

# INDEPENDENCE ISSUE PAPER

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## AVOIDING AN AUTOMATIC TAX INCREASE IN 1987

### Here Comes the 33% Surprise

By John K. Andrews, Jr.

Beginning in a matter of days, throughout 1987 and each year thereafter unless state legislators take action, more than one-quarter billion dollars per year in higher state taxes will be soaked out of the paychecks of Colorado citizens and the earnings of Colorado businesses as a result of side-effects from the new federal tax law increasing the exposure of state taxpayers here.

Almost everyone will have to pay more, according to a series of typical personal tax returns for 1987 developed by CU and DU tax experts from state estimates. The average increase is about 33% (see appendix for detail). A one-earner couple with one child, paying in a low-income bracket, would

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### How to Save Taxpayers from the Shortfall

By Barry W. Poulson

Sometimes the language of public policy has more to do with packaging for public acceptance than with accurately describing what's inside the policy package. Take the popular use of the term windfall to describe the impact of federal tax reform on state income taxes in Colorado.

Most people would define a windfall as a sudden improvement in their wealth, for example, winning the state lottery. If we say that federal tax reform has created a windfall for our state, most people will perceive that to be an unexpected transfer of wealth from the federal government to the government of Colorado. The opposite will actually occur as a result of the

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### ----- IN BRIEF -----

- The State of Colorado will collect more than \$250 million in higher income taxes from individuals and businesses in 1987 as a side-effect of federal tax reform.
- Taxpayers face an average increase of 33% unless the legislature acts.
- This shortfall in family budgets has been misleadingly described as a "windfall" by the spending lobbies, leaving many Coloradans thinking the money will come from Washington rather than their own pockets.
- Federal promises of neutrality in tax reform are mocked by the state shortfall.
- The Colorado General Assembly should act to restore neutrality, increase simplicity, and maintain progressivity in the state income tax by correcting the shortfall through some combination of cuts in rates and base.

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owe about 7% more in 1987 than 1986. For a childless couple of medium income, both working, 53% more. Two earners, two children, higher income -- 60% more.

A single mother supporting her baby on \$22,000 a year will face a state tax hike of 8%. A widow of 67, seeing \$29,000 from her pension and some bonds, now pays \$3 in Colorado income tax; it would jump to \$24, half a week's food budget, if changes are not made.

For the unmarried yuppie, salaried at \$40,000, federal taxes are already jumping 10%; a state tax increase of 23% will further pinch the BMW payment. And so it goes, across the board. Businesses too will feel the bite.

While Colorado is not one of the more heavily taxed states, there are few reported instances each April 15 of citizens or companies voluntarily overpaying or telling the state to keep the refund. Most taxpayers seem to have more than enough uses for every dollar of their earnings not claimed by the IRS or the state revenue department.

Of course, a legitimate argument can be made over whether the money to be pulled in by a 1987 increase is more "needed" or will "do more good" if levied and spent collectively by the state than if kept and spent individually by you and me.

That debate should not overlook the key role of relative tax burdens and up- or downward tax trends in today's fierce competition among states for a favorable business climate.

\* \* \* \* \*  
\* Direct linkage between tax trends \*  
\* and state economic growth is doc- \*  
\* umented in publications by Robert \*  
\* Genetski, a Chicago economist in \*  
\* the Independence Research Network. \*  
\* \* \* \* \*

But the point is, there ought to be a debate over this major boost in the price of state government. It should be an open and honest discussion on the merits, not simply a political shell game behind the smokescreen of confusing rhetoric about the Great Federal-State Tax Windfall.

If you get around the state and keep your ears open, you hear a lot of evidence that confusion, not understanding, is the prevailing condition on this issue. Here are some recent examples:

Scene 1: A candidate for statewide office is discussing the outlook for Colorado's economic revival with the head of one of the state's largest financial institutions at the height of the 1986 campaign. The businessman startles the candidate by admitting that he believes the much-discussed "tax windfall" to be federal money that the state has coming, rather than (what it is) Colorado citizens' own money that the state will begin collecting through an automatic tax increase on January 1.

Scene 2: Four suburban couples are seated together at a civic club dinner shortly after the election. When the educator says he hopes the legislature will "give the windfall back," he is laughed down by the wholesaler, the doctor, the insurance man, and their wives -- all of whom reasoned as did the financier, above: Why should the state government return this nice gift worth tens of millions?

Scene 3: The Governor-elect unveils his economic development plan before a blue-ribbon group of several dozen business leaders and an audience of several hundred in Denver on November 25. "Spend the windfall" is one of the most repeated themes in the afternoon's discussion of how to create jobs and stimulate the state's economy. The negative incentive of tax increases as a damper on wealth expansion is mentioned by no one.

\* \* \* \* \*  
\* Facts and myths about the \*  
\* role of tax policy in economic \*  
\* development are discussed in \*  
\* Independence Issue Paper No. \*  
\* 13-86, "Game Plan for Economic \*  
\* Development in Colorado." \*  
\* \* \* \* \*

To cut through the confusion about whose money this is and how it should be spent, the first step is to call things by their right names. Leaders from the legislature and the business community have asked the Independence Institute to prepare a short primer on the language of state and federal tax reform.

Barry Poulson, Independence senior fellow and chairman of the economics department at CU-Boulder, untangles the vocabulary snarl in the accompanying article which concludes with a discussion of approaches for correcting the Colorado income tax shortfall (miscalled windfall).

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POULSON: CORRECTING THE SHORTFALL - Continued

recent federal tax reform bill, however. The federal changes will impose a greater burden on Colorado taxpayers.

For truth-in-packaging, politicians, the media, and the spending lobbies should be talking about a shortfall, not a windfall. That's the bad news: Colorado taxpayers who anticipate paying their 1987 state income taxes at the same level they did in 1986 will find that the money they set aside for the state revenue collector will fall short of the amounts due as a consequence of federal tax reform.

The explanation for this shortfall is that the base for the Colorado personal income tax is tied to the base for federal income taxes. Federal tax reform, by expanding its own base effective January 1, automatically broadened the base for Colorado personal income taxes.

One of the terms widely used in defending federal tax reform was tax neutrality. In the strictest sense, a neutral tax reform would have left the wealth of all individual and corporate taxpayers unchanged, and we know that this is not true of the recent federal tax reform. However, the term "neutral" was used in the narrower sense that federal tax reform would generate the same level of federal revenues as the existing tax system. Indeed, one could argue that the widespread acceptance of federal tax reform was predicated upon this concept of neutrality in which the majority of taxpayers anticipated no increase in their income taxes (some taxpayers may even have expected their income taxes to fall).

This perception of federal tax reform carries the implicit (if not explicit) expectation that state tax laws would not turn around and undo all or part of what was accomplished at the federal level. Specifically, most taxpayers expecting tax neutrality would not anticipate an increase in their state income

taxes simply because of a reform in federal taxes. But this is exactly what will happen to most Colorado citizens without some revision of the Colorado state tax law.

If Colorado is to reform its tax laws to return taxpayers to the revenue neutral condition in which their tax burden does not increase, then the shortfall must be offset. There are basically three options in offsetting that shortfall: a tax rebate, a change in the tax base, and/or a change in the tax rate.

\* \* \* \* \*  
\* The next Independence Issue \*  
\* Paper, to be published before \*  
\* the January legislative session \*  
\* begins, will lay out this menu \*  
\* of options in greater detail. \*  
\* \* \* \* \*

Option A, the easiest approach, and one which is being considered in a number of states similar to Colorado, is a tax rebate. Colorado has experience in income tax rebates or tax credits; their implementation involves determining the total amount to be returned to taxpayers and the magnitude of the rebate per taxpayer.

The rebate is the least attractive of the three options to be considered, however. It would create temptations for legislators to play favorites, leave the state with the existing cumbersome and inefficient state income tax law, and require not one but a continuous series of rebates in state income taxes to taxpayers each year to offset the shortfall.

Option B is a change in the tax base for the state income taxes. The most obvious way to do this would be to adjust the standard deduction and personal exemptions for state income tax purposes to match those incorporated in the new federal income taxes. The argument for adjusting the state standard deduction and personal exemption to match the federal is to achieve both neutrality and simplification.

(The term simplification, unfortunately, has also acquired a unique new meaning in the literature on tax reform. Most people perceive a simplification in tax law as a reform designed to make the system easier to understand and administer. Certainly tax simplification was one of the arguments used to defend the federal tax reform. But preliminary evidence now suggests that unless we were really aiming for tax complication, then federal tax reform has failed miserably. Even before that reform, the burden of tax record-keeping, reporting, and administration was estimated in excess of \$10 billion per year, and the new federal tax law appears likely to increase rather than decrease that burden.)

But there truly is a way to simplify Colorado tax law -- and that is to have the base for state taxes conform to that for federal taxes, requiring only one set of records and calculations for both federal and state tax purposes.

Option C in state tax reform is to adjust the rates on personal income taxes so as to offset the shortfall. A reduction in rates could be achieved either by reducing the present graduated rates by some proportion, or by adopting a flat-rate tax on income.

Many believe that a flat-rate tax holds the most promise in achieving both tax neutrality and tax simplification. Colorado currently has a progressive state income tax, although this is yet another term we must be careful in using.

\* \* \* \* \*  
\* Dr. Poulson's flat-rate \*  
\* proposal, with specific \*  
\* figures, will be pub- \*  
\* lished soon by the \*  
\* Independence Institute. \*  
\* \* \* \* \*

A progressive tax structure is defined as one in which the individual's share of income paid in taxes increases as income increases. A progressive tax structure does not necessarily require graduated tax rates such as those contained in the present state income tax law.

A flat-rate tax with a constant rate for all income may be very progressive if it is combined with a generous standard deduction and personal exemptions such as those advocated under Option B. This would be attractive in that low-income families would pay little or no income taxes -- keeping in step with one of the best features of the federal reform, whereby millions of less affluent Americans were taken off the tax rolls. Those in middle- and high-income brackets, meanwhile, would pay one flat-rate tax on incomes of whatever size.

Whatever approach is used, it is imperative for our state government to fulfill the expectations of Colorado taxpayers in a truly neutral tax reform. Elected officials and opinion leaders should not hide a tax increase from the ordinary citizens who foot the bills for an already expensive state government by calling it a windfall.

A more honest appraisal is to admit that Colorado taxpayers face a shortfall, not a windfall, as a result of the hot potato that Congress tossed the General Assembly when it rewrote the U.S. revenue code. A top priority for the new Legislature and Governor in 1987 should be to offset the shortfall in taxpayers' family budgets by reforming the state income tax law.

\* \* \* \* \*  
\* To order any of the related \*  
\* publications described in \*  
\* these starred boxes, write \*  
\* or phone the Independence \*  
\* Institute. \*  
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EDWARD J. ROCHE, JR., associate professor of tax law, University of Denver, assisted Dr. Poulson in preparing the hypothetical tax returns (appendix).

JOHN K. ANDREWS, JR., is president of the Independence Institute and editor of the Issue Paper Series.

HYPOTHETICAL RETURNS FOR EIGHT TYPICAL TAXPAYERS

By Edward J. Roche, Jr.  
and Barry W. Poulson

Data and assumptions reflect the final federal tax law changes as enacted by both houses of Congress and signed into law.

The figure of a 33% average increase, cited on page 1, is arrived at by taking all of the individual percentage increases except the very high Example 4, adding them, and dividing by 7.

	1986 Colorado Tax	After Federal Tax Reform**
<b>EXAMPLE 1:</b>		
<b><u>SINGLE, NO DEPENDENTS</u></b>		
Salary	\$ 14,000	\$ 14,000
TOTAL INCOME:	14,000	14,000
LESS: Deductions		
Standard deduction *	0	(3,000)
Personal exemption *	(1,080)	(2,000)
Federal taxable income	<u>\$ 12,920</u>	<u>\$ 9,000</u>
Federal income tax *	\$ 1,526	\$ 1,350
Colorado income tax	\$ 443	\$ 443
Tax change		0
% change		

\* denotes areas affected by federal tax reform.

\*\* "After Federal Tax Reform" figures assume all tax reform changes are fully phased in.

EXAMPLE 2:  
MARRIED, TWO DEPENDENTS

	<u>1986 Colorado Tax</u>	<u>After Federal Tax Reform</u>
Salary	\$ 22,000	\$ 22,000
Interest income	300	300
TOTAL INCOME	<u>\$ 22,300</u>	<u>\$ 22,300</u>
LESS: Deductions		
Standard deduction	*	(5,000)
Personal exemption	*	(8,000)
Federal taxable income	<u>\$ 17,980</u>	<u>\$ 9,300</u>
Federal income tax	*	\$ 1,395
Modifications for Colorado:		
Interest Exclusion	(300)	(300)
Personal Exemption (1,200)	(480)	3,200
Standard Deduction (1,420)	(1,420)	3,580
Federal Income Taxes	(2,007)	(1,395)
Colorado taxable income	<u>\$ 13,773</u>	<u>\$ 14,385</u>
Colorado income tax	\$ 714	\$ 762
Tax change		\$ 48
% change		6.7%

EXAMPLE 3:  
SINGLE, ONE DEPENDENT

Salary	\$ 17,000	\$ 17,000
Alimony income	5,000	5,000
TOTAL INCOME	<u>\$ 22,000</u>	<u>\$ 22,000</u>
LESS: Deductions		
Standard deduction	*	(4,400)
Personal exemptions	*	(4,000)
Federal taxable income	<u>\$ 19,840</u>	<u>\$ 13,600</u>
Federal income tax	*	2,040
Child care credit (\$2,400 spent)	600	600
Net federal income tax	<u>2,183</u>	<u>1,440</u>
Modifications for Colorado:		
Personal exemption	(240)	1,600
Standard deduction	(1,420)	2,980
Child care expenditure	(2,400)	(2,400)
Federal income taxes	(2,183)	(1,440)
Colorado taxable income	<u>\$ 13,597</u>	<u>\$ 14,340</u>
Colorado income tax	701	758
Tax change		57
% change		8.1%

\* denotes areas affected by federal tax reform.

1986 Colorado Tax	After Federal Tax Reform
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EXAMPLE 4:  
SINGLE: AGE 67

Taxable pension	\$ 25,000	\$ 25,000
Interest income	4,000	4,000
Federal AGI	<u>\$ 29,000</u>	<u>\$ 29,000</u>
LESS: Deductions		
Standard deduction	*	3,750
Personal exemption	*	2,000
Federal taxable income	<u>\$ 26,840</u>	<u>\$ 23,250</u>
Federal income tax	*	4,180
Modifications for Colorado:		
Pension exclusion	(20,000)	(20,000)
Personal exemption	(240)	(400)
Standard deduction	(1,420)	2,330
Federal income taxes	(4,885)	(4,180)
Interest exclusions	<u>(200)</u>	<u>(200)</u>
Colorado taxable income	95	800
Colorado income tax	3	24
Tax change		21
% change		700.0%

\* denotes areas affected by federal tax proposal



After  
Federal  
Tax Reform

1986  
Colorado  
Tax

1986  
Colorado  
Tax

After  
Federal  
Tax Reform

EXAMPLE 5:  
SINGLE, NO DEPENDENTS

Salary		\$ 40,000	\$ 40,000
Interest income		750	750
Dividend income (net of \$100 exclusion)		400	500
TOTAL INCOME		\$ 41,150	\$ 41,250
LESS: Adjustments			
Employee business expense	*	(300)	0
IRA contribution	*	(2,000)	0
EQUALS: Federal AGI		\$ 38,850	\$ 41,250
LESS: Deductions			
Sales tax	*	(300)	0
State income tax		(1,200)	(1,200)
Other taxes		(1,100)	1,100
Mortgage interest		(8,000)	8,000
Consumer interest	*	(1,200)	0
Contributions		(1,000)	(1,000)
Misc deductions	*	(300)	0
Personal exemption	*	(1,080)	(3,000)
Federal taxable income		\$ 27,150	\$ 27,950
Federal income tax	*	\$ 4,978	\$ 5,506
Modifications for Colorado:			
Dividend exclusion		(200)	(200)
Interest exclusion		(100)	(200)
Personal exemption		(120)	800
Federal ZBA		(2,480)	
State income taxes		1,200	1,200
Federal income taxes		(4,978)	(5,506)
Colorado taxable income		\$ 20,472	\$ 24,044
Colorado income tax		\$ 1,249	\$ 1,534
Tax change			\$ 285
% change			22.8%

\* denotes areas affected by federal tax reform.

	<u>1986 Colorado Tax</u>	<u>After Federal Tax Reform</u>
<b>EXAMPLE 6: MARRIED, NO DEPENDENTS</b>		
Taxpayer salary	\$ 25,000	\$ 25,000
Spouse salary	15,000	15,000
Interest income	1,000	1,000
Dividend income (net if \$100 exclusion)	800	1,000
Long term capital gain (net) *	2,000	5,000
<b>TOTAL INCOME</b>	<u>\$ 43,800</u>	<u>\$ 47,000</u>
<b>LESS: Adjustments</b>		
Employee business expense *	(300)	0
IRA contribution *	(2,250)	0
Two-earner deduction *	(1,500)	0
<b>EQUALS: Federal AGI</b>	<u>\$ 39,750</u>	<u>\$ 47,000</u>
<b>LESS: Deductions</b>		
Sales tax *	(700)	0
State income tax	(1,200)	(1,200)
Other taxes	(1,700)	(1,700)
Mortgage interest	(9,000)	(9,000)
Consumer interest *	(800)	0
Charitable contributions	(1,500)	(1,500)
Misc deductions *	(300)	0
Personal exemption *	(2,160)	(4,000)
<b>Federal taxable income</b>	<u>\$ 26,150</u>	<u>\$ 29,600</u>
Federal income tax *	3,652	4,440
<b>Modifications for Colorado:</b>		
Two-earner deduction	1,500	0
Dividend exclusion	(200)	(400)
Interest exclusion	(400)	(400)
Personal exemptions	(480)	3,200
Federal ZBA	(3,670)	
State income taxes	1,200	1,200
Federal income taxes	(3,652)	(4,440)
<b>Colorado taxable income</b>	<u>\$ 20,448</u>	<u>\$ 28,760</u>
Colorado income tax	\$ 1,247	\$ 1,912
Tax change		\$ 665
% change		53.3%

\* denotes areas affected by federal tax reform.

1986
After
Colorado
Federal

Tax
Tax Reform

EXAMPLE 7:  
MARRIED, TWO DEPENDENTS

Taxpayer salary		\$ 45,000		\$ 45,000
Spouse salary		35,000		35,000
Rental house income		4,500		4,500
Interest, taxes, etc.		(5,500)		(5,500)
Depreciation	*	(3,168)		(1,254)
Net rental income	*	(4,168)		(2,254)
<b>TOTAL INCOME</b>		<u>\$ 75,832</u>		<u>\$ 77,746</u>
LESS: Adjustments				
Two-earner deduction	*	(3,000)		0
Employee business expense	*	(600)		0
401 (k) contribution	*	(9,000)		7,000
IRA contribution	*	(4,000)		0
<b>EQUALS: Federal AGI</b>		<u>\$ 59,232</u>		<u>\$ 70,746</u>
LESS: Deductions				
Medical (\$3,500)	*	(538)		0
Sales tax	*	(900)		0
State income tax	*	(2,000)		(2,000)
Other taxes	*	(2,300)		(2,300)
Mortgage interest	*	(12,000)		(12,000)
Consumer interest	*	(1,000)		0
Charitable contributions	*	(2,500)		(2,500)
Misc. deductions	*	(2,000)		(500)
Personal exemption	*	(4,320)		(8,000)
<b>Federal taxable income</b>		<u>\$ 35,344</u>		<u>\$ 50,446</u>
Federal income tax	*	6,030		10,257
Modifications for Colorado:				
Two-earner deduction		3,000		0
Personal exemption		(480)		3,200
Federal ZBA		(3,670)		
State income taxes		2,000		2,000
Federal income taxes		(6,030)		(10,257)
<b>Colorado taxable income</b>		<u>\$ 30,164</u>		<u>\$ 45,389</u>
Colorado income tax		\$ 2,024		\$ 3,242
Tax change				\$ 1,218
% change				60.2%

\* denotes areas affected by federal tax reform.

	1986 Colorado Tax	After Federal Tax Reform
<b>EXAMPLE 8: MARRIED, TWO DEPENDENTS</b>		
Taxpayer salary	\$125,000	\$125,000
Spouse salary	35,000	35,000
Tax Shelter	(30,000)	0
Long term capital gain (net) *	8,000	20,000
<b>TOTAL INCOME</b>	<b>138,000\$</b>	<b>\$180,000</b>
LESS: Adjustments		
Two-earner deduction *	(3,000)	0
Employee business expense *	(1,600)	0
IRA contribution *	(4,000)	0
<b>EQUALS: Federal AGI</b>	<b>\$129,400</b>	<b>\$180,000</b>
LESS: Deductions		
Medical (\$8,000) *	(1,530)	0
Sales tax *	(1,900)	0
State income tax *	(4,500)	(4,500)
Other taxes	(2,300)	(2,300)
Mortgage interest	(24,000)	(24,000)
Consumer interest *	(6,000)	0
Charitable contributions	(3,500)	(3,500)
Misc. deductions *	(3,200)	0
Personal exemption *	(4,320)	(8,000)
<b>Federal Taxable income</b>	<b>\$ 81,820</b>	<b>\$137,700</b>
Federal income tax *	23,539	37,979
Modifications for Colorado:		
Two-earner deduction	3,000	0
Personal exemptions	(480)	3,200
Federal ZBA	(3,670)	0
State income taxes	4,500	4,500
Federal income taxes	(23,539)	(37,979)
<b>Colorado taxable income</b>	<b>\$ 61,631</b>	<b>\$107,421</b>
Colorado income tax	4,541	8,204
Tax change		3,663
% change		80.7%

\* denotes areas affected by federal tax reform.