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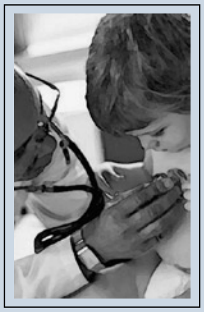
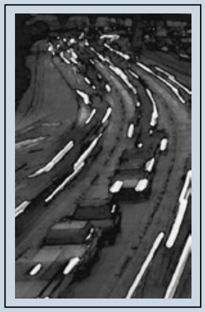
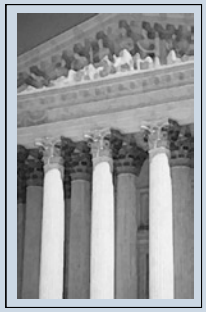


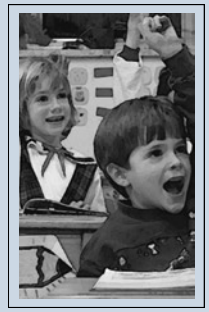

Proposition 103: What Is The Cost To Colorado Taxpayers?

Barry W. Poulson, Senior Fellow in Fiscal Policy and
Professor of Economics (retired), University of Colorado, Boulder
and
John D. Merrifield, Professor of Economics, University of Texas

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13952 Denver West Parkway • Suite 400 • Golden, Colorado 80401-3141
www.IndependenceInstitute.org • 303-279-6536 • 303-279-4176 fax

Proposition 103: What Is The Cost To Colorado Taxpayers?

Executive Summary

Proposition 103 is an initiative that will increase Colorado tax rates and require the state to spend the money on government schools. Prop 103 increases the personal income tax, the corporate income tax, and the statewide sales and use tax for the years 2012 through 2016.

The Fiscal Impact Statement prepared by Colorado's Legislative Council Staff estimates the cost of the tax increase at $2.9 billion. However, the cost for Colorado taxpayers will be significantly greater than staff estimates. Legislative Council uses static analysis, measuring only the direct impact of the higher taxes on state revenue. They ignore the negative impact the tax increase will have on economic growth and jobs in Colorado.

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This study uses dynamic scoring to show how the Prop 103 tax increase will significantly reduce economic growth and jobs in the state:

1. The total cost of the tax increase, including the loss in personal income, is estimated between $4.8 billion and $6.0 billion. The total cost per household is estimated between $2,169 and $2,711.

2. The higher tax will reduce job opportunities in Colorado. The total loss in jobs from the Prop 103 tax increase is estimated between 7,400 and 11,600.

3. The higher tax will also reduce the tax base, partially offsetting the revenue generated by the tax. Prop 103 will exacerbate a $1 billion structural deficit in the state budget.

Colorado has created one of the best business tax climates in the country by reducing tax rates. As a result, the state has experienced higher rates of economic growth, and attracted more new business investment and jobs than most states. People are attracted to Colorado by the rapid growth in incomes and jobs.[1]

Prop 103 will reverse these trends, imposing higher tax burdens that are likely to remain for the long term. Prop 103 will move our state toward a path similar to that in California, with higher tax burdens, lower economic growth, and reduced job opportunities for Colorado citizens.

Introduction

In November Colorado citizens will vote on Proposition 103. Prop 103 is an initiative that will increase state taxes and require the state to spend the money on government schools. The Fiscal Impact Statement prepared by Colorado Legislative Council Staff estimates the cost of the tax increase at $2.9 billion.[2] However, the cost for Colorado taxpayers will be significantly greater than staff estimates. Legislative Staff uses static analysis, measuring only the direct impact of the higher taxes on state revenue. They ignore the negative impact the tax increase will have on economic growth and jobs in Colorado. This study uses dynamic scoring to show how the tax increase will significantly reduce economic growth and jobs in the state.

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Proposition 103 also will exacerbate the structural deficit in the state budget. The revenue generated by the tax increase will be much less than that estimated by Legislative Staff.

This study explores the negative impact that the structural deficit will have on fiscal discipline. To the extent that fiscal discipline is eroded, the state will experience increased taxes and spending, causing retardation of economic growth in the long run.

Dynamic Scoring the Prop 103 Tax Increase

Proposition 103 increases taxes for the calendar years 2012 through 2016. The personal and corporate income tax rates increase from 4.63 percent to 5.0 percent. The sales and use tax rate increases from 2.9 percent to 3.0 percent. The legislative staff's estimate of a $2.9 billion cost assumes Coloradans will not respond rationally to higher tax burdens.

Individuals and businesses have an incentive to engage in activities that minimize their tax burden. When income and sales taxes are increased, individuals have less incentive to work, reducing income and expenditures. When corporate income taxes are increased, businesses have less incentive to invest and engage in entrepreneurial activity, reducing corporate income and expenditures. These rational responses to higher tax burdens tend to distort resource allocation resulting in inefficiency and lower economic growth.

State and local governments face a unique constraint in their ability to raise taxes. As taxpayers encounter higher tax burdens in one state, they tend to migrate to other states with lower tax burdens. Similarly, businesses respond to higher tax burdens in one state by investing and relocating in other states with lower tax burdens.[3]

Colorado has created one of the best business tax climates in the country by reducing tax rates. As a result, the state has experienced higher rates of economic growth than most states. The state has attracted new business investment and jobs at a higher rate than most states. People are attracted to Colorado by the rapid growth in incomes and jobs.[4]

If Colorado tax burdens are rising relative to other states in the region, we should expect Colorado to become less competitive in attracting new business investment.

The tax increase in Prop 103 will reverse these trends. At a time when other states in the region, such as Oklahoma, are reducing tax rates, Colorado will take the opposite approach. Some states, including Wyoming and Texas, impose no income tax. If Colorado tax burdens are rising relative to other states in the region, we should expect Colorado to become less competitive in attracting new business investment. Businesses will relocate to states with lower tax burdens, and people will migrate to those states as well.

There is now an extensive literature on the impact higher tax rates have on economic growth in states with mobile capital and labor.[5] This study analyzes the impact higher tax rates proposed in Prop 103 will have on the Colorado economy. Dynamic scoring is used to measure the impact the tax increases will have on economic growth and jobs.

Poulson and Kaplan use regression analysis to measure the impact of taxes on state economic growth.[6] They find evidence that an increase in the marginal tax rate in one state relative to that in other states has a negative impact on economic growth in that state. The regression analysis provides a range of estimates of this negative impact. Every 1 percent increase in the marginal tax rate in a state relative to the average marginal tax rate for the nation as a whole reduces the growth rate in that state between 0.250 percent and 0.374 percent.[7]

The marginal tax rate is the increment in taxes paid when an individual earns additional income. The marginal tax rate differs in each state depending on the tax structure in that state. The average marginal tax rate for the country as a whole is the average of the marginal rates levied in each state.

This estimate is used to measure the impact of the tax increase in Prop 103 on economic growth in Colorado using a previously developed dynamic scoring model.[8] The Prop 103 tax increase is simulated on personal income and tax revenue for fiscal years 2007-2011, a period of time comparable to the number of years that Prop 103 will be in effect. Through the simulation we compare simulated and actual personal income and employment, and measures of state revenue and spending for FY 2011, and for the entire period FY 2007-2011.

The Loss in Personal Income

With the Prop 103 tax increase in place, economic growth would have been significantly lower than actual growth. The cumulative reduction in personal income over the period as a whole would have been between \$2.0 billion and \$3.2 billion.

The total cost of the Prop 103 tax increase per household is between \$2,169 and \$2,711.

The negative impact of the tax increase would have been greater each year that the tax was in effect. The reduction in personal income increases by \$200-300 million each year. By the end of the period in which the tax is simulated, FY 2011, the annual loss in personal income is estimated between \$700 million and \$1.1 billion.

The total cost of the Prop 103 tax increase is estimated between \$4.8-6.0 billion, i.e. the \$3.9 billion in higher taxes plus the loss in personal income. The total cost of the Prop 103 tax increase per household is between $2,169 and $2,711.

The Loss in Jobs

Because the tax increase in Prop 103 reduces economic growth and personal income, it also reduces job opportunities in Colorado. To estimate the loss in jobs we use the most recent Legislative Council Staff estimate for employment elasticity in the total Colorado economy.[9] The employment elasticity measures the percentage change in employment relative to the percentage change in personal income. The Legislative Staff estimates that for every one percent reduction in personal income there is a .34 percent reduction in total non-farm employment.[10]

The loss in jobs from the Prop 103 tax increase for the period as a whole is estimated between 7,400 and 11,600.

The loss in jobs from the Prop 103 tax increase for the period as a whole is estimated between 7,400 and 11,600. Each year that the tax increase is in effect the loss in jobs as well as personal income is greater. By the end of the simulation period, FY 2011, the annual loss in jobs is between 2,400 and 3,800.

Exacerbating the Structural Deficit in the State Budget

Legislative Council estimates that the Prop 103 tax increase will yield $2.9 billion in revenue.[11] But this estimate is based on static analysis, it ignores the negative impact the tax increase has on personal income. Lower personal income reduces the tax base and the amount of revenue generated from that tax base. Dynamic scoring enables us to estimate the negative impact the tax has on tax revenue.

The lower personal income caused by Proposition 103 will reduce revenues between $72 million and $118 million. That is between 2.4 percent and 4.07 percent of the increase in revenue that the Legislative Staff estimates for the tax.

If Prop 103 will generate less tax revenue than that estimated by Legislative Staff this will mean less funding earmarked for education. Unfortunately, there is a high probability that the Legislature will ignore this budget constraint because of the structural deficit that Prop 103 builds into the state budget.

A structural deficit occurs when revenues are less than expenditures in the long term. Henry Sobanet, budget director for Governor Hickenlooper recently told members of the Joint Budget Committee that there is about a $1 billion structural deficit in the Colorado budget, and that about half of this structural deficit will persist into the next fiscal year.[12]

This structural deficit is due in large part to the “annualization” of fiscal stimulus dollars, much of which is earmarked for education.[13]

Prop 103 will exacerbate this structural deficit in the state budget. The revenue generated by the tax increase will be earmarked for education. It is not clear what education programs would be funded, but there is a high probability that most of the money will be used to cover operating costs of ongoing education programs. A basic rule in public finance is that one-time money should not be used to finance ongoing programs. Annualizing one-time money will exacerbate the structural deficit in the budget.

At the end of five years the Prop 103 tax increase will come to an end, but the ongoing education programs funded by that tax increase will remain. This structural deficit will put tremendous pressure on the state to extend the tax increase and make it permanent.[14]

Weakening the Fiscal Constitution

Proponents cannot help but know that Prop 103 will exacerbate the structural deficit in the state budget. They are also aware of taxpayer resistance to a permanent tax increase in Colorado. Since the Taxpayer’s Bill of Rights (TABOR) was passed in 1992, Colorado citizens have approved only one state tax increase, while rejecting eight ballot measures proposing increased state taxes.[15] Proponents of Prop 103 know that a large majority of Colorado citizens support the fiscal discipline imposed on the state by the TABOR Amendment.[16] Their strategy is to erode TABOR’s spending constraints by earmarking state revenue

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The education lobby has already carved out a privileged position in the state budget with Amendment 23.[17] Passed in 2000, that Amendment earmarks a significant share of state income tax revenue for a trust fund to finance K-12 education, exempt from the TABOR limit. The state is mandated to increase K-12 spending at the rate of inflation, even when the economy experiences a recession. This means that in recessions resulting in revenue shortfalls, the mandated K-12 spending must come at the expense of other state programs. General Fund spending for K-12 education has increased to 40 percent of the state budget; Prop 103 will result in an even greater share of the budget allocated to fund education K-12.[18]

The government education lobby used this same strategy in California to erode the constraints imposed on state spending by the GANN Amendment, a spending limit similar to TABOR.[19] By exempting spending for education and other programs from the GANN limit legislators were able to significantly increase state spending, accompanied by increased deficits and debt. Over the past two decades the California State Legislature has imposed one of the highest tax burdens in the country. They have created one of the worst business tax climates in the country. Businesses have relocated from California to Colorado and other states with lower tax burdens. As the California economy has stagnated, workers have followed the flow of capital, moving to states with growing economies and better job opportunities.

Prop 103 will move us toward a path similar to the one taken in California, with higher tax burdens, lower economic growth, and reduced job opportunities for Colorado citizens.

Colorado has avoided a fiscal crisis such as that experienced in California and other states largely because of the fiscal discipline imposed by TABOR. Total state and local spending has grown at roughly the same rate of growth as personal income since TABOR passed.[20] In periods of rapid growth when revenue exceeded the TABOR limit state and local governments rebated surplus revenue to taxpayers. Because of this fiscal discipline Colorado has been able to reduce tax burdens at both the state and local level.

Prop 103 will reverse these trends, imposing higher tax burdens that are likely to remain for the long term. Prop 103 will move us toward a path similar to the one taken in California, with higher tax burdens, lower economic growth, and reduced job opportunities for Colorado citizens.

Conclusion

Colorado citizens have already borne the brunt of the recent recession with reduced job opportunities and lower incomes. They have learned to live with the budget constraints imposed by lower household incomes. It is time for the government to learn to live with the budget rules by our state Constitution.

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JON CALDARA is President of the Independence Institute.

DAVID KOPEL is Research Director of the Independence Institute.

BARRY W. POULSON is a Senior Fellow at the Independence Institute, and a retired Professor of Economics at the University of Colorado, Boulder.

JOHN D. MERRIFIELD is Professor of Economics at the University of Texas, San Antonio.

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Endnotes

[1] For a discussion of tax policy and economic growth in Colorado see Barry W. Poulson, *What is at Stake in the Current Battle over Colorado's Tax and Spending Limits?* Independence Institute Issue Backgrounder no. 2009-C, (March 2009), http://tax.i2i.org/files/2011/02/IB_2009_C_a.pdf.

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[3] For a discussion of how taxes impact state and local economic growth see Richard Vedder, "Tiebout, Taxes, and Economic Growth," *Cato Journal*, vol. 10, no. 1 Spring/Summer 1990.

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[6] Ibid.

[7] Ibid.

[8] For a detailed discussion of this methodology see John Merrifield, Barry Poulson, and Dave Trabert, "Kansas Fiscal Policy Simulations and Analysis," Kansas Policy Institute, (forthcoming 2011); and John Merrifield and Derek Monson, "Simulation of a Constitutional Spending Limit for a Conservative State: With Dynamic Adjustment and Sensitivity Analysis," *Public Budgeting and Finance* 31:3 2011, forthcoming.

[9] Colorado Legislative Council Staff, "Focus Colorado: Economic and Revenue Forecast," June 20, 2011.

[10] Ibid., pg. 55.

[11] Colorado Legislative Council, "Fiscal Impact Statement."

[12] Tim Hoover, "Colorado Budget Projections Show Deficit of up to $500 million next Fiscal Year," *Denver Post*, September 21, 2011. See also Governor's Office of State Planning and Budgeting, "The Colorado Outlook," September 20, 2011.

[13] For a discussion of the structural deficit in higher education budgets see Barry W. Poulson, *The Funding Crisis in Colorado's Higher Education System*, Independence Institute Issue Backgrounder no. 2010-D (December 2010), http://tax.i2i.org/files/2010/12/IB_2010_D_a.pdf.

[14] We should add that there is little evidence that this increased funding earmarked for education improves schooling outcomes. See for example John D. Merrifield, *School Choices: True and False* (Oakland, Calif.: Independent Institute, 2002).

[15] Poulson, *What is at Stake.*

[16] Ibid.

[17] Barry W. Poulson, *Amendment 23: A Critique*, Independence Institute Issue Paper no. 5-2000 , (September 2000), http://www.scribd.com/doc/23685596/Amendment-23-A-Critique.

[18] Governor's Office of State Planning and Budgeting, "The Colorado Outlook."

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[20] State of Colorado, "Colorado Comprehensive Annual Report," various issues.