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MEMORANDUM

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July 6, 2009

TO: Long-Term Fiscal Stability Commission
FROM: Jason Schrock and Ron Kirk, Economists, (303) 866-3521
SUBJECT: Colorado's State Government Revenue Structure

This memorandum provides an overview of Colorado's state government revenue structure. First, a broad overview of the state's revenue sources is provided. The state's income and sales tax are then described in more depth. Although property taxes are an important revenue source for school finance, they are not covered in this memorandum because they are not directly collected by the state.

Colorado's State Government Revenue Structure

Coloradans paid 30 percent of their income in federal, state, and local taxes in 2006. Approximately 71 percent of these taxes were paid to the federal government, primarily in the form of income and social security taxes. The remaining 29 percent of taxes paid were split almost evenly between state and local governments (Figure 1). Colorado is one of only a handful of states in which the state collects less in taxes than local governments.

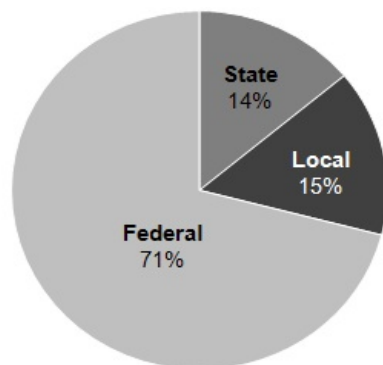


Figure 1
Where Do Our Taxes Go?
2006: \$59.5 Billion

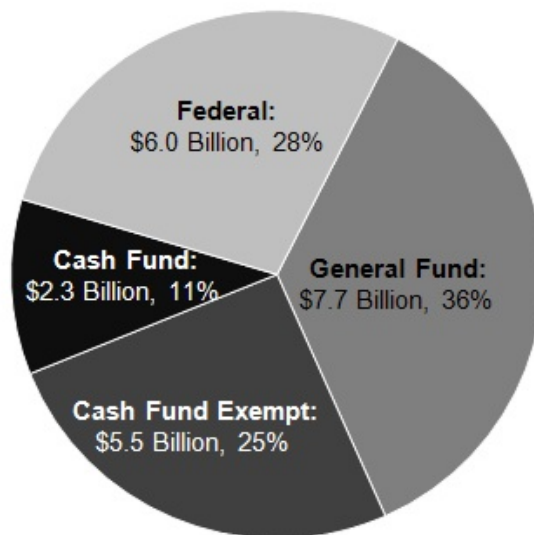
Colorado's Revenue Structure

Colorado receives the majority of its revenue from the federal government, state taxes, and state fees. The state also receives some money from fines and penalties. The General Fund, where general-purpose tax revenue is deposited, is used for the state's core programs, such as education, human services, corrections, and health care. Cash funds, where most fee-revenue and program-specific taxes are deposited, are earmarked for specific programs.

General Fund revenue is primarily – about 95 percent – made up of income and state sales taxes. The General Fund also receives revenue from excise taxes on cigarettes, taxes, and liquor as well as from parimutuel taxes, insurance premium taxes, investment income, and a variety of miscellaneous revenue sources, such as from fines and penalties.

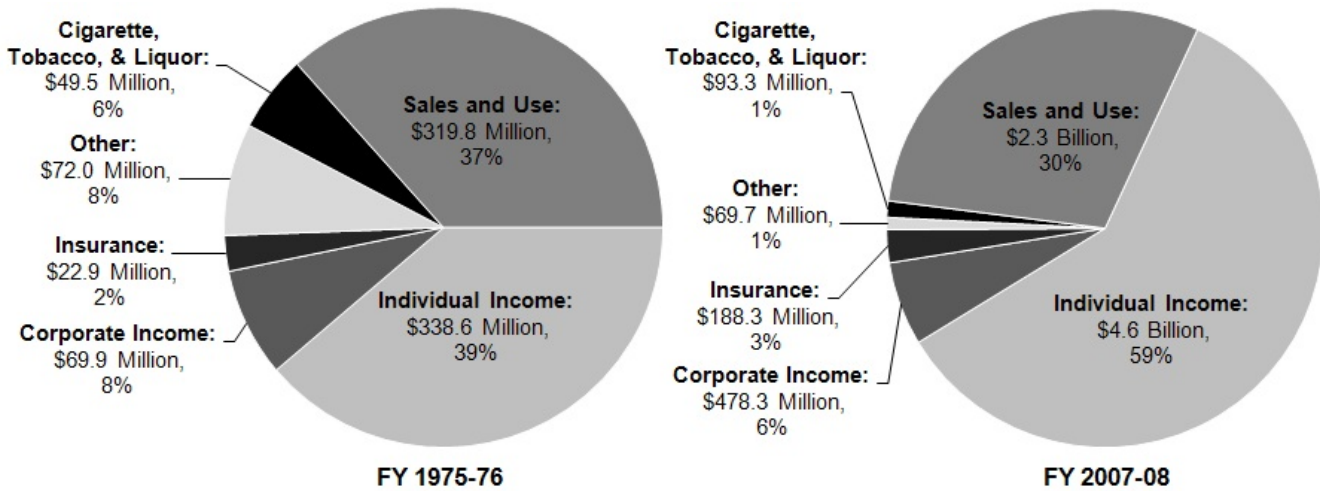
In FY 2007-08, 36 percent, or \$7.7 billion, of state revenue was received by the General Fund (Figure 2). Cash Fund revenue, both exempt (totaling \$5.5 billion) and nonexempt (totaling \$2.3 billion), also accounted for roughly 36 percent of state revenue, and federal funds (totaling \$6.0 billion) comprised the remaining 28 percent. Nonexempt cash fund revenue is subject to TABOR, while exempt cash fund revenue is not.

Figure 2
Revenue Sources By Fund Type, FY 2007-08



General Fund revenue sources have changed significantly since the 1970s, as illustrated in Figure 3. The state has become more reliant on individual income taxes and less reliant on sales and use and corporate income taxes since FY 1975-76. In FY 2007-08, 59 percent of the state's General Fund came from individual income taxes, compared with only 39 percent in FY 1975-76. In contrast, sales and use taxes comprised 30 percent of General Fund revenue in FY 2007-08 versus 37 percent in FY 1975-76. The share of General Fund revenue attributable to corporate income taxes has declined slightly from 8 percent in FY 1975-76 to 6 percent in FY 2007-08. All other General Fund revenue sources comprised 5 percent of the total in FY 2007-08, dropping from 17 percent in FY 1975-76.

Figure 3
Comparison of General Fund Revenue, FY 1975-76 and FY 2007-08

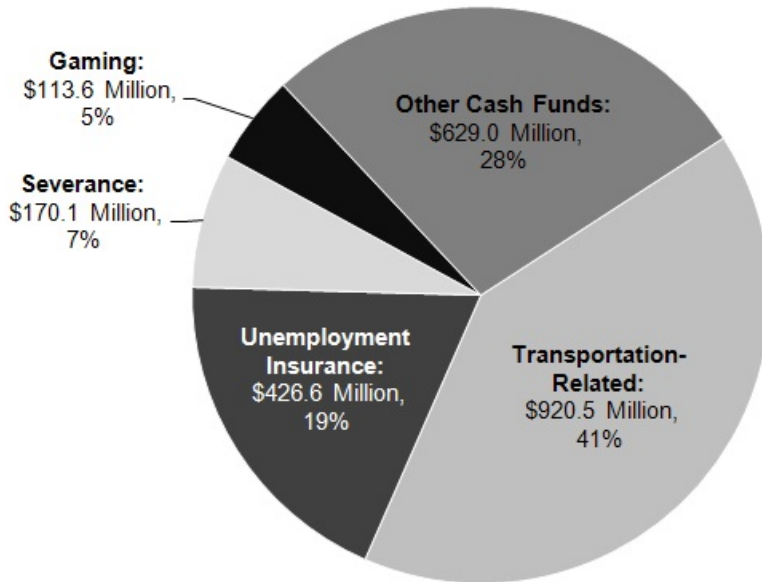


Several reasons account for the shift in General Fund revenue sources. First, many sales tax exemptions were enacted in the late 1970s and early 1980s when the state had significant budget surpluses. When the large surpluses evaporated in the mid-1980s recession, the sales tax exemptions were not repealed. While the state also enacted many income tax reductions in the late 1970s and early 1980s, these reductions were largely repealed to help the state's budget during the recession.

A second reason for the shift is that federal tax reform in 1986 significantly broadened the tax base upon which individual income taxes are levied. Since Colorado uses federal taxable income as its starting point for the calculation of Colorado's income tax base, the broadening of the federal tax base, which Colorado adopted for the most part along with its own tax law changes in 1987, increased the state's reliance on individual income taxes. Conversely, the state's sales tax base has become smaller over time. Consumer spending has shifted from goods to services and there are an increasing amount of e-commerce transactions – a portion of which have sales and use taxes that are due that go uncollected. Finally, Coloradans have experienced steady increases in income over time, which is partially responsible for the increasing share of income tax revenue to the state.

Cash fund revenue is earmarked for a variety of specific purposes. Figure 4 displays the relative importance of cash fund revenue sources subject to TABOR (nonexempt) in FY 2007-08. The largest cash funds were earmarked for transportation (41%), unemployment insurance (19%), mineral severance programs (8%), and for gaming impacts and economic development programs supported by gaming revenue (5%). The transportation funds primarily receive money from fuel taxes and motor vehicle registration fees. Unemployment insurance revenue comes from the unemployment insurance tax, severance taxes are primarily imposed on natural gas and oil producers, and gaming revenue comes from taxes on casino proceeds from gaming.

Figure 4
Major Cash Fund Revenue Sources Subject to TABOR, FY 2007-08
Total Revenue: \$2,259.8 Million



Cash Fund exempt revenue mostly consists of revenue that is transferred among state government programs and revenue that is exempt from TABOR when it is received by the state. The largest sources of cash fund revenue exempt in the latter category in FY 2007-08 were received by entities designated as enterprises such as public universities and colleges, the state lottery, and the Division of Wildlife. Other relatively large sources of exempt revenue the state receives include the Amendment 35 cigarette and tobacco tax passed by voters in 2005, the revenue the state receives from tobacco companies as a result of the Master Settlement Agreement, and federal mineral leasing revenue that the state receives when individuals or companies lease federal lands for mineral production.

During the 2009 session, the General Assembly adopted HB 09-1363. As a result of this bill, revenue to the UI Trust Fund (Unemployment Compensation Section in the Department of Labor and Employment) and the Employment Support Fund will no longer be subject to TABOR beginning in FY 2009-10. The legislation establishes the UI section as an enterprise as long as it retains authority to issue revenue bonds and receives less than 10 percent of its total annual revenue from state and local grants.

Colorado's Income, and Sales and Use Taxes

About 95 percent of General Fund revenue is made up of income and state sales and use taxes. In FY 2009-10, total state income taxes are estimated at \$4.6 billion, or 63 percent of total General Fund revenue, while state sales and use taxes are estimated at \$2.2 billion, or about 32 percent.

Individual Income Taxes

Individual Income Tax Highlights	
Enacted:	1937.
History:	33rd state to enact an income tax.
Citations:	Article X, Sections 17 and 19, Colorado Constitution, Title 39, Article 22, C.R.S.
Tax Base:	Federal taxable income adjusted by modifications.
Tax Rate:	4.63 percent (flat tax).
Ranking:	29th lowest of 43 states having an income tax.
Collections:	\$4.3 billion; estimated for FY 2009-10.
Disposition of Revenue:	One-third of one percent of federal taxable income is credited to the State Education Fund. The remaining money is credited to the General Fund.

Tax overview. Colorado's largest source of tax revenue comes from the individual income tax and is expected to generate about \$4.3 billion in revenue in FY 2009-10. In terms of the General Fund, this main revenue source is estimated to make up about 60 percent of General Fund revenue and 94 percent of total income taxes in FY 2009-10.

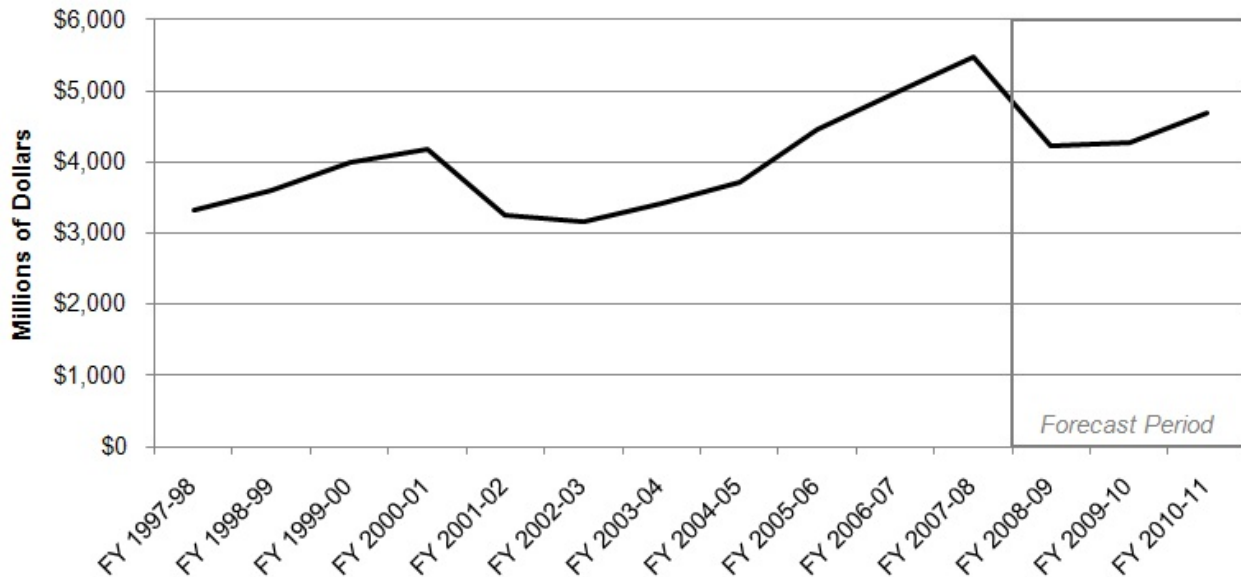
The individual income tax plays a vital role in financing state governments and accounts for about one-third of total state tax revenue in the nation. This revenue source has become increasingly important to Colorado over the past decades. In the late 1990s, Colorado saw considerable growth in individual income tax receipts due to a booming economy fueled by rapid growth in the high-technology industry, the proliferation of employee stock options, and an escalating real estate market that helped drive the stock market to record-high levels.

The individual income tax has been very volatile during Colorado's current and prior recessionary periods. During the recession of the early 2000s, the composition of the workforce and capital gains taxes were the culprits. Colorado saw many of its high-paying jobs disappear in the high-tech industry. In addition, stock market declines hit Colorado extremely hard as capital gains

tax receipts declined precipitously. During this recession, individual income taxes declined 22.3 percent from FY 2000-01 to FY 2001-02.

In the current recession, the ongoing loss of jobs and a stock market that at one point lost about 50 percent of its value are driving individual income tax receipts downward. From FY 2007-08 to FY 2008-09, individual income tax revenue is estimated to fall 22.7 percent. Figure 5 shows how individual income tax receipts have fallen during the prior and current recessions.

Figure 5
Individual Income Tax Collections, FY 1997-98 to FY 2010-11
(Dollars in Millions)



Colorado is one of the 43 states that levy an individual income tax and like many other states, uses federal taxable income as the tax base or starting point for calculating Colorado taxable income. Federal taxable income is first modified by either adding or subtracting tax modifications. This amount is multiplied by the 4.63 percent tax rate to determine Colorado gross taxable income. The gross tax liability is then reduced by any tax credits to determine the amount of taxes owed by the taxpayer to the state. Figure 6 shows how net individual income tax liability is calculated.

Figure 6
Colorado Net Individual Income Tax Liability

$\text{Net Tax Liability} = [\text{Federal Taxable Income} (\pm) \text{ State Modifications}] \times 4.63\% \text{ less Credits}$

Enacted in 1937. The individual income tax was one of the last state revenue sources enacted in the late 1930s and initially made up about 7.5 percent of total state revenue. At the time, the major state revenue sources were motor fuels taxes, which made up 32.2 percent of total revenue, and sales and use taxes (26.0 percent). Early tax studies found that the significance of the income tax was its capability to provide an element of progressivity to the combined state and local tax

structure, which at that time was viewed as a highly regressive. The adoption of the tax was advocated by organized farm, labor, and public education groups for a quarter of a century before it was enacted. Income tax receipts totaled \$2.8 million in 1939, the first full year of collections. Of this, \$1.7 million, or 61 percent, was from individual income taxes. Prior to its adoption, 32 states other than Colorado had an income tax.

Corporate Income Taxes

Corporate Income Tax Highlights	
Enacted:	1937.
History:	31st state to enact a corporate income tax.
Citations:	Article X, Sections 17 and 19, Colorado Constitution, Title 39, Article 22, C.R.S.
Tax Base:	Income generated by property in the state and from activities carried on in the state.
Tax Rate:	4.63 Percent (flat tax).
Ranking:	41st lowest of 46 states having a corporate income tax.
Collections:	\$285.2 million; estimated for FY 2009-10.
Disposition of Revenue:	General Fund.

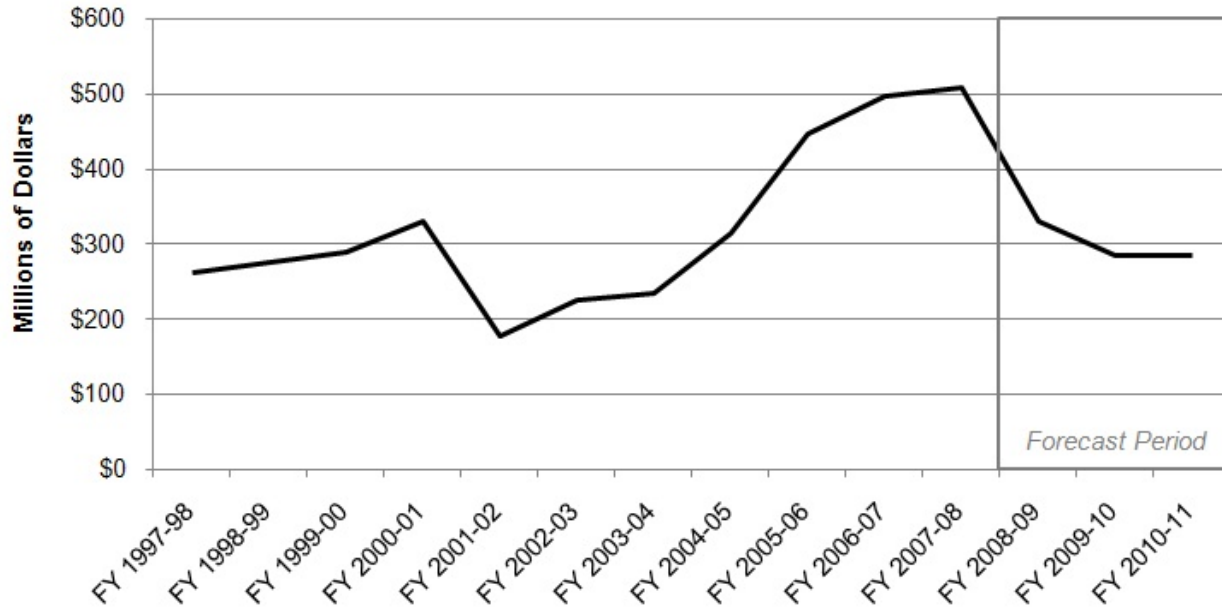
Tax overview. Colorado's corporate income tax is expected to generate about \$285.2 million in revenue in FY 2009-10, about 5 percent of General Fund revenue. In most cases, states that tax individual income also tax the income of corporations. Colorado is one of 46 states that impose a corporate income tax. Corporate income taxes are expected to make up 6 percent of total income taxes in FY 2009-10.

The corporate income tax is one of the most complicated components of state revenue systems, mainly due to its application of the tax to interstate business and the apportionment process that determines how much a corporation owes. For many states, including Colorado, the tax makes up a very small portion of state revenue. Like the individual income tax, it is very volatile during recessionary periods of the business cycle.

During the recession of the early 2000s, the closure of many high-technology firms helped drive corporate tax receipts downward. From FY 2000-01 to FY 2001-02, revenue declined 46 percent. During the current recession, the decline in demand in domestic and international goods and services is depressing corporate profits, and in turn, driving corporate tax revenue down. In addition, the current decline can be attributed to tax breaks provided through the economic stimulus packages of 2008 and 2009. For the most recent fiscal year, from FY 2007-08 to FY 2008-09,

revenue is estimated to fall 34.8 percent and is expected to drop another 13.9 percent in FY 2009-10 before it rebounds in the following year. Figure 7 shows how corporate tax receipts have fallen during the prior and current recession.

Figure 7
Corporate Income Tax Collections, FY 1997-98 to FY 2010-11
(Dollars in Millions)



Enacted in 1937. Taxes on corporations were originally utilized as an emergency revenue source. In 1911, the U. S. Supreme Court upheld the tax as "an excise upon the particular privilege of doing business in the corporate capacity." When Colorado adopted the corporate income tax, 30 states other than Colorado taxed corporate income. During 1939, the first full year of collections, less than 2,000 corporate returns were filed. Corporations paid \$1.1 million of \$2.8 million (39 percent) of total income tax revenue collected by the state.

State Sales And Use Taxes

State Sales and Use Tax Highlights	
Enacted:	1935.
History:	19th state to enact a sales tax.
Citations:	Title 39, Article 26, Part 1, C.R.S. - State; Title 29, Article 2, Part 1, C.R.S. - Local.
Tax Base:	Gross receipts from sales of tangible personal property, unless specifically exempted by statute, and certain services are subject to the sales tax.
Tax Rate:	2.9 Percent (flat tax).
Ranking:	44th lowest of 45 states having a sales and use tax.
Collections:	\$2.2 billion; estimated for FY 2009-10.
Disposition of Revenue:	State sales taxes are credited to the General Fund and the Old Age Pension Fund, as required by the Colorado Constitution, and the Aviation Fund as required by Section 28-6-101, C.R.S.

Tax overview. Colorado's second largest source of tax revenue is the state sales and use tax. For FY 2009-10, the tax is estimated to generate \$2.2 billion. In terms of the General Fund, this main revenue source is estimated to make up over 30 percent of General Fund revenue in FY 2009-10.

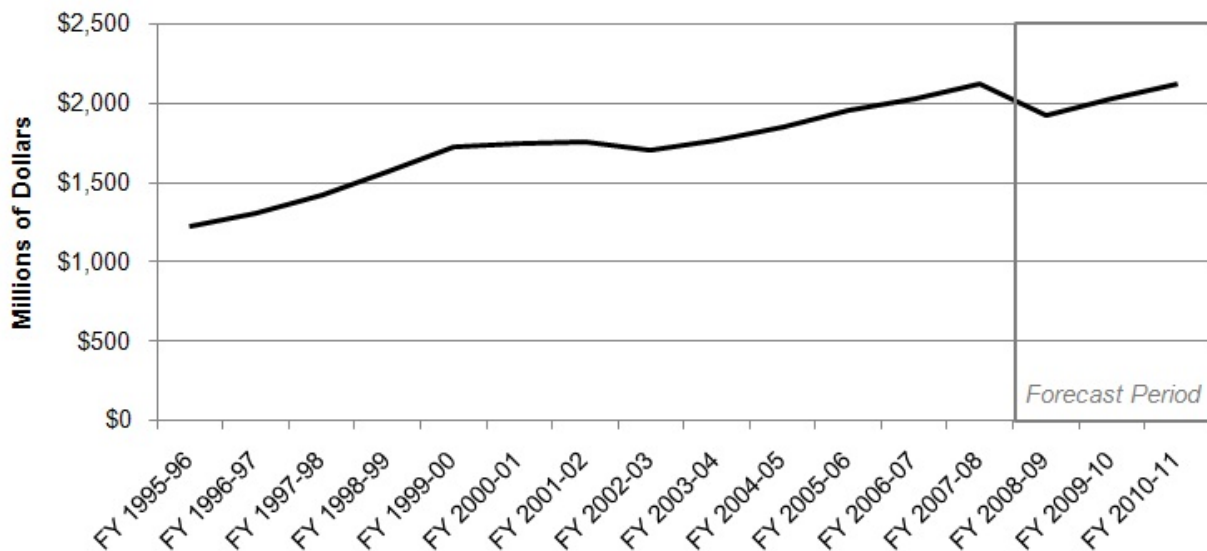
The state sales tax is among the most important sources of revenue for state governments, and similar to the individual income tax, accounts for about one-third of total state tax revenue in the nation. Colorado is one of the 45 states that levy a sales and use tax. The five states that do not impose the tax make up less than 3 percent of the nation's population.

Despite the sales and use tax's durability over the past 50 years, it has been declining over the past decade as a percentage of total state tax revenue as the individual income tax continues to grow in prominence. One reason for the decline is the growing number of sales and use tax exemptions. Another reason is an increasing amount of e-commerce transactions. Sales and use taxes go uncollected on a portion of these transactions due to the state's inability to enforce collections. According to the U.S. Bureau of the Census, e-commerce sales grew at a 13.3 percent average annual growth rate from 1999 to 2006. These sales are expected to continue to rise.

Also, consumers are spending less on goods – which make up the most significant portion of the state's sales tax base – and more on services, which are generally not subject to the sales tax. When the sales tax was enacted in 1935, services represented about 40 percent of total spending. By 2008, spending on services had increased to 60 percent.

Similar to the income tax, state sales and use taxes are reactive to the business cycle, though they are generally less volatile. However, the current recession is providing an exception. Given the ongoing loss of jobs and housing and stock values declines, consumers have cut spending, with many only purchasing goods that are necessities. This pattern of spending is driving sales tax receipts downward, and at present, is much worse than the prior recession of the early 2000s. For example, in the prior recession, the state saw state sales taxes fall 3 percent from FY 2001-02 to FY 2002-03. In contrast, from FY 2007-08 to FY 2008-09, state sales tax revenue is expected to fall 9.3 percent. Figure 8 shows how state sales tax receipts have fallen during the prior and current recessions.

Figure 8
State Sales Tax Collections, FY 1997-98 to FY 2010-11
(Dollars in Millions)



To determine sales taxes owed on taxable goods or services, the price is multiplied by the 2.9 percent tax rate. Figure 9 shows how state sales tax liability is calculated.

Figure 9
State Sales Tax Liability

$\text{Sales Tax Liability} = [\text{Price of Good or Services} \times 2.9 \text{ Percent}]$
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Enacted in 1935. Since the 1930s, state sales taxes have changed from secondary to major revenue sources for state governments. The first state general sales tax was adopted by West Virginia in 1921 and was initially levied on gross sales for retailers, extractive industries, and other business enterprises. Initially, West Virginia passed the tax to provide revenue for

emergency purposes. In 1929, Georgia followed with the adoption of its general sales tax on gross receipts on retail, manufacturing, and wholesale products.

The Great Depression and its financial crisis resulted in many other states adopting state sales taxes and, by 1934, 18 states had sales taxes. In 1935, Colorado and nine other states followed Georgia's lead. Most of these states levy the tax on gross receipts at the retail level. By 1939, state sales taxes were the second largest revenue source, making up 26 percent of total revenue for Colorado, while motor fuel taxes made up 29 percent. In the early 1980s, sales taxes would grow to make up over 40 percent of total state tax revenue. Since this high point, sales tax revenue has declined likely due to the growing number of state sales and use tax exemptions. They are expected to make up 32 percent of General Fund revenue in FY 2009-10.

Exemptions: Since 1935, Colorado has enacted 71 sales tax exemptions. For FY 2009-10, estimates show that the total revenue impact of these exemption was over \$1.86 billion.