

Issue Brief



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Colorado Tax Expenditures

Summary

Tax exemptions and credits reduce available state revenue by billions of dollars, yet they receive little attention and are not reviewed in the same manner as regular state appropriations. Colorado should join the many other states that regularly analyze tax expenditures so that policymakers and taxpayers can determine whether they still belong in the state's fiscal structure.

Introduction

The state of Colorado spends billions of dollars annually with little discussion and hardly anyone noticing. These payments are made in the form of ongoing tax credits and exemptions – some enacted many years ago – that are not subject to the same scrutiny given regular appropriations during the General Assembly's yearly budget process.

Tax expenditures, as they are called, amounted to at least \$2.2 billion in FY 2005-06, the latest year for which a total can be calculated. This figure is significant because it represented a nearly 24 percent reduction in potential General Fund revenues.

Unlike more than 30 other states, Colorado does not undertake a periodic review of tax expenditures so that policymakers have the information they need to evaluate their worthiness and get a full picture of the state's fiscal structure. This lack of transparency is reason enough to call for a regular study of tax expenditures. But such a review is needed now more than ever for two additional reasons: plummeting state revenues caused by a deep economic recession and a March 2009 ruling by the Colorado Supreme Court ruling that voter approval is not required to repeal existing tax credits

and exemptions when governments are below their TABOR revenue limits. Following the court decision, the legislature employed this new-found revenue-raising flexibility by removing two tax expenditures: a sales tax exemption for cigarettes and a capital gains deduction. These actions should generate nearly \$50 million for the General Fund in FY 2010-11.

Going forward, however, lawmakers will find it difficult to raise a substantial amount of additional revenue by eliminating tax expenditures. Many of the largest were passed for important public policy reasons that may still be valid. Others would be difficult to remove for political or constitutional reasons. The single largest expenditure – a sales tax exemption for ingredients or component parts – amounted to \$507 million or nearly a quarter of the total in FY 2005-06. It was passed in 1935 to prevent double taxation when a final manufactured product is subject to taxation. The food-at-home and home heating fuel exemptions were enacted in the 1980s to reduce the regressivity of the sales tax. Together, they accounted for \$294.7 million or 13.4 percent of total tax expenditures in FY 2005-06. The five largest expenditures accounted for 55.5 percent of the total. The 10 largest accounted

Top 10 Tax Expenditures — FY 2005-06

Tax Expenditure	Expenditure Amount
Sales tax exemption for ingredient or component parts	\$507.0 million
Sales tax exemption for food purchased for home	\$214.6 million
Sales tax exemption for gasoline purchases	\$179.2 million
Income tax deduction for pension income	\$169.9 million
Income tax credit for taxes paid to other states	\$150.0 million
Income tax credit for conservation easements	\$85.1 million
Sales tax exemption for residential heat, light, and power	\$80.1 million
Sales tax exemption for construction materials on public works projects	\$78.1 million
Sales tax exemption for machinery and machine tools	\$77.4 million
Sales tax exemption for sales to governments	\$69.4 million

for 73.2 percent.

What is a Tax Expenditure?

Tax expenditures are provisions in the tax code — exemptions, deductions, tax credits, deferrals or preferential tax rates — that are intended to encourage certain kinds of activities or help taxpayers in special circumstances. Lawmakers enacted many tax expenditures during relatively flush economic periods to keep increasing tax burdens to a minimum. Tax expenditures do not include tax rate reductions such as the income and sales tax rate reductions of 1999 and 2000. They also do not include methods to refund TABOR surpluses because these exemptions, deductions, tax credits and preferential tax rates are temporary.

An analysis of other states' studies shows that the definition is subjective. Some legislatures, for instance, mandate that federal deductions flowing through to a state's income tax code receive the same analysis as state-enacted deductions. We do not include these federal deductions as Colorado tax expenditures. For simplicity and administrative burden reasons, Colorado and most other states deliberately adopted the federal tax expenditures.

Many states define tax expenditures as the departure from a typical tax base. For instance, most pension income is taxable at the federal level. Colorado's adoption of federal taxable income as its starting point for the state income tax automatically incorporates federal treatment of pension income. Colorado provides for a deduction of up to \$24,000 of pension income, a deduction that can properly be called a tax expenditure.

It might seem contradictory to use the words "tax" and "expenditure" together as one term. "Tax" implies revenue coming into the government, while "expenditure" implies the spending of that revenue. However, the public policy intent of tax expenditures is similar to that of direct appropriations. For instance, the federal and state governments have tax credits for child care expenses. They could send checks directly to households incurring such expenses, but it is simpler and more efficient to have a household apply for the tax credit. The tax credit serves the same purpose as an appropriation. Because Colorado has for many years limited annual increases in General Fund appropriations,¹ it might be that our fiscal structure

¹ SB 09-228 changed the General Fund appropriations limit to 5 percent of Colorado personal income. General Fund appropriations had been limited to whichever was less: a 6 percent increase from the previous year's appropriation level or 5 percent of Colorado personal income.

avored the enactment of tax expenditures over direct appropriations.

Tax expenditures also differ from direct appropriations in that tax expenditures are typically ongoing, while direct appropriations can be reduced or eliminated in difficult fiscal times. A relatively small number of Colorado's tax expenditures have sunset dates. Appropriations are reviewed each year, while tax expenditures receive little scrutiny.

Why Analyze Tax Expenditures?

Since the passage of the Taxpayer's Bill of Rights in 1992, Colorado's policymakers were generally viewed as not having the authority to outright repeal a tax deduction or tax credit that results in a net revenue gain to the state. But in March 2009, the Colorado Supreme Court ruled that a tax policy change resulting in a revenue gain to a district could occur without voter approval providing that the gain would not cause revenue to exceed the district's revenue limits.²

Why else should legislators support a tax expenditure study for Colorado? Tax expenditures typically favor relatively small groups of taxpayers. Lawmakers should be able to weigh a tax rate increase that would affect *all* taxpayers against the repeal of a particular tax expenditure benefitting a *smaller* number of taxpayers, assuming that each would raise an equal amount of revenue.

Generally, tax expenditures were enacted for specific purposes. Another reason to review them is to determine whether they are accomplishing their intended purposes and whether the same results could be achieved with a lesser tax expenditure or more effectively through another mechanism.

The periodic review of tax expenditures also would provide the same kind of accountability provided by the normal appropriations process. When direct appropriations are made for a publicly funded program, the public can determine with precision exactly how much is being spent for that

purpose each year. By contrast, for tax expenditures, there is no way to know whether public funds are being spent, in what amounts and for what purposes. Tax expenditures lie beneath the surface, invisible to taxpayers and policymakers alike.

The Advisory Commission on Intergovernmental Relations (ACIR), an agency that studies the federal government's intergovernmental relationships, lists three reasons why tax expenditures should be reviewed periodically. *First*, a review of expenditures could assist in giving taxpayers and voters confidence that a state's tax structure is **equitable**. *Second*, recurring tax expenditure reports can yield **fiscal discipline**. Such reports would give state lawmakers and other policymakers more information on available resources and how they are used. State programs, whether funded via a direct appropriation or a tax expenditure, should work in unison so that desired policy objectives are attained. *Third*, a periodic review would foster a discussion among state lawmakers about whether tax expenditures meet the **goals of a sound tax structure**: revenue adequacy and stability; efficiency; equity; low administrative burden; tax neutrality; and simplicity.

State policymakers also should know the value of tax expenditures as a percentage of traditional spending. We calculate this amount as nearly 24 percent of General Fund revenue, a significant level.

A Cautionary Note About the Estimates

Estimating the loss of revenue attributed to Colorado's tax expenditures can be subject to significant error despite the best research. Some estimates rely on fiscal notes that may be imprecise. For example, the tax credit for conservation easements was originally estimated at only a few million dollars annually but has proven to be much more popular. While some abuse of this tax credit is alleged, the annual cost has been as much as

² Mesa County Board of County Commissioners v. State of Colorado, http://www.courts.state.co.us/Courts/Supreme_Court/opinions/2008/08SA216.pdf, pp. 22-24.

\$98.4 million.

The estimates also are conducted within a static, rather than a dynamic, framework. In other words, taxpayer behavior is not taken into account. A vivid example is the tax credit for solar panels that was in effect in the early 1980s. This tax credit, in conjunction with a similar federal tax credit, paid for 70 percent of the cost of solar panel installations. The two tax credits expired at the same time in 1985. Dozens of solar firms sprouted and grew when the credits were in effect, and many went out of business when the credits expired. The original static estimates did not foresee the magnitude of the growth of the solar industry, with the resulting job gains and economic growth, nor did they foresee the job losses and economic decline when they expired.

Although Colorado does not conduct a formal study of tax expenditures, information on many can be found in various state government documents. For example, the annual report of the Colorado Department of Revenue lists the amounts claimed for some state income tax credits. The Department has other unpublished information about deductions on the state income return.

The compendium that accompanies this report catalogues state government tax expenditures to the fullest extent possible. The total is understated due to our inability to calculate amounts attributed to Colorado deductions on nontaxable income tax

returns. We also did not have access to deductions on Colorado's corporate income tax returns.

A Framework For Presenting Tax Expenditures

The attached compendium focuses on Colorado's General Fund taxes. A brief discussion of each tax is presented and the following information is listed for each tax expenditure: the statute citation, year of enactment, sunset date if one exists, a brief explanation, the estimated amount of the expenditure and the number of beneficiaries if known. Most of the estimates are for FY 2005-06, and several individual income tax credits are combined together into lump sums. The state Department of Revenue recently sampled these credits to estimate their individual amounts. The sampling was based on 2006 income tax returns filed in 2007, one year later than the rest of the framework of this analysis. The subtotal for these tax credits in FY 2005-06 was \$143.2 million, while the Department of Revenue sampling yielded a total of \$185.9 million for the following year.

Author: Tom Dunn

The Center for Colorado's Economic Future at the University of Denver is an independent, nonpartisan organization that conducts research on matters related to Colorado's fiscal health, trends affecting the state's economy and proposed legislation relating to taxation and public spending.

[Click here for a compendium of Colorado tax expenditures](#)