


Colorado's Competitive Standing to Attract Business

A Compilation of Colorado Rankings from the "2013 State and Business Tax Climate Index"

by Sam Beck

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727 East 16th Avenue • Denver, Colorado 80203
www.IndependenceInstitute.org • 303-279-6536 • 303-279-4176 fax

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The Tax Foundation, a non-partisan, non-profit organization established in 1937, provides education and analysis of tax policy issues. Beginning in the 2012 fiscal year, the Tax Foundation released its annual *State Business Tax Climate Index*.[1] The *Index* allows business leaders, government policymakers, and taxpayers to weigh their state's tax system against other states by presenting the rankings of all 50 states' tax climates. The latest version of the *Index*, written by Scott Drenkard and Joseph Henchman and released in October 2012, represents the relative tax advantages and disadvantages for each state as of July 2012, the first day of the standard 2013 state fiscal year.

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Business leaders, public policy decision-makers, taxpayers, and journalists in Colorado need a quick synopsis of the report's findings, limited to Colorado's performance, rather than wade through a 56-page work that details the outcomes for all 50 states. This piece will focus on how and why the Tax Foundation's 2013 *Index* ranks Colorado's tax system 18th nationwide.

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In January 2012, the Independence Institute's Fiscal Policy Center released "How Colorado's Tax Burdens Rank Nationally,"[2] authored by Anthony Ryan Gonzalez. Gonzalez's paper ranks Colorado 26th (1st being the state with the highest tax burden, and 50th being the state with the lowest). This analysis differs from Colorado's Tax Foundation *Index* ranking. Gonzalez ranked states by per capita state and local combined tax burden, whereas the Tax Foundation's *Index* ranks states based not on how much people and businesses pay in taxes, but rather how the states structure their tax codes. Scores that states receive in the *Index* are based on the following five components: 1) individual income tax, 2) sales tax, 3) corporate income tax, 4) property tax, and 5) unemployment insurance tax. These five components are comprised of a total of 118 variables measured in the report. The five variables are weighted separately based on the variability of the 50 states' scores from the mean.

Taxes Matter to Business

The Tax Foundation reminds us that in a world of mobile capital and labor, the tax burden is an important factor, affecting business locations and decisions regarding job creation and retention. Taxes diminish profits, so a state's competitiveness and the long-term health of its economy heavily depend on its tax structure. Property tax is Colorado's best ranking in the *Index* (ninth best overall), followed by individual income tax (16th overall) and corporate tax (20th overall). Colorado's least favorable rankings are sales tax (44th overall) and unemployment insurance tax (39th overall). Our state is moving in the wrong direction when compared to the previous year's ranking in the *2012 State Business Tax Climate Index*, in which Colorado ranked 16th. The component that changed significantly in rank from the 2012 *Index* to the 2013 *Index* is the unemployment insurance tax, where Colorado dropped from 23rd to 39th.

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Corporate Taxes

The corporate income tax sub-index "measures the impact of each state's principal tax on business activities." The score received on the corporate income tax sub-index is based on how Colorado's corporate income tax top rate, bracket structure, and gross receipts rate compare to other states. On a scale with 10 being the best and 0 the worst, Colorado scores a 5.25 on the corporate income tax sub-index placing it at 20th overall nationwide, a little better than the national median. This sub-index accounts for 20.1 percent of Colorado's combined national rating.

Colorado scores well in the *Index* as one of 27 states that have a single rate system. Unlike the system in place in Colorado, a bracketed system causes changes in behavior when the taxpayer's income reaches the end of one tax rate bracket and moves into a higher bracket. Colorado has a flat corporate income tax rate of 4.63 percent. This rate is the lowest national maximum corporate tax rate of the states that levy a corporate income tax.

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States score poorly for providing tax credits on corporate taxes because they "complicate the tax system, narrow the tax base, increase the tax rates of companies that do not qualify, distort the free market, and often fail to achieve the economic growth they set out for." Colorado is penalized in the sub-index for allowing corporate tax credits in the following areas:

- Number of jobs created over a specified period of time
- Research and development
- Investment

Most states permit corporations to use net operating loss deductions in previous or future years. However, Colorado has temporarily (2011-13) limited the amount of net operating losses that can be carried forward to future years to $250,000. This limitation lowers its score in the sub-index. Other minor factors impact Colorado's score in the sub-index.[3]

Individual Income Tax

The individual income tax sub-index measures "the impact of tax rates on the marginal dollar of individual income using three criteria: the top tax rate, the graduated rate structure, and the standard deductions and exemptions which are treated as a zero percent tax bracket." Colorado scores a 6.63 and ranks 16th in the nation in the individual income tax sub-index, which accounts for 33.1 percent of its total combined ranking.

Of the 41 states that have a broad-based individual income tax, Colorado is one of only seven that have a single low tax rate.[4] This single low rate of 4.63 percent of federal taxable income is the fifth lowest maximum individual tax rate in the nation. Since Colorado offers exemptions and standard deductions, the *Index* classifies it as being one of seven states with only two individual tax brackets. Colorado's low maximum tax rate and few brackets allow it to score well in this sub-index.

Colorado is one of nine states[5] that are penalized in the sub-index for having an alternative minimum tax because, according to the *Index*, "evidence shows that AMTs are an inefficient way to prevent tax deductions and credits from totally eliminating tax liability." Colorado is also penalized for taxing interest, dividends, and capital gains income, causing all three to be taxed at both the individual level and the corporate level. Other minor factors contribute to Colorado's score in this sub-index.[6]

Sales Tax

The sales tax sub-index makes up 21.5 percent of Colorado's total combined score. The *Index* measures the state and local sales tax rate. A combined rate is computed by adding the general state rate to the weighted average of the county and municipal rates. Colorado scores a 3.66 and ranks 44th nationwide in the sales tax rate sub-index, nearly the worst score in the nation.

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Of the 45 states with a statewide sales tax, Colorado has the lowest at 2.9 percent. However, Colorado is penalized in the *Index* for having the second highest local average sales tax at 4.52 percent (the highest is Louisiana at 4.86 percent). Of the states with a statewide sales tax, Colorado is one of only four (the other three are Alabama, Louisiana, and New York) that have an average local rate higher than the statewide rate. Colorado's gasoline, diesel, cigarette, beer, and spirit excise taxes are also all below the national average.[7]

The sales tax exemptions that Colorado offers for business-to-business transactions also raise its score in this sub-index. These exemptions prevent businesses from paying taxes on manufacturing equipment and raw materials, then collecting sales tax on their products resulting in a tax being charged on a tax, with some industries being taxed more heavily than others. Specific exemptions and taxable business-to-business transactions are measured by the *Index*.[8]

Colorado's sales tax exemptions on gasoline for consumers actually penalize the state in the *Index* because "there is no economic reason to exempt gasoline from the sales tax, as it is a final retail purchase by consumers." Colorado's sales tax exemptions on groceries also penalizes its score because instead of benefitting the low-income consumers the exemptions are meant for "exempting groceries from the sales tax mostly benefits grocers and higher income people," and "widespread availability of public assistance for the purchase of groceries from the Women, Infants and Children (WIC) program or the food stamps program makes the argument for such exemptions unpersuasive."

Unemployment Insurance Tax

The unemployment insurance tax component of the *Index* accounts for 11.4 percent of the total combined score and consists of two equally weighted sub-indexes, one that measures each state's rate structure and one that focuses on the tax base. Colorado has a score of 4.64 on the unemployment insurance tax component of the *Index* and ranks 39th nationally. This component is the only one that changed significantly from the 2012 *Index*, in which Colorado ranked 23rd in unemployment insurance tax. The significant loss of position against other states of this variable forced Colorado down from a total combined national ranking of 16th in the 2012 *Index* to 18th in this year's *Index*.

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The unemployment tax rate for any particular business depends on the experience rating. Businesses with the best experience ratings pay the minimum rate possible on the rate schedule while those with the worst experience rating pay the maximum rate. States with lower minimum and maximum rates receive the best scores in the *Index*. Colorado's minimum rate is 1 percent, approximately .243 percentage points above the national average. Colorado's maximum rate is 11.02 percent, which is about 3.029 percentage points above the national average. Last year's maximum rate was only 5.4 percent, contributing to the change in ranking. Another component that changed from last year is Colorado's national wage base. A lower taxable wage base results in a better score in the *Index*. Colorado currently has a taxable wage base of $11,000 (about $8,541 below the national average). Last year Colorado had a taxable wage base of $10,000. The rate structure sub-index also includes the state's minimum and maximum rates that change as unemployment insurance trust funds are flush or low.[9]

The unemployment insurance tax base sub-index scores states on "how they determine which businesses should pay the unemployment insurance tax and how much, as well as other unemployment insurance related taxes for which businesses may also be liable." Colorado's experience rating formula determines the rate the firm must pay. Colorado is penalized for using a contribution formula because it is "based solely on the business's experience and is therefore non-neutral by design." Colorado is also penalized in the *Index* for charging companies for benefits if the employee refused suitable work or continues to work for the employer part-time. Other minor variables are part of this sub-index and can be found in the footnotes.[10]

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Property Tax

Property taxes in Colorado are collected at the local level. The property tax component of the *Index* is "comprised of taxes on real and personal property, net worth, and transfer of assets." Colorado scores a 5.72 and is ranked ninth in property tax. This component accounts for 14 percent of the total combined national score.

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The *Index* includes both property tax collections per capita and property tax collections as a percent of personal income to "gain a better understanding of how much each state collects in proportion to its population and income," and states with lower amounts score better in the *Index*. Colorado's property tax collection per capita is $1,253, which is $46.36 above the national average. Tax collection expressed as a percentage of income is 2.99 percent, which is approximately .291 percentage points below the national average.

This sub-index also measures the different types of property taxes levied by states, and states are penalized for each type of property tax they levy. Colorado is only penalized for levying a real estate asset transfer tax. The *Index* measures other types of taxes that Colorado does not levy.[11]

Concerns

The authors of the *Index* state that property tax is immensely difficult to place in a ranking, because it is most frequently a locally imposed tax and property taxes can have many different jurisdictions and permutations imposed on different specific holdings. For example, Jefferson County alone has 188 taxing authorities and 15 urban renewal districts that together create 746 different property tax combinations. The range of tax burdens runs from a low of 74.897 mills to a high of 172.175 mills, meaning that one property may carry nearly double the tax cost of a similarly configured neighbor.[12] The *Index* notes, "Since a high percentage of property taxes are levied on the local level, there are countless jurisdictions. The sheer number of different localities makes data collection almost impossible."

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The need for the *Index* to use simplifying measures leads to concerns that Colorado's competitive advantage has been overstated when it comes to property taxes. The business personal property tax is a public policy issue of great concern, because it constitutes a large portion of revenues for several large counties and provides perverse incentives. It discourages manufacturing business that has a disproportionate amount of machinery, favoring instead service business that rely on very little taxable business property. The *Index* also has to ignore the disproportionate incidence of taxation in Colorado on commercial property rather than residential property, which at the margin theoretically discourages business investment.

INDEPENDENCE INSTITUTE is a non-profit, non-partisan Colorado think tank. It is governed by a statewide board of trustees and holds a 501(c)(3) tax exemption from the IRS. Its public policy research focuses on economic growth, education reform, local government effectiveness, and constitutional rights.

JON CALDARA is President of the Independence Institute.

DAVID KOPEL is Research Director of the Independence Institute.

SAM BECK works in the life insurance and financial services industry. He successfully completed an internship in the Future Leaders Program at the Independence Institute during 2010. Mr. Beck earned a degree in Economics from the University of Colorado at Boulder. In his free time he indulges a passion for playing music.

ADDITIONAL RESOURCES can be found at: http://www.i2i.org/.

Endnotes

[1] http://taxfoundation.org/sites/taxfoundation.org/files/docs/2013_Index.pdf.

[2] http://tax.i2i.org/files/2012/02/IP_1_2012_a.pdf.

[3] Colorado is penalized in the corporate income tax sub-index for: offering gross receipts tax deductions, "adding another layer of tax complexity" by adopting throwback rules, and not allowing deductions for taxes paid to foreign jurisdictions. Colorado scores well in the corporate income tax sub-index for: conforming to the federal definitions of income, adopting MACRS and ACRS schedules for depreciation and federal depletion schedules, and having no corporate alternative minimum tax.

[4] The other six states are: Illinois, Indiana, Massachusetts, Michigan, New Hampshire, and Tennessee.

[5] The other eight states are: California, Connecticut, Iowa, Maine, Minnesota, Nebraska, New York, and Wisconsin.

[6] Colorado scores well in the individual income tax sub-index for: not having a marriage penalty, conforming to federal definitions of individual income, offering credit for state taxes paid to other jurisdictions, indexing tax brackets, standard deductions, and personal exemptions for inflation to prevent de facto increases of individual income due to inflation, and recognizing LLCs and S corporations.

[7] Gasoline: Colorado excise tax is 22 cents per gallon, which is about 1.706 cents per gallon below the national average. Diesel: Colorado excise tax is 20.5 cents per gallon, which is about 3.550 cents per gallon below the national average. Cigarettes: Colorado excise tax is 84 cents per pack, which is about 62.468 cents below the national average. Beer: Colorado excise tax is 8 cents per gallon, which is about 21.614 cents below the national average. Spirits: Colorado excise tax is 2.28 dollars per gallon, which is about 4.17 dollars below the national average.

[8] The exemptions on sales tax for business-to-business transactions offered by Colorado that are measured by the index are: insecticides and pesticides, fertilizer, seed, feed, seedlings, plants/shoots, manufacturing machinery, manufacturing utilities/fuel, farm machinery, general cleaning services, transportation services, repair services, professional and personal services, custom software, downloaded software, and raw material. Non-exempt business-to-business transactions that are measured by the index include: modified canned software, leasing motor vehicles, leases/rentals of tangible personal property, leasing rooms/lodgings, office equipment, and pollution control equipment for air and water.

[9] Colorado's most favorable (unemployment insurance funds are flush) minimum tax rate: 0%, about .129 percentage points below national average. Colorado's most favorable maximum rate: 5.4%, about 1.140 percentage points below the national average. Colorado's least favorable (unemployment insurance funds are low) minimum tax rate: 1%, about .338 percentage points above the national average. Colorado's least favorable maximum rate: 5.4%, about 2.199 percentage points below the national average.

[10] In the tax base sub-index Colorado is penalized for: having a solvency tax, taxes for socialized costs or negative balance employers, loan and interest repayment surtaxes, surtaxes for unemployment insurance administration or non-unemployment insurance purposes, and voluntary contributions. Colorado is rewarded in the tax base sub-index for having a one year time period to qualify for experience rating.

[11] The other types of property taxes, not levied by Colorado, are: intangible property, inventory, estate tax, inheritance tax, generation-skipping transfer tax, and gift tax.

[12] Jim Everson, Jefferson County Assessor, interview with Penn R. Pfiffner, Director of the Independence Institute's Fiscal Policy Center, November 27, 2012.