all the states, including Colorado.

Of all the taxes imposed by the states, inheritance taxes least satisfy the basic principles of taxation. Inheritance taxes are arguably the least efficient and least equitable of all taxes imposed by the states. A major source of inefficiency is the bias of inheritance taxes against savings and investment. By the time that individuals pay the inheritance tax they will have been subject to triple taxation: primarily, they pay taxes on the income they earn; secondly, they pay taxes on the interest, dividends, and capital gains generated by their savings; thirdly, they pay inheritance tax on that portion of their savings passed on to their heirs.

In contrast, individuals who choose to consume their income rather than save and invest escape the inheritance tax. Today there is much concern regarding the low rate of savings of U.S. citizens compared to that in other countries. To some extent Americans are simple responding to the disincentives of double and triple taxation on savings in our tax laws, including the inheritance tax.

Abolishing the inheritance tax would remove this bias and create more incentives for savings and investment.

In the past, inheritance taxes were paid by the wealthy; for example, when California abolished its inheritance tax, it applied to fewer than one in 20 state residents. However, in recent years a larger percentage of citizens, many of whom would be considered in the middle class, are now subject to inheritance taxes. As more citizens accumulate estates that are subject to inheritance taxes, it becomes more difficult to defend these taxes as a 'soak the rich' ploy. Inheritance taxes clearly fail the test of horizontal equity, i.e., treating individuals equally in terms of their tax liability. For two individuals with equal lifetime incomes, the inheritance tax rewards the spendthrift, and punishes the frugal individual who saves and invests. Abolishing the inheritance tax would move the tax system closer to one consistent with citizens' perception of fairness and equity.

Finally, the inheritance tax is one of the taxes most difficult to enforce and collect. It raises little money, and encourages wasteful forms of property transfer and ownership. Problems of tax avoidance and tax evasion in response to the inheritance tax impose a further deadweight loss.

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