



TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

COLORADO'S 2020 TAX STUDY GROUP: AN OVERVIEW OF MEETINGS AND RESEARCH

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At the start of 2020, Governor Jared Polis organized a Tax Study Group and charged it with analyzing the efficiency and equity of Colorado's tax system. Over the course of the year, the Tax Study Group held five learning sessions. Throughout this process, the Urban Institute's State and Local Finance Initiative, a project of the Urban-Brookings Tax Policy Center, shared its research expertise, microsimulation model data, and national and state policy perspectives with the group. This report summarizes that work.

INTRODUCTION

Governor Jared Polis announced the creation of a bipartisan Tax Study Group in his 2020 State of the State address.¹ In the speech, the governor outlined his broader vision for tax reform in Colorado, asking state lawmakers to “continue down the path of eliminating tax breaks for special interests so that we can lower rates for everyone without reducing state revenue.” He concluded, “A broader base taxed at a lower rate will boost economic growth with the ancillary benefit of preventing the corrosive influence of crony capitalism.”

The Tax Study Group included seven legislators (four Democrats and three Republicans), current and former leaders of the Office of State Planning and Budgeting and Department of Revenue, and stakeholders from public policy organizations, including the Bell Policy Center and Independence Institute. The group was charged with learning about Colorado’s tax system and how it compares with other states. It was not charged with considering specific tax changes or making policy recommendations.

The group was staffed by members of Governor Polis’s policy team and researchers from the Urban Institute’s State and Local Finance Initiative, a project in the Urban-Brookings Tax Policy Center (referred to as the “Tax Policy Center” throughout this report). The Tax Policy Center provided nonpartisan research, distributional data and revenue estimates from the Tax Policy Center’s federal and state microsimulation models, and national and state policy perspectives on how and why state and local governments across the country raise, spend, borrow, and invest public money.

At the first meeting, the Tax Policy Center suggested the following three principles should guide the group’s research:

1. **Simple, broad, and modern.** Taxes should be simple, have a broad base, and parallel current economic activity.
2. **Equity.** Similar taxpayers should pay similar amounts of tax (horizontal equity) and overall tax burdens should be commensurate with taxpayers’ abilities to pay (vertical equity).
3. **Limited negative effects.** Taxes should efficiently raise revenue with minimum effect on household and business decisions unless the explicit goal of the policy is to change consumer behavior (e.g., cigarette taxes).

At the time of that meeting, March 4, 2020, the state’s economy and revenues were both growing. However, the Tax Study Group’s work was then immediately interrupted by the COVID-19 pandemic and the resulting economic volatility. Still, in its first post-pandemic (virtual) meeting on April 22, the group decided to maintain its research goals even as it broadened its scope to study pandemic-specific fiscal issues.

Ultimately, the Tax Study Group conducted five learning sessions plus a series of direct virtual conversations between individual members of the group and the Tax Policy Center’s team of researchers. The meetings ended in September 2020, and the individual conversations concluded in October 2020.

As with the discussions of the Tax Study Group, this report focuses on the state’s individual income tax and general sales tax. The Tax Study Group did not study all of Colorado’s state taxes because of scope limitations, nor did it study local

taxes because the goal was to inform group members about state tax policy. The report also includes a summary of Colorado's tax system and how it compares with other state tax systems.

The Tax Study Group, Tax Policy Center, and this report do not make policy recommendations. The goal of this report is to help policymakers, journalists, and community members better understand prominent Colorado tax policy issues and possible tools for addressing them.

This report summarizes the research the Tax Policy Center presented to the group. Thus, it mostly describes Colorado's tax policy as it was during those meetings in calendar year 2020. However, some recent state tax changes are noted. Specifically, in 2020 and 2021, the Colorado legislature passed and Governor Polis signed three major pieces of tax legislation: House Bill 20-1420,² House Bill 21-1311,³ and House Bill 21-1312.⁴ The major tax provisions in those bills are briefly explained in the next section and highlighted throughout the report. While the Tax Study Group and the Tax Policy Center were not directly a part of those legislative efforts, their research and analysis contributed to the Colorado legislature's knowledge and understanding of state tax policy.

At the end of the state's 2021 legislative session, Governor Polis thanked the Tax Policy Center for its contributions to Colorado's tax policy debates over the past two years. "The Tax Policy Center did outstanding work for us on how we could improve Colorado's tax code," said Governor Polis. "We've gotten rid of special interest tax breaks and provided broad tax relief, including tax relief for small businesses and doubling our state earned income tax credit."

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—Governor Jared Polis

THE TAX POLICY CENTER

State and Local Finance Initiative

The Urban Institute's State and Local Finance Initiative is a project of the Urban-Brookings Tax Policy Center. The Tax Policy Center, the Urban Institute, and the Brookings Institution are independent and nonpartisan research organizations in Washington, DC. The Tax Policy Center provides timely, reliable, and unbiased research, data, and analysis. Its goal is to equip policymakers, citizens, and journalists with tools necessary to understand and address the fiscal challenges and opportunities facing federal, state, and local governments.

As part of its Fiscal Innovations Project, the State and Local Finance Initiative directly assists state lawmakers as they discuss and debate fiscal policy issues. However, the Tax Policy Center and the State and Local Finance Initiative do not make policy recommendations or endorsements. While working with Colorado's Tax Study Group, the Tax Policy Center provided high-quality data and analytical tools that helped illuminate the effects of potential reforms, including data from its renowned microsimulation tax model. The Tax Policy Center's assistance was made possible by grants from Arnold Ventures, the Bill and Melinda Gates Foundation, and other funders that support the State and Local Finance Initiative.

The Tax Policy Center's State Tax Model

The Tax Policy Center uses its state-of-the-art microsimulation model to provide comprehensive, rigorous, and objective analyses of federal tax policies and major tax reform proposals. The State and Local Finance Initiative expanded the Tax Policy Center model to include state tax policies and interactions between state and federal tax systems. These enhancements allow us to answer questions such as how proposed federal tax changes affect residents of individual states, what the combined effects of federal and state taxes on families of various sizes and income levels are, and what are the revenue and distributional effects of state tax policy changes.

HB 20-1420, HB 21-1311, HB 21-1312

Major provisions included in House Bill 20-1420

- Raised the state's earned income tax credit (EITC) from 10 to 15 percent of the federal credit in tax year 2022
- Created an income eligibility limit on the state's pass-through deduction for tax years 2021 and 2022
- Limited some state tax benefits that were created (via federal-state tax conformity) by the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020

Major provisions included in House Bill 21-1311

- Funded a state child tax credit that is available to Colorado filers beginning in tax year 2022
- Increased the state's EITC from 15 percent to 20 percent of the federal credit for tax year 2022, and then to 25 percent for tax years 2023, 2024, and 2025. The match rate is scheduled to return to 20 percent in tax year in 2026
- Exempted Social Security income from Colorado's personal income tax for filers ages 65 and older
- Capped itemized deductions for filers with more than \$400,000 in adjusted gross income
- Extended an income eligibility limit on the state's pass-through deduction through tax year 2025
- Created a cap (\$20,000 for single filers and \$30,000 for married filers, adjusted annually for inflation) on the annual amount of contributions to 529 accounts that a filer can use to reduce Colorado taxable income

Major provisions included in House Bill 21-1312

- Clarified that "digital goods" are included in the state's definition of tangible personal property for the purposes of the state's general sales tax
- Eliminated the vendor fee (a credit for businesses collecting the state's general sales tax) for businesses with \$1 million or more in taxable sales each month
- Changed qualification rules for both a special insurance premium tax rate and the insurance premium tax exemption
- Increased the business personal property tax exemption from \$7,900 to \$50,000
- Restricted a deduction for companies paying severance taxes (i.e., taxes on oil and gas production)
- Eliminated a tax credit for coal production

HOW COLORADO'S TAX SYSTEM COMPARES

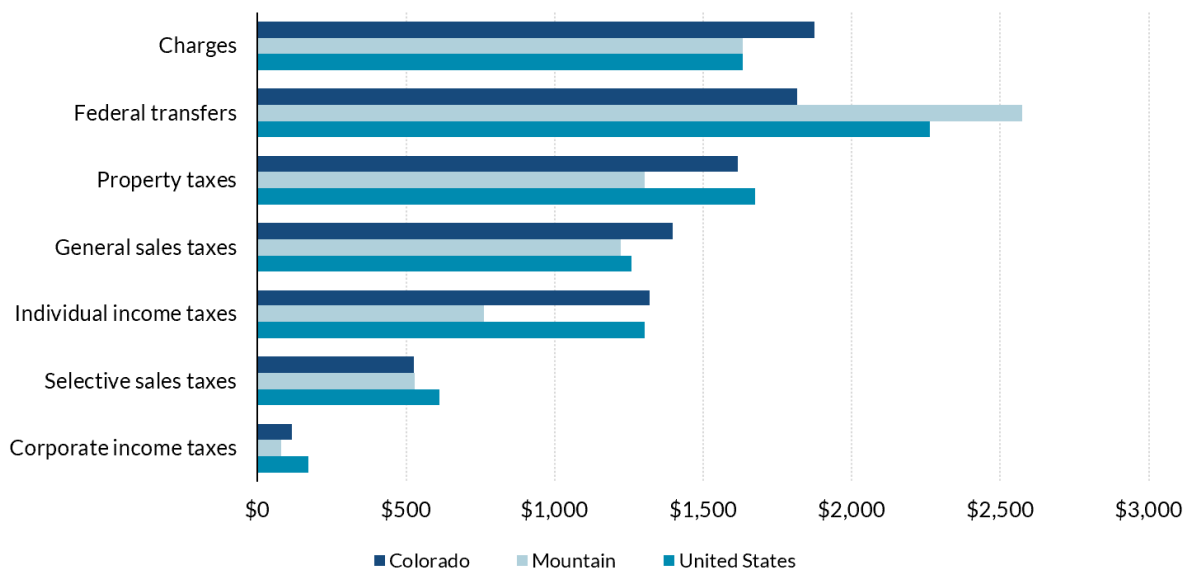
Colorado's combined state and local general revenues (including federal transfers) were \$55.4 billion in fiscal year 2018, or \$9,731 per capita.⁵ Although this report focuses on state-level taxes, for comparisons across states, combined state and local data are preferable because different levels of government levy different taxes in different states. National per capita state and local general revenues were \$10,071 in 2018, while neighboring state per capita general revenues ranged from \$8,013 in Oklahoma to \$14,838 in Wyoming.

Colorado uses all major state and local taxes. Colorado's largest source of per capita revenue in 2018 was charges (\$1,874). Charges are public payments connected with a specific government service. These include tuition paid to a state university, payments to a public hospital, tolls on highways, sewerage fees, and parking meter payments collected by a city. Colorado's second-largest source of per capita revenue was federal transfers (\$1,816), even though the state collected less from transfers than the national per capita average (\$2,264). Overall, Colorado's per capita revenue collections from major taxes were roughly in line with national averages.

FIGURE 1

Colorado's State and Local Per Capita Revenue, Fiscal Year 2018

Compared with national and regional averages



Source: US Census Bureau Annual Survey of State and Local Government Finances, 1977-2018 (compiled by the Urban Institute via State and Local Finance Data: Exploring the Census of Governments; accessed 04-May-2021 02:02), <https://state-local-finance-data.taxpolicycenter.org>.

Note: Census's definition of the Mountain region includes Arizona, Colorado, Idaho, Minnesota, New Mexico, Nevada, Utah, and Wyoming.

Wyoming's high per capita general revenue total in 2018 is an illustrative example of why per capita revenue is not an adequate measure of a state's average individual tax burden. Wyoming does not levy an individual income tax and its residents have a relatively low tax burden, but the state often collects a large amount of severance tax revenue (i.e., taxes on oil and natural gas), which can drive up its total tax collections and thus its per capita general revenue total. As such, a

per capita total does not give a complete picture of a state's tax system. For example, Colorado collected roughly as much per capita individual income tax revenue as the national average not because it has an average tax rate (its flat income tax rate is relatively low), but because the state has relatively high per capita income (it ranked 10th in the nation in 2020).

Looking at taxes another way, as a percentage of general revenue, Colorado collected 19 percent from charges, 17 percent from property taxes, 14 percent from general sales taxes, and 14 percent from individual income taxes in 2018. All of these percentages were roughly in line with national averages. As with per capita revenue, the one exception was that Colorado was slightly more dependent on revenue from charges than most states.

All of Colorado's eight neighboring states levy each major state and local tax except for South Dakota and Wyoming—both states do not levy an individual income tax or a corporate income tax. Nationally, nine states do not levy a broad-based individual income tax, six do not levy a corporate income tax (although, four of these states instead levy a gross receipts tax on businesses), and five do not levy a general sales tax.

Public finance experts support balanced revenue systems because major state and local taxes complement each other. It's extremely difficult for one tax to conform with *all* the consensus characteristics of a quality revenue system: simple, reliable, economically neutral, and equitable (Auxier, Gordon, and Rueben 2020). Thus, using multiple taxes allows policymakers to navigate the tensions and trade-offs inherent in each tax with a system that provides complements and balance.

Individual Income Tax

Colorado levied a flat 4.55 percent personal income tax rate in tax year 2020. The rate was lowered from 4.63 percent after voters approved Proposition 116 in November 2020. Colorado is one of nine states that uses a flat tax rate on all taxable income. Hawaii has the most tax brackets with 12.

In 2021, among the 41 states and the District of Columbia with a broad-based individual income tax, only five states (Arizona, Indiana, Michigan, North Dakota, and Pennsylvania) had a lower top individual income tax rate than Colorado. Colorado's top rate was also relatively low among its neighbors, with top rates in the other six states with an individual income tax ranging from 4.5 percent in Arizona to 6.84 percent in Nebraska. California's 13.3 percent rate on taxable income above \$1 million was the highest top state income tax rate in the nation in 2021.

TABLE 1

Regional Comparison of Major Tax Rates

Tax year 2021



State	Top Individual Income Tax Rate	Ranking
Colorado	4.55%	6
Arizona	4.50%	7
Kansas	5.70%	3
Nebraska	6.84%	1
New Mexico	5.90%	2
Oklahoma	5.00%	4
Utah	4.95%	5
Wyoming	N/A	N/A

Source: The Federation of Tax Administrators, January 2021.

Note: In November 2020, Arizona voters approved Proposition 208, which raised the state's top tax rate to 8.0%. However, the Arizona legislature lowered the top rate to 4.5% in 2021.

General Sales Tax

Among the 45 states and the District of Columbia with a general state sales tax in 2021, Colorado's 2.9 percent state rate was the lowest in the nation. After Colorado, the next-lowest state general sales tax rate was 4.0 percent in Alabama, Georgia, Hawaii, New York, and Wyoming. The highest state general sales tax rate in 2021 was California's 7.25 percent. Among its neighbors, state sales tax rates ranged from 4.0 percent in Wyoming to 6.5 percent in Kansas.

However, when Colorado's local sales tax rates are included, the rate paid by consumers in Colorado was at or above the national average in 2021. For example, the general sales tax rate in Denver was 8.81 percent when the local rate was added to the state rate.⁶ According to the Tax Foundation, the average local sales tax rate in Colorado was 4.82 percent in 2021, and the average combined state and local rate of 7.72 percent was the 16th highest combined rate in the nation.⁷

TABLE 2**Regional Comparison of Major Tax Rates**

Tax year 2021



State	General Sales Tax Rate	Ranking
Colorado	2.90%	8
Arizona	5.60%	3
Kansas	6.50%	1
Nebraska	5.50%	4
New Mexico	5.13%	5
Oklahoma	4.50%	6
Utah	6.10%	2
Wyoming	4.00%	7

Source: The Federation of Tax Administrators, January 2021.

As explained in greater detail in the section on general sales taxes, a state’s sales tax base is as important as its sales tax rate. A narrow tax base restrains how much revenue a state collects from its general sales tax and can force governments to raise rates to compensate. Colorado’s sales tax base is relatively narrow (i.e., there are many purchases that the state does not tax), but the average state’s tax base is also relatively narrow. Only a handful of states have a broad general sales tax base.

In fact, a recent Tax Policy Center study found the amount of purchases subject to the sales tax, including general sales taxes and excise taxes like the motor fuel tax, ranged from 5 percent in Delaware (no general sales tax but excise taxes) to 36 percent in Vermont and 91 percent in Hawaii. The Tax Policy Center found 34 percent of household spending is taxable in Colorado. This total is at the lower end of states but not far off from the US average of 39 percent (Airi and Sammartino 2021).

Taxpayer Bill of Rights

Although the Tax Study Group did not study or discuss any changes to Colorado’s Taxpayer Bill of Rights (TABOR), the tax limitation was and must be a part of any tax conversation in Colorado. Many states have revenue and expenditure restrictions, and TABOR is one of the most stringent revenue limitations in the country.

TABOR requires voter approval for any increases in state or local tax rates and requires the state to return any excess revenue beyond the previous year’s limit—increased annually by population growth and inflation—to its taxpayers. The rule may only be overridden by a vote of the people. Thus, any tax reform legislation that increases tax revenue must account for how the new revenue would interact with the TABOR limit.

COLORADO'S INDIVIDUAL INCOME TAX

Colorado currently levies a flat 4.55 percent individual income tax rate. The rate was lowered from 4.63 percent after voters approved Proposition 116 in November 2020. In tax year 2019, the rate was 4.5 percent because a revenue surplus triggered a one-year rate reduction provision in TABOR. There are no local individual income taxes in Colorado.

The starting point for Colorado's individual income tax is federal taxable income (FTI). Most states use federal adjusted gross income (AGI) as the starting point for their state tax. FTI is AGI plus the federal calculations for the standard or itemized deductions (e.g., mortgage interest and charitable contributions) and any personal exemptions (which are currently set at \$0 at the federal level). **Using FTI instead of AGI** gives Colorado an extra level of conformity with the federal tax code, which makes the state's income tax simpler for filers, but it also makes the state's tax more susceptible to changes in federal law.

Colorado's strong connection to the federal tax code is particularly important because Colorado is a "rolling" conformity state. That is, Colorado automatically accepts all federal changes into its tax code (with the exception of federal tax changes that apply to previous tax years). In contrast, "static" conformity states must pass legislation to accept any federal tax changes.

An example of rolling conformity leading to unanticipated consequences for Colorado's tax system is **the pass-through deduction**. This complex provision, which is claimed by businesses that pay tax via the individual income tax rather than the corporate income tax, was created by Congress as part of the Tax Cuts and Jobs Act (TCJA) to address the significant difference in the top federal individual income tax rate (37 percent) and the federal corporate tax rate (21 percent). Even though Colorado has the same flat tax rate for both its state individual and corporate income taxes, the pass-through deduction automatically became a part of Colorado's income tax when Congress passed the TCJA.

In addition to these issues, the Tax Policy Center also provided research and analysis on:

- **State earned income tax credits (EITC) and child tax credits (CTC).** Colorado's EITC was 10 percent of the federal EITC at the time of the Tax Study Group meetings. The state did not offer a CTC when the group was meeting.
- Colorado's **pension and annuity exemption**, which makes a set amount of retirement income exempt from state income tax for eligible filers.
- Colorado's personal income tax base and **state income tax expenditures**.

Research Issue: Colorado’s Pass-Through Deduction

Most businesses in the United States do not pay corporate income taxes. Instead, profits from these businesses are “passed through” and taxed on the owner’s individual income tax return. Pass-through businesses include sole proprietorships, partnerships, and S-corporations. Excluding sole proprietorships, more than 80 percent of businesses were organized as pass-through entities in 2014. The remaining one-fifth of businesses filed corporate income tax returns as C-corporations.⁸

Although pass-through businesses are often described as small businesses, a business of any size can file its taxes this way. A part-time retailer selling a handful of items online, a self-employed plumber, and a large law firm can all file taxes as a pass-through business. However, most pass-through income is concentrated among high-earning filers. At the federal level, about 85 percent of all pass-through income is reported by taxpayers in the top 20 percent of the income distribution, and more than 50 percent is reported by the top 1 percent of taxpayers.⁹

The TCJA allowed federal taxpayers who earn income from pass-through businesses to deduct 20 percent of such income—officially referred to in the law as the qualified business income (QBI) deduction—when calculating their federal taxable income. Congress included the pass-through deduction in the TCJA in part because the TCJA lowered the federal corporate income tax rate well below the top federal individual income tax rate. There are some limits on the deduction based on the filer’s total income, the nature of the business, and the amount the business pays in wages. The pass-through deduction, like most of the TCJA’s changes to personal income tax, expires after tax year 2025.

Colorado automatically adopted the pass-through deduction as part of its tax code because the state begins its income tax with FTI and is a rolling conformity state (this is explained in more detail in the next section). However, Colorado has no apparent need for a pass-through deduction—at least from an equity perspective—because, unlike at the federal level, the state levies the same tax rate on both C-corporations and pass-through businesses. Thus, the pass-through deduction in Colorado gives a tax *preference* to certain businesses based on how they file taxes—the opposite goal of the TCJA provision.

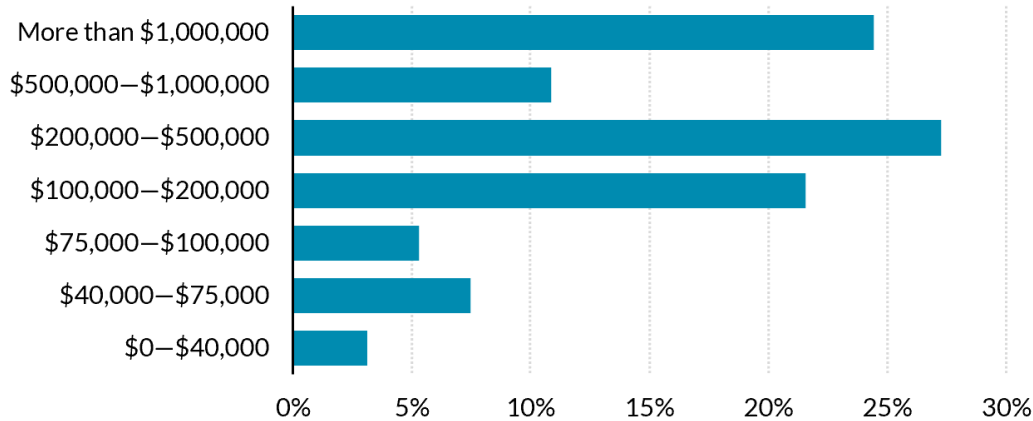
Further, Colorado’s pass-through deduction is relatively costly and delivers most of its benefit to high-income filers. The Tax Policy Center state income tax model estimated that in tax year 2018 Colorado’s pass-through deduction reduced the state’s tax revenue by between \$150 million and \$200 million, and nearly two-thirds of its benefit went to households earning \$200,000 or more.

FIGURE 2



Share of Total Tax Benefit of Pass-Through Deduction

Colorado, 2018



Source: Tax Policy Center State Income Tax Model.

Note: Distribution of state tax policy by adjusted gross income (AGI). These data are based on Colorado's pass-through deduction in tax year 2018, prior to the income limits enacted in HB20-1420.

During the Tax Study Group's meetings, Colorado enacted HB 20-1420, which eliminated the deduction for pass-through business owners with an AGI greater than \$500,000 if single and \$1 million if married filing jointly in tax years 2021 and 2022. (Note: This and other possible changes only affect Colorado's pass-through deduction. All Colorado filers can still access the deduction on their federal tax return.) Filers who report farm income on their federal tax return are exempt from this rule. The Tax Policy Center estimated this change would increase state revenue by roughly \$50 million in each year that it is in effect (roughly in line with estimates from Colorado's Legislative Council Staff²⁰).

This income limitation in part addressed the deduction's revenue loss and vertical equity problems. But even with the income limitation rule in place, the Tax Policy Center estimated that Colorado's pass-through deduction would still cost the state roughly \$100 million annually and that nearly half of the benefits would still go to taxpayers earning \$200,000 or more. Further, the income limitation did not change the distorting effect of the pass-through deduction on business taxation.

In contrast, Minnesota, Oregon, South Carolina, and Vermont all eliminated state pass-through deductions created by federal-state conformity before they could take effect. Idaho and North Dakota are the only other states that offer the full federal pass-through deduction in their state income tax calculations. All other states avoided the pass-through deduction because they use AGI instead of FTI. Only one AGI state, Iowa, created a connection to the federal pass-through deduction in its state tax calculation. Iowa allows filers to take a deduction equal to 25 percent of their federal pass-through deduction on their Iowa income tax return.

While the pass-through deduction primarily benefits high-income filers, policymakers should understand that some lower-income filers benefit from it and thus they would pay more state tax if Colorado's deduction was eliminated. However, if Colorado wants to provide tax relief to these pass-through businesses, it could enact a more targeted and less costly state tax credit to replace the pass-through deduction.

For example, Colorado could offer a credit calculated at 10 percent of a filer's federal QBI deduction and capped at \$250. Under current policy, a filer with \$12,500 in QBI is eligible for a \$2,500 federal deduction and a \$2,500 Colorado deduction. Under the proposed tax credit, the same filer is eligible for a \$2,500 federal deduction and a \$250 Colorado tax credit. In this example, the Colorado taxpayer would be better off, as the \$250 credit is worth more than the value of a \$2,500 deduction (\$2,500 times the state's 4.55 percent tax rate equals \$113.75). However, filers with higher levels of QBI would get a lower benefit because the credit is capped at \$250 while the current deduction is uncapped.

The Tax Policy Center modeled this credit with three different eligibility restrictions based on tax year 2020 (i.e., without HB 20-1420's income limitation). One simulation made the credit available to all filers eligible for the federal pass-through deduction. The other two simulations restricted the credit based on the filer's AGI: one restricted the credit to single filers with AGI up to \$75,000 and married filers with AGI up to \$150,000, and the other put the income limits at \$200,000 and \$400,000. Against the 2020 baseline, this type of credit would increase Colorado's revenue by roughly \$110 million (available to all filers), \$120 million (limited to single filers with incomes below \$200,000), or \$140 million (limited to single filers with incomes below \$75,000).

Colorado could also choose to phase the credit out over a range of income (e.g., \$75,000 to \$85,000) instead of creating a cliff. This policy option would raise slightly less revenue (a couple million dollars in the Tax Policy Center simulations) but possibly prevent filers from manipulating their incomes to stay under the income limit.

In 2021, after the Tax Study Group's meetings, Colorado enacted HB 21-1311, which extended the pass-through deduction income limitation enacted in HB 20-1420 through tax year 2025. The federal pass-through deduction is set to expire at the end of tax year 2025. HB 21-1311 did not make any other changes to the Colorado pass-through deduction.

Research Issue: Federal Taxable Income, Adjusted Gross Income, and Tax Conformity

All states use the federal tax code in their state income tax calculations and, most importantly, through federal definitions of income such as federal adjusted gross income (AGI) and federal taxable income (FTI). When states conform with these definitions and other federal tax rules, it benefits both residents (fewer calculations and documents are required) and state tax administrators (the state can rely on federal resources like the IRS's auditing capacity). However, conformity is always a choice, and states can and should decouple when federal rules do not fit their budget or values.

Thirty-two states and the District of Columbia use AGI as the starting point for their state income tax. AGI is a taxpayer's gross income after "above-the-line" adjustments, such as deductions for individual retirement account contributions and student loan interest. Another five states use their own definitions of income as a starting point for their tax, but these state definitions rely heavily on federal tax rules and roughly mirror AGI.

Colorado and three other states—Idaho, North Dakota, and South Carolina—go one step further and use FTI as their starting point. FTI is AGI plus the federal calculations for the standard or itemized deductions (e.g., mortgage interest and charitable contributions), any personal exemptions, and the pass-through deduction (discussed in the previous section).

Notably, the TCJA roughly doubled the federal standard deduction, set the federal personal exemption at \$0, and expanded the federal child tax credit (CTC). In combination, these three changes either cut federal taxes for families or held tax liabilities constant. However, while the standard deduction and personal exemption are part of FTI the CTC is not. Thus, only the changes to the standard deduction and personal exemption automatically became part of Colorado’s tax rules. As a result, after the TCJA, many Colorado families with multiple children lost their state personal exemptions, did not gain a state CTC, and faced an increase in state income tax liability. In contrast, most states were not affected by any of these changes because they use AGI instead of FTI as their starting point (Auxier and Maag 2018).

Further, because all of the TCJA’s personal income tax changes (except for the new inflation measurement) are set to expire and revert to previous law at the end of tax year 2025, Colorado’s tax code could soon change again because of the sunsets—or if new federal legislation supplants the TCJA. In either case, Colorado’s tax code would change without input from its own lawmakers.

This also became an issue in the aftermath of the pandemic. The Coronavirus Aid, Relief, and Economic Security (CARES) Act²¹ made several changes to the federal individual income tax that affected Colorado’s tax system, including some retroactive tax changes that could have affected the state’s TABOR limits in prior years. The Colorado Department of Revenue clarified that Colorado’s rolling conformity only held for forward changes or those that go into effect before the last day of a given year.²² Still, it was another example of how much control the state gives the federal government by using FTI as its starting point for its income tax.

Colorado could exercise greater control over its individual income tax by changing its starting point from FTI to AGI. If that change were made, Colorado policymakers would then need to create their own rules for governing the state’s standard deductions, personal exemptions, and itemized deductions. (See table 3 for the state rules used by some of Colorado’s neighboring states).

While AGI states can create their own rules for state standard deductions, personal exemptions, and itemized deductions, many still choose to conform with some federal rules. In fact, most AGI states conform with federal itemized deductions (although, typically with a subtraction for state income taxes). In the year after the TCJA passed, Minnesota and Vermont both changed their tax starting points from FTI to AGI and established new rules for their standard deductions, personal exemptions, and itemized deductions.

TABLE 3

Regional Comparison of Major State Deductions and Exemptions

Tax year 2020



State	Income Tax Starting Point	Standard Deduction (Single/Married)	Personal Exemption	Major Differences from Federal Itemized Deductions
Colorado	Federal taxable income	\$12,200/\$24,400	\$0	None
Arizona	Adjusted gross income	\$12,200/\$24,400	\$25-\$100	All medical expenses are fully deductible
Kansas	Adjusted gross income	\$3,000/\$7,500	\$2,250	Only 75% of the federal deduction for property taxes, mortgage interest, and medical expenses paid is deductible
Nebraska	Adjusted gross income	\$6,900/\$13,800	\$137 credit	None
New Mexico	Adjusted gross income	\$12,200/\$24,400	\$4,050	No itemized deductions
Oklahoma	Adjusted gross income	\$6,350/\$12,700	\$1,000	All itemized deductions except those on medical expenses and charitable contributions are capped
Utah	Adjusted gross income	6% of federal standard deduction, offered as a credit and phased out at higher income levels	\$579	6% of federal itemized deductions, offered as a credit that phases out at higher income levels
Wyoming	N/A	N/A	N/A	N/A

Source: Tax Policy Center State Income Tax Model and Tax Policy Center analysis of state income tax forms.

Notes: Arizona and New Mexico conform with the federal standard deduction amounts. Arizona's and Utah's exemptions are only available for dependents.

As the table above shows, switching from FTI to AGI is not one choice, but rather the start of a series of choices about the state personal income tax.

Research Issue: State Earned Income Tax Credits and Child Tax Credits

Most state and local tax systems are regressive. That is, lower-income residents pay a higher share of their income in taxes than higher-income residents. Higher-income residents still typically pay the largest sum of tax (because they have far more income and wealth), but regressivity is defined by the *burden* on taxpayers at different income levels. Most state and local tax systems are regressive because nearly all state and local tax systems rely heavily on consumption taxes, such as general sales taxes and excise taxes (these taxes are regressive because lower-income households spend a larger share of their income on consumption than higher-income households) and real property taxes (these taxes are typically regressive or proportional depending on the tax system). In contrast, the federal government's tax system is highly progressive because it collects most of its revenue from a progressive income tax that has both marginal income tax rates that rise with income and generous refundable tax credits that benefit low-income households.

Colorado's state and local tax system is not an exception to the rule. But, at the time of the Tax Study Group meetings, Colorado did offer some deductions and credits that reduced the regressivity of its state and local tax system. Specifically, Colorado's standard deductions were (and remain) among the highest in the nation. This is a great benefit to middle-income filers because it significantly reduces their taxable income. However, for lower-income households, the benefit is not as generous because a standard deduction can only reduce a filer's personal income tax liability to zero. Thus, it cannot provide tax relief for other, more regressive taxes such as general sales taxes. For that, the state must offer refundable tax credits, such as the EITC and CTC, that deliver any excess credit above the filer's tax liability as a refund—thus providing benefits to filers with little taxable income. A benefit of both the EITC and CTC is that Colorado can piggyback on the

federal government's rules and administration for both credits. However, as noted previously, linking to federal policy would also leave the state vulnerable to federal tax changes.

The federal EITC provides a refundable credit to taxpayers based on their income and family circumstances (i.e., marital status and number of children). If the federal EITC was to be considered a transfer payment, it would be the single most effective antipoverty program for working-age people, having lifted about 5.6 million people out of poverty in 2018, including 3 million children (Center on Budget and Policy Priorities 2019). The benefits of the federal EITC are concentrated among the lowest earners, with roughly half of its benefits going to households in the bottom quintile of the income distribution and virtually all of the credit going to households in the bottom three quintiles.¹³

In tax year 2020, Colorado offered a refundable EITC that was 10 percent of the federal EITC. During the Tax Study Group's research, the Colorado legislature passed HB 20-1420, which increased the state's EITC match rate to 15 percent in tax year 2022 and made filers without Social Security numbers (mostly undocumented immigrants) eligible for the state credit (all members of a filer's household must have a Social Security number to claim the federal credit). However, even at the higher match rate, Colorado's EITC was still relatively low compared with other states.¹⁴

The Tax Policy Center's state income tax model estimated that increasing Colorado's match rate another 5 percentage points, from 15 percent to 20 percent, would cost the state \$40 million in revenue annually. Each subsequent 5 percentage-point increase would also cost roughly another \$40 million (i.e., increasing Colorado's match rate from 15 percent to 30 percent would cost roughly \$120 million). These estimates were based on tax year 2020 data but used the 15 percent EITC baseline that was set to take effect in tax year 2022.

Further, the estimates did not include the EITC changes included in the American Rescue Plan (ARP), which were enacted after the Tax Study Group completed its research. The ARP significantly expanded the federal EITC for childless workers—roughly tripling the maximum credit that these workers can claim from \$538 to \$1,502—but only for tax year 2021. Because Colorado's EITC is a percentage of the federal credit, Colorado's maximum EITC benefit for childless workers also increased from \$54 to \$150 that tax year (Maag and Weiner 2021). If the ARP rules for childless workers were made permanent, each 5 percentage-point increase in the state's *overall* EITC match would cost closer to \$50 million in annual revenue.

Related, Colorado could consider expanding its EITC to workers without children on their *state* tax return. Although we refer to these people as "childless workers" for tax purposes, many of them have and support children (the children are just listed as dependents on another person's tax return). But outside of the one year that the ARP expanded the credit, few childless workers are eligible for the federal EITC and those who are get a fraction of the benefits available to workers with children. As a result, because Colorado's EITC is a percentage match, these workers also got relatively small benefits from the state's EITC—and will do so again if the ARP rules are not expanded beyond tax year 2021.

States can assist these workers by increasing their match rate for childless workers above the state's match rate for workers with children. For example, the District of Columbia's EITC match rate in tax year 2020 was 40 percent for workers

with children but 100 percent for childless workers.¹⁵ The Tax Policy Center estimated that under the pre-ARP rules, it would cost Colorado roughly \$3 million to increase its match rate just for childless workers to 25 percent, \$10 million to increase it to 50 percent, and \$30 million to increase it to 100 percent. If the ARP rules are made permanent, increasing the match rate for these workers would cost more revenue, but Colorado would not need to increase the rate as high to achieve the policy goal of supporting this group of workers. Under the ARP rules, increasing Colorado's match just for childless workers to 25 percent would cost \$20 million, increasing it to 50 percent would cost \$70 million, and increasing it to 100 percent would cost \$170 million.

Another way to assist low- and middle-income families is to enact a state CTC. Further, a Colorado CTC would specifically benefit the many Colorado households who saw their state tax liabilities increase after the TCJA raised Colorado's standard deductions but eliminated its personal exemptions (for more details, see the previous section on federal-state tax conformity; Auxier and Maag 2018).

Colorado did not offer a CTC in tax year 2020 during the Tax Study Group research. There was a CTC in the state's tax code, but the law that created it (SB 13-001¹⁶) required Congress to pass a law related to states taxing online purchases for it to take effect. SB 13-001 specifically said the Colorado CTC would only take effect when Congress passed the Marketplace Fairness Act or any "other act with substantially similar requirements." However, it is now highly unlikely that Congress will ever enact such legislation because states gained the power to tax online sales with the Supreme Court's 2018 ruling in the *South Dakota v. Wayfair* case (Auxier and Rueben 2018). Still, at that time, Colorado could have enacted a state CTC by simply removing the "trigger" from the legislation.

SB 13-001 CTC was designed as a percentage of the federal CTC but with two additional eligibility restrictions: the Colorado CTC would be limited to single filers with an AGI of less than \$75,000 and joint filers with an AGI of less than \$85,000, and it would be only available for children under the age of six. Further, for eligible families, the Colorado CTC percentage of the federal credit would be based on the filer's AGI. For a single filer, the Colorado CTC would be 30 percent of the federal credit if AGI is less than \$25,000, 15 percent if AGI is above that but below \$50,000, and 5 percent if AGI is above \$50,000 but below \$75,000. For married filers, the percentages are the same but the AGI cutoffs are \$35,000, \$60,000, and \$85,000.

As with the EITC, Colorado policymakers would need to monitor congressional changes to the federal CTC because SB 13-001 links Colorado's CTC to the federal CTC. For example, the ARP raised the maximum federal CTC amount for children under age six from \$2,000 to \$3,600 and made more filers eligible for the credit but only for tax year 2021.¹⁷

In tax year 2022, the federal CTC parameters are set to revert to their TCJA-created rules, which include a maximum \$2,000 nonrefundable credit, a maximum \$1,400 refundable credit, and fewer eligible low-income families. Additionally, the TCJA is set to expire after tax year 2025, at which point the maximum CTC would drop to \$1,000 (among other changes to the calculation of the credit).¹⁸

The Tax Policy Center modelled the tax benefits from activating the CTC in SB 13-001 under both the ARP rules (table 4) and the TCJA rules (table 5). Under both sets of rules, roughly 6 percent of all Colorado households would be eligible for the Colorado CTC, with eligibility for the Colorado CTC peaking at about 11 percent of Colorado households earning between \$20,000 and \$70,000.

While the ARP made the federal CTC newly available to many lower-income filers, our estimates do not show a significant difference in Colorado CTC claims between the ARP rules and the TCJA rules. The assumption is that many lower-income households will continue to not file taxes even though they are newly eligible for the benefit. The filing habits of lower-income households may change over time, however, if the ARP rules are made permanent. Additionally, the federal stimulus payments, which households claimed via filing tax returns if they did not receive the checks, may also increase the number of lower-income households who file in the future.

Under the ARP rules, the average Colorado CTC benefit among those claiming the Colorado CTC is \$861 if the Colorado credit is made refundable and \$404 if the credit is made nonrefundable. If the Colorado credit is refundable, the largest average credit (\$1,409) goes to households with AGI between \$10,000 and \$20,000. If the Colorado credit is nonrefundable, the largest average credits (\$633) goes to households earning closer to \$40,000. The Colorado CTC under the ARP rules would cost \$165 million in revenue annually if it was refundable and closer to \$60 million if it was nonrefundable.

TABLE 4

Tax Cuts under Colorado's Child Tax Credit (CTC) and American Rescue Plan (ARP) Law
Colorado individual income tax, 2020



AGI Group	Refundable CTC		Nonrefundable CTC	
	Percentage of filing units with a tax cut	Average tax cut for those benefiting	Percentage of filing units with a tax cut	Average tax cut for those benefiting
\$0 – \$10K	3%	-\$1,366	0%	\$0
\$10 – \$20K	9%	-\$1,409	2%	-\$118
\$20 – \$30K	12%	-\$1,124	10%	-\$302
\$30 – \$40K	11%	-\$803	11%	-\$522
\$40 – \$50K	10%	-\$704	10%	-\$633
\$50 – \$75K	11%	-\$387	11%	-\$373
\$75 – \$100K	4%	-\$225	4%	-\$225
\$100 – \$200K	0%	-\$180	0%	-\$180
\$200 – \$500K	0%	\$0	0%	\$0
\$500 – \$1 Million	0%	\$0	0%	\$0
More than \$1 Million	0%	\$0	0%	\$0
All	6%	-\$861	5%	-\$404
Revenue Cost		\$165 Million		\$58 Million

Source: Tax Policy Center State Income Tax Model.

Note: Numbers in households eligible for the Colorado CTC are rounded.

Under the TCJA rules, the average Colorado CTC benefit among those claiming the Colorado CTC is \$349 if the credit is made refundable and \$260 if the credit is made nonrefundable. If the Colorado credit is refundable, lower-income households would claim the largest credits, with the largest average credit (\$486) going to households with AGI between \$20,000 and \$30,000, while the largest average nonrefundable Colorado credit (\$378) would go to households earning closer to \$40,000. The Colorado CTC under TCJA rules would cost \$65 million each year if it was refundable and closer to \$40 million if it was nonrefundable.

TABLE 5

Tax Cuts under Colorado's Child Tax Credit (CTC) and Tax Cuts and Jobs Act (TCJA) Law
Colorado individual income tax, 2020



AGI Group	Refundable CTC		Nonrefundable CTC	
	Percentage of filing units with a tax cut	Average tax cut for those benefiting	Percentage of filing units with a tax cut	Average tax cut for those benefiting
\$0 – \$10K	2%	-\$196	0%	\$0
\$10 – \$20K	9%	-\$456	2%	-\$122
\$20 – \$30K	11%	-\$486	10%	-\$250
\$30 – \$40K	11%	-\$399	11%	-\$344
\$40 – \$50K	10%	-\$382	10%	-\$378
\$50 – \$75K	11%	-\$212	11%	-\$212
\$75 – \$100K	4%	-\$124	4%	-\$124
\$100 – \$200K	0%	-\$100	0%	-\$100
\$200 – \$500K	0%	\$0	0%	\$0
\$500 – \$1 Million	0%	\$0	0%	\$0
More than \$1 Million	0%	\$0	0%	\$0
All	6%	-\$349	5%	-\$260
Revenue Cost		\$65 Million		\$37 Million

Source: Tax Policy Center State Income Tax Model.

Note: Numbers in households eligible for the Colorado CTC are rounded.

Alternatively, Colorado could have decided to discard SB 13-001 and design a new state CTC. As of 2021, four states offered a state-level CTC:

- Idaho provided a nonrefundable \$205 CTC based on federal CTC eligibility.
- New York provided a refundable CTC that was 33 percent of the federal CTC or \$100 per qualifying child (whichever of the two was greater), but eligibility was based on the TCJA rules and the credit is only for children older than age four.
- North Carolina provided a \$100 nonrefundable credit for all children younger than age 17, but single filers with AGI greater than \$60,000 and married filers with AGI greater than \$100,000 were not eligible.
- Oklahoma provided a nonrefundable CTC that was 5 percent of the federal credit or 20 percent of the federal child and dependent care tax credit (whichever of the two is greater), but filers with AGI greater than \$100,000 were not eligible.

In 2021, after the Tax Study Group’s meetings, HB 21-1311 increased Colorado’s EITC match rate from 15 percent to 20 percent for tax year 2022 and then to 25 percent in tax years 2023, 2024, and 2025. In tax year 2026 (and beyond) the state’s EITC is scheduled to fall back to 20 percent of the federal credit. HB 21-1311 also made the state EITC available childless workers ages 19 to 25 (other than for tax year 2021, these workers are not eligible for the federal EITC).

Additionally, HB 21-1311 repealed SB 13-001’s requirement that Congress pass a law related to online sales taxes, and thus the Colorado CTC established by that law is now set to take effect in tax year 2022 (and beyond). HB 21-1311 keeps the top AGI limit for claiming the Colorado CTC (\$75,000 for single filers and \$85,000 for married filers) and the match rate for the federal CTC (30 percent, 15 percent, and 5 percent, depending on income). However, if Congress does not extend the ARP CTC changes beyond tax year 2022, the Colorado match rates will increase (60 percent, 30 percent, and 15 percent) to compensate for the reduced federal CTC. Colorado’s CTC is refundable.

Research Issue: Colorado’s Pension and Annuity Deduction

Colorado taxpayers can deduct up to \$20,000 or \$24,000 (depending on the filer’s age) in retirement income from the state’s individual income tax. Retirement income eligible for the deduction includes income from public and private pensions, annuities and individual retirement accounts, and the taxable portion of Social Security income.¹⁹ Each member of a married couple may independently claim the deduction, but each spouse can only claim up to \$20,000 or \$24,000 for his or her specific retirement income (i.e., a couple cannot claim a \$40,000 deduction if only one filer has taxable retirement income).

Most states deduct or exempt at least a portion of retirement income from their state individual income tax, and some states totally exempt pension income. State pension deductions and exemptions vary considerably both across states and by type of pension (i.e., some states give more generous exemptions for military and public pension income than private pension income). Among states that don’t exempt all pension income, Colorado’s deduction is one of the most generous. There are no income qualifications for Colorado’s deduction, so filers at all income levels can claim the deduction. With Social Security income, most states either use the federal rules and tax a portion of Social Security income or completely exempt Social Security income from state tax.²⁰

While low-income filers are eligible for the pension and annuity deduction, many Colorado seniors do not have enough taxable income—after using the state’s standard deduction—to benefit from it. In tax year 2020, a Colorado resident age 65 or older got a \$13,700 standard deduction if single and a \$27,400 standard deduction if married on their state tax return.²¹ Colorado’s relatively high standard deduction is a beneficial policy for low- and middle-income seniors because it means many pay little or no state income tax, especially as many have little or no taxable income because Social Security benefits are entirely or partially exempt on both the federal and Colorado tax return. But, as a result, an elderly Colorado filer must earn a decent amount of taxable income above the state’s standard deduction to receive any benefit from the state’s pension and annuity income deduction.

The Tax Policy Center's state income tax model estimated that roughly 323,000 Colorado households benefited from the state's pension and annuity deduction in tax year 2020, or 11 percent of all Colorado households. Colorado households with AGI between \$50,000 and \$200,000 were the most likely to benefit from the deduction. Households with less income did not earn enough taxable income to benefit from the deduction, while households with more income typically earned income from sources not eligible for the deduction (e.g., investment and business income).

There are also systemic issues (separate from state policy choices) that push retirement income tax benefits to relatively high-earning households. In general, those who had higher-paying jobs during their working careers are more likely to have both worked for an employer who offered a pension program or other form of retirement benefit and accumulated larger sums of retirement income. In contrast, low-income workers typically have weaker labor force attachment (i.e., they change employment more often), are less likely to work for employers who offer retirement benefits, and are less likely to participate in retirement plans when eligible (Yanyuan Wu, Rutledge, and Penglase 2014). Thus, both access and participation in retirement benefits increase with income.²² As a result, relatively affluent households are more likely to earn retirement income and benefit from the state's pension and annuity deduction.

One way to shift the benefit of Colorado's pension and annuity deduction away from relatively high-income households is by creating income-based eligibility limits—as Missouri, Montana, Rhode Island, and Wisconsin have for their pension exemptions. Further, the state could then use the revenue it saves from the income limits to provide other, more targeted tax credits for lower-income seniors.

The AGI limits in these four states span a wide range of income. In Wisconsin, a single filer loses the benefit if their AGI is above \$15,000 (\$30,000 if married), while in Rhode Island a single filer can claim the pension benefit as long as their AGI is below \$81,900 (\$102,000 if married). The formulas for these provisions also differ among these four states based on filing status and the type of pension (public or private), showing the range of options policymakers have when considering AGI-based limits.

Additionally, Missouri and Montana phase out their pension benefits, while Rhode Island and Wisconsin have an income "cliff" (i.e., the filer loses the benefit if they earn one dollar over the amount). Income cliffs are generally viewed as undesirable tax policy that can arbitrarily punish filers or create incentives to lower or hide income.

The Tax Policy Center modeled three different pension and annuity deduction reform options using its state income tax model. The possible reforms phase out Colorado's deduction at three different AGI ranges: from \$75,000 to \$123,000, from \$100,000 to \$148,000, and from \$200,000 to \$248,000. The Tax Policy Center also modeled eliminating Colorado's pension and annuity deduction.

As table 6 shows, a lower income phase-out means more Colorado taxpayers lose the deduction (and thus face a tax increase) and the state raises more tax revenue, while a higher income phase-out affects fewer Colorado taxpayers but raises less revenue. If the pension and annuity deduction is phased out starting at \$75,000, roughly 5 percent of Colorado households see a tax increase, or about half of the households currently benefiting from the deduction, while the state

sees a revenue increase of roughly \$160 million. If the deduction is phased out starting at \$200,000, 1 percent of households face a tax increase and the revenue increase is closer to \$30 million.

TABLE 6

Revenue Increase from Pension and Annuity Reforms

Colorado individual income tax, 2020



Phase out range (AGI)	Households Facing Tax Increase	Percentage of All CO Households	Average Tax Increase	Estimated Revenue (Millions)
\$75,000–\$123,000	164,000	5%	\$979	\$161
\$100,000–\$148,000	106,000	4%	\$1,021	\$109
\$200,000–\$248,000	35,000	1%	\$1,173	\$29
Eliminate the exemption	323,000	11%	\$1,072	\$346

Source: Tax Policy Center State Income Tax Model.

Notes: AGI = Adjusted gross income. Numbers in households facing a tax increase are rounded. Numbers in average tax increases are only among households with a tax increase.

The average tax increase among households seeing a tax increase for all four reform options is roughly \$1,000. The average tax increases across the policy options are roughly equal because relatively few filers have incomes in the phase-out range. Thus, most filers currently benefiting from the deduction are either unaffected (their income is below the phase-out level) or lose it entirely (their income is above the phase-out level).

An additional consideration is how reforms to the pension and annuity deduction would treat Coloradans who do not have Social Security income. Specifically, some public employees in Colorado’s Public Employees Retirement Association plan are not eligible for Social Security benefits because they did not pay federal payroll taxes while employed by the Colorado governments.²³ These workers can receive Social Security income based on contributions from other jobs or their spouse’s employment, but not from their time working for the state or local government (if they did not pay federal payroll taxes). Social Security originally excluded state and local government employees because of constitutionality concerns over levying a federal payroll tax on state and local governments. Congressional action later allowed public employers to opt into Social Security, but roughly a quarter of state and local employees are still not covered by Social Security.²⁴ As of 2008, 71 percent of Colorado state and local employees were not covered by Social Security, a relatively high share as only Louisiana, Massachusetts, Nevada, and Ohio had a higher percentage of state and local employees not covered by Social Security (Congressional Research Service 2011).

Finally, if Colorado did indeed add income qualifications to its pension and annuity deduction, it could consider simultaneously implementing new tax policies that benefit Colorado seniors who either lose some tax benefits from the AGI limitations or do not earn enough taxable income to benefit from the existing deduction.

One such type of targeted tax policy is a property tax circuit breaker program.²⁵ This type of tax relief is generally for older residents, but eligibility can be targeted based on age, income, or both.²⁶ Circuit breakers are provided to eligible residents who have property tax liabilities above a specified percentage of income. Although relief is based on property tax or rent payments (including the latter helps make the tax relief available to lower-income residents who do not own their home), it is typically provided via an individual income tax credit. For example, the District of Columbia’s circuit breaker (using tax year 2018 parameters) is an income tax credit available to filers older than age 70 with income below \$62,600

and residents younger than age 70 with income below \$51,000.²⁷ The credit is calculated as the amount of property tax payments (actual or from a calculation for renters based on rent paid) that exceed 3 percent of AGI. The District of Columbia's maximum credit was \$1,025 in 2018.

The Tax Policy Center estimates that a similar credit in Colorado equal to the amount of property tax that exceeds 3 percent of a Colorado filer's income, capped at \$513 and only available to seniors with income under \$62,600, would cost roughly \$70 million in revenue.

In 2021, HB 21-1311 made all Social Security income exempt from Colorado tax for taxpayers ages 65 and older. It did not make any other changes to the pension and annuity deduction.

Research Issue: Colorado's Income Tax Expenditures

Tax expenditures are special provisions in the tax code, such as exclusions, deductions, deferrals, credits, and preferential tax rates, that cost revenue and benefit specific activities or groups. For example, the pension and annuity exemption discussed above—which benefits residents with retirement income and reduces Colorado tax revenue—is a tax expenditure. As such, tax expenditures are often referred to as “spending through the tax code.” Tax expenditures can be both a regular part of the tax system's structure (e.g., the exemption of Social Security income) or a special subsidy targeted at specific taxpayers or business activities (e.g., a business tax incentive).

Reforming and eliminating tax expenditures is how policymakers can broaden the state's tax base. When the state limits or eliminates a tax expenditure, it collects more revenue, and that revenue can be used to lower tax rates (or other policies). However, reforming and eliminating tax expenditures is difficult.

First, most Colorado tax expenditures—as with most tax expenditures in all 50 states—were created by Congress, not Colorado lawmakers, and then adopted by Colorado through federal-state conformity (see the section on conformity for more details). In a 2020 report, the Tax Policy Center found that federal-state tax conformity accounted for 85 percent of income and business tax expenditures in California and Minnesota and 72 percent in the District of Columbia and Massachusetts (Boddupalli, Sammartino, and Toder 2020). These four states use a variety of tax conformity rules. Colorado was not a part of this analysis, but because it uses federal taxable income as the starting point for its income tax, we can assume it would most likely be at the higher end of this range. Still, the actual percentage would depend on any limits Colorado put on those federal expenditures and the number of state-specific credits and deductions it has enacted.

Second, tax expenditures are often politically popular. The same Tax Policy Center study found that most state-implemented tax expenditures, and particularly tax expenditures with high revenue costs, are for either economic development, income security, or social policy (i.e., provisions intended to help specific groups, like seniors). That means few, if any, tax expenditures in Colorado's tax code could easily be eliminated without upsetting a politically sympathetic group.

Thus, often the best thing state policymakers can do is to constantly monitor tax expenditures to ensure these programs are working as intended and achieving their stated policy goals. Thankfully, as that Tax Policy Center report notes, Colorado already has “exemplary evaluations of both small and large tax provisions.” Indeed, these evaluations from the Colorado Office of the State Auditor and the Colorado Department of Revenue formed the backbone for the Tax Study Group’s discussion of tax expenditures and this analysis of tax expenditures.

Every two years, the Colorado Department of Revenue publishes the “Tax Profile & Expenditure Report,” detailing tax expenditures and their estimated revenue impacts.²⁸ The Colorado Office of the State Auditor also evaluates expenditures to determine whether they are meeting their intended goal.²⁹

The Tax Policy Center focused on the following expenditures in its presentations to the Tax Study Group:

- tuition program contribution deduction
- immediate expensing and accelerated depreciation
- Colorado-sourced capital gains deduction
- alternative minimum tax credit

This is not an exhaustive list and, in general, the Tax Policy Center’s main observation was that consistently monitoring and studying all tax expenditures often allows policymakers to better target limited public dollars.

TUITION PROGRAM CONTRIBUTION DEDUCTION

Colorado taxpayers can subtract from federal taxable income an amount equal to all payments or contributions made during the taxable year to qualified 529 accounts or other tuition program savings accounts to the extent included in federal taxable income. (Federal law allows earnings in 529 plans to accumulate on a tax-deferred basis; the federal government does not tax distributions but also does not offer credits or deductions for contributions.) These savings accounts must be used for qualified higher education expenses, including for student loan payments, computers, and the cost of apprenticeship programs.

The vast majority of the revenue loss from the Colorado tuition program contribution deduction is likely from contributions to 529 college savings accounts. And, at the time of the Tax Study Group research, Colorado had a generous program. Although virtually every state offers a 529 plan, most states impose limits on the size of the accounts and the amount of contributions that can be made each year that investors can deduct from their taxable income.³⁰ The majority of states with a deduction capped annual contributions at amounts ranging from \$1,000 to \$15,000. When the Tax Study Group was meeting, Colorado did not cap annual contributions.

Further, Colorado was one of only four states—along with New Mexico, South Carolina, and West Virginia—that allowed residents to make annual tax deductions up to the account limit. Most states limited the tax deduction and seven

states offered no state tax deduction for contributions to 529 plans. Even without a deduction from current contributions, distributions and earnings on these accounts were still tax free.

Working in combination, these rules can create vertical equity problems. In fact, according to the Colorado Department of Revenue, two-thirds of the benefit from Colorado’s tuition program contribution deduction went to individuals earning \$200,000 or more.

Furthermore, because Colorado had no annual limit and no minimum required holding period between when the money was deposited into an account and when it was withdrawn to pay for qualified expenses, taxpayers could in theory deposit money into a 529 account for mere days, and then withdraw the funds and claim a full tax deduction on the amount withdrawn. This lack of a holding period or maximum annual amount eligible for the deduction further tilted the benefit to the highest-income earners.

In 2021, HB 21-1311 established a new cap on the annual amount of contributions a filer can make to a 529 account that can be used to reduce Colorado taxable income. The caps are \$20,000 for a single filer and \$30,000 for married filing jointly filers; the caps are increased annually based on a tuition-related inflation adjustment.

IMMEDIATE EXPENSING AND ACCELERATED DEPRECIATION

Taxpayers can account for the “wear and tear” of business property via deductions for the depreciation of equipment, buildings, and rental homes. The TCJA greatly expanded the depreciation allowance by letting taxpayers deduct larger amounts of investments from federal taxable income (and thus also from Colorado taxable income) in the first year of the investment, instead of deducting them more slowly over a longer period. Congress similarly made federal depreciation deductions more generous through a series of reforms in the 1980s. Large depreciation deductions are meant to encourage investment, but they often result in large amounts of forgone revenue, as well as capital equipment decisions driven by tax and not economic benefit.

COLORADO SOURCE CAPITAL GAINS DEDUCTION

Taxpayers who have certain types of capital gains income included in their federal taxable income from property purchased on or after May 9, 1994—and held for at least five uninterrupted years—can deduct it when calculating their Colorado taxable income. Eligible property does not include intangible property like stocks and bonds. If tangible personal property was purchased on or after June 4, 2009, then it qualifies, even if it is located outside of Colorado. If real property, it must be located in Colorado but acquired before June 4, 2009. A deduction of up to \$100,000 is available per eligible Colorado taxpayer.

Many states allow taxpayers to deduct capital gains from their state taxable income, and the federal government already provides a preferential rate on capital gains held for more than one year, plus a \$250,000 exemption (\$500,000 if married) for capital gains income from a home sale. However, Colorado’s deduction is relatively narrow, causing a horizontal equity problem among various types of capital gains income. For example, a second home purchased in April 1994 would qualify for the deduction, but a second home purchased in June 1994 would not. Further, proponents of

reforming the deduction noted that it benefits a small number of wealthy taxpayers and, in the case of partnerships, has been expanded because of a recent Colorado Department of Revenue ruling allowing the \$100,000 deduction for *each* partner.

COLORADO ALTERNATIVE MINIMUM TAX CREDIT

Alternative minimum taxes (AMTs) are levied to ensure that taxpayers, after accounting for all eligible deductions and exemptions, pay a minimum amount of tax. Both the federal government and Colorado have an AMT on individuals but not corporations. The TCJA ended the federal AMT on corporations and increased the exemption amount for the individual AMT.³¹ Colorado conforms with the increased TCJA exemption amounts because Colorado's AMT (3.47 percent) is levied on any income eligible for the federal AMT.³² However, like the other changes to individual income taxes in that law, the higher exemption amounts are set to expire at the end of tax year 2025.

Colorado, like the federal government, allows taxpayers to recoup "extra" amounts paid because of the AMT in later years with AMT credits. The credit helps filers but further complicates record-keeping.

AMT repeal would simplify tax filing for the roughly 6,000 Coloradans currently subject to the tax, but it would reduce revenue. According to the Colorado Department of Revenue, Colorado collects roughly \$2 million in revenue from its AMT each year. State-level AMTs are not common. As of 2020, in addition to Colorado, only California, Connecticut, Iowa, and Minnesota levied a state-level AMT. New York also has a minimum tax, but it is not tied to the federal AMT.³³

COLORADO'S GENERAL SALES TAX

Colorado levies a 2.9 percent general sales tax. That was the lowest state general sales tax rate in the country in 2021. However, when the state rate was combined with local general sales tax rates, the combined sales tax rate levied on purchases in Colorado was average, if not high, when compared with other states.

On questions of revenue and equity, a state's sales tax base (i.e., what purchases are taxed) is as important as its sales tax rate. State sales tax bases vary considerably across the nation. A Tax Policy Center study found the amount of purchases subject to the sales tax, including general sales taxes and excise taxes like the motor fuel tax, ranged from 5 percent in Delaware (the state does not levy a general sales tax but does levy excise taxes) to 36 percent in Vermont and 91 percent in Hawaii (Airi and Sammartino, 2021). The Tax Policy Center found 34 percent of household spending was taxable in Colorado. This total was at the lower end of states but not far off the US average of 39 percent.

The reason most states were on the lower end of the spectrum is the **limited taxation of services**, such as dry cleaning, carpentry, hairdressing, and accounting. All states tax some services, but exemptions and omissions are common. And very few states tax professional services such as those rendered by doctors and lawyers—Hawaii and New Mexico are the two notable exceptions to this rule. The problem is that in most states, services often do not fall under existing definitions of "tangible goods," which is what sales taxes were designed for when most states enacted them in the 1920s and 1930s. Thus, states typically must add these purchases to the state tax base via legislation.

As with the income tax, the other part of understanding the state's sales tax base involves **analyzing tax expenditures**. Many sales tax expenditures were enacted to benefit lower-income residents, support businesses, or achieve other politically popular policy goals. Policymakers should closely analyze these expenditures and ensure they are achieving their stated policy goals.

Finally, an additional obstacle to any policy change is Colorado's complex relationship between state and local general sales taxes. Colorado has 294 separate local taxing jurisdictions, including municipalities, counties, school districts, and special districts, and many have established a sales tax base that significantly differs from the state's tax base. Further, because these taxing jurisdictions frequently overlap, there are 756 different combinations of sales taxes throughout the state that businesses must navigate. The taxation of online purchases, made possible by the Supreme Court's 2018 decision in *South Dakota v. Wayfair*, has only made the situation more complex. As a result, Colorado is often ranked as having one of the most complex sales taxes in the country. The state recently passed legislation to streamline sales tax collections, but further **harmonizing state and local tax bases** and coordinating tax bases across overlapping jurisdictions are another logical step in general sales tax reform in Colorado.

Research Issue: Taxing Services

Colorado's sales tax applies to "tangible personal property," which is defined in the state's statute as "corporeal personal property" plus a small list of services such as telecommunications and restaurant meals.³⁴ As such, this definition excludes most services.

This limited sales tax base is problematic given the increased consumer consumption of services over the past few decades. Noted public finance economist John Mikesell estimated the “breadth” of Colorado’s sales tax base was 40 percent larger in 2000 than in 2018.³⁵ Nationally, the breadth of the sales tax base was roughly 35 percent larger in 2000. To maintain revenue, many states raised their general sales tax rates as their sales tax bases shrank. However, Colorado’s general sales rate has been 2.9 percent since 2001 (when it was reduced from 3 percent) and was last increased (for only 15 months) in 1983.³⁶ But, due in part to the shrinking tax base and unchanged tax rate, the share of Colorado’s own-source revenue from its general sales taxes has fallen over the past 40 years, while its share from the income tax has risen.³⁷

If Colorado wants to broaden its sales tax base, it would need to make more service purchases taxable. According to the Federation of Tax Administrators,³⁸ Colorado taxed only 21 of 176 services included in a survey sent to each state in 2017.³⁹ Among the states with a general sales tax, only Massachusetts and Virginia taxed fewer services than Colorado. This creates a challenge for Colorado’s tax system because services comprised 70 percent of the state’s consumption in 2017, up from 65 percent in 1997 (mirroring the national trend).⁴⁰ Services also constituted the largest component of the state’s economic growth in 2018.⁴¹

A 2021 Tax Policy Center study found Colorado taxed 95 percent of durable goods, 48 percent of nondurable goods, and 17 percent of services, which results in Colorado taxing 32 percent of overall household spending (Airi and Sammartino 2021). The percentage of services and overall spending taxed by Colorado was roughly in line with national averages.

Colorado could consider expanding its general sales tax via legislation to include services that are taxable in many other states. According to the Federation of Tax Administrators, the following services are exempt from tax in Colorado but taxed in at least 20 states (neighboring states that tax these services are listed in parentheses):

- Pet grooming: 20 states (KS, NE, NM, UT)
- Landscaping: 21 states (AZ, KS, NM)
- Carpet and upholstery cleaning: 20 states (NE, NM)
- Diaper service: 22 states (AZ, KS, NE, NM, UT, WY)
- Garment services: 20 states (KS, NE, NM, UT, WY)
- Gift and package wrapping: 22 states (KS, NE, NM, UT, WY)
- Health clubs, tanning parlors: 23 states (KS, NE, NM, OK)
- Laundry and dry cleaning: 21 states (KS, NM, UT, WY)
- Shoe repair: 21 states (KS, NE, NM, UT, WY)
- Car washing and waxing: 24 states (KS, NE, NM, UT, WY)
- Car road service and towing: 20 states (KS, NE, NM, UT, WY)
- Car repairs: 25 states (KS, NM, UT, WY)
- Parking lots and garages: 21 states (NM, OK)
- Amusement park admission: 36 states (AZ, KS, NE, NM, OK, UT, WY)
- Billiard parlors: 28 states (AZ, KS, NE, NM, OK, UT)
- Bowling alleys: 28 states (AZ, KS, NE, NM, OK, UT)
- Admission to professional sports events: 36 states (AZ, KS, NE, NM, OK, UT, WY)

In general, although broadening the sales tax base is a near universal goal across the country, only a handful of states have succeeded in the past decade. Further, in the three states that recently enacted such legislation—Connecticut, the District of Columbia, and North Carolina—the sales tax base expansion was relatively modest.

Research Issue: Colorado’s General Sales Tax Expenditures

As with the study of income tax expenditures, the Tax Policy Center benefited greatly from the Colorado Department of Revenue’s “Tax Profile & Expenditure Report” and the Colorado Office of the State Auditor’s evaluation of expenditures.

In presentations to the Tax Study Group, the Tax Policy Center focused on the following general sales tax expenditures:

- sales tax allowance vendor fee
- fuel sales tax exemption
- coins and precious metal bullion exemption
- interstate commerce exemption (trucks and telecommunications)
- energy used for industrial and manufacturing purposes exemption

SALES TAX ALLOWANCE VENDOR FEE

Colorado retailers are responsible for collecting the sales tax and remitting it to the Department of Revenue. However, a portion of the sales tax collected may be retained by the retailer to cover the expense of its collection and remittance of the tax. This expense is known as the “vendor fee.” The fee has ranged between 1.35 percent and to 5 percent of a retailer’s tax collections since the fee was created in in 1935. House Bill 19-1245 increased the vendor fee to its current level of 4 percent and implemented a \$1,000 vender fee cap per retailer. However, the fee has not always been in place. Between 2009 and 2011, during the budget crisis caused by the Great Recession, the fee was set at 0 percent and thus practically eliminated for this period.

Among the 44 other states and District of Columbia that levy a general sales tax, 26 offer retailers a vendor fee. Among this group, Colorado’s vendor fee is one of the most generous in the country.

HB 21-1312 eliminated the vender fee for businesses that have more than \$1 million in taxable sales each month.

FUEL SALES TAX EXEMPTION

When a consumer purchases gasoline and diesel in Colorado, the state levies an excise tax (a per gallon gas tax) but not its general sales tax. All 50 states levy an excise tax on gasoline and diesel purchases, but 11 states additionally levy their general sales tax on motor fuel purchases.

COINS AND PRECIOUS METAL BULLION SALES TAX EXEMPTION

All sales, storage, use, or consumption of precious metal bullion coins are exempt from Colorado sales and use tax. The exemption narrowly applies to precious metal bullion and coins that are, or were at one time, used as currency or as a medium of exchange in the United States or a foreign country. Colorado has temporarily repealed this exemption on two previous occasions, including during the Great Recession.

INTERSTATE COMMERCE EXEMPTIONS (TRUCKS AND TELECOMMUNICATIONS)

Sales, purchases, and long-term leases of new and used commercial trucks, trailers, semitrailers, truck tractors, and truck bodies are exempt from Colorado's sales tax if the property is (1) used exclusively outside Colorado or in interstate commerce or (2) removed from the state within 30 days and permanently licensed and registered outside of Colorado. In addition, these trucks and trailers are also exempt from use tax if they were previously used in interstate commerce and registered in another state for at least six months before being relocated to and registered in Colorado. Finally, if sales or use tax was paid on any 2010 or later model commercial truck or trailer with a gross vehicle rating of 56,000 pounds or greater, then the taxpayer can receive a refund for the amount of tax paid over three years.

Telecommunications service (phone calls, texts, and paging) to customers whose place of primary use is outside Colorado, or where the communication begins or ends outside of Colorado, is also exempt from state sales tax.

ENERGY USED FOR INDUSTRIAL AND MANUFACTURING PURPOSES SALES TAX EXEMPTION

Sales and purchases of electricity, coal, gas, fuel oil, steam, coke, or nuclear fuel used in processing, manufacturing, mining, refining, irrigation, construction, telegraph communication, telephone communication, radio communication, street transportation services, and all industrial uses are exempt from state sales and use taxes. The Colorado General Assembly temporarily repealed the exemption from March 1, 2010, until June 30, 2012, during the budget crisis created by the Great Recession.

Research Issue: Colorado's State and Local General Sales Tax Bases

Each state and locality with a general sales tax must define what purchases are taxable. While every state must choose what to exempt from its tax, localities typically conform with their state's exemptions and definitions to keep the tax as simple as possible for businesses and consumers. The desire and pressure to harmonize state and local tax bases have only increased since the Supreme Court's 2018 decision in the *South Dakota v. Wayfair* case made most remote (i.e., online) purchases taxable.

However, in part because of its tradition of decentralized local control, Colorado is one of just six states that does not have a uniform sales tax base. Most Colorado jurisdictions are state-collected jurisdictions, meaning businesses remit both the state and local taxes to the Department of Revenue, and the department then delivers the local share of revenue to the jurisdiction. Although these constitute a majority of jurisdictions, only 32 percent of the state's population live solely in a state-collected jurisdiction (jurisdictions can overlap). The remaining 68 percent of residents live in at least one home-rule jurisdiction. And among these 97 jurisdictions, 71 towns and cities (including Denver and Broomfield) are completely free

to create their own sales tax base—and the definitions in these municipalities are considerably different from the state. Overall, home-rule jurisdictions typically exempt fewer purchases from the sales tax than the state.

Since July 2017, the Sales and Use Tax Simplification Committee has been meeting periodically to study the potential simplification and harmonization of state and local sales tax bases in Colorado. The committee is specifically searching for revenue-neutral changes that would not require constitutional amendments or voter approval.

The committee and Department of Revenue have partnered with the Colorado Municipal League and other stakeholders to streamline aspects of sales tax determination, collection, and remittance for businesses.

As of May 2021, 50 of the 71 home-rule jurisdictions with completely independent sales tax bases have agreed to use a new single online tax portal operated by the state, with the hope that this cooperation will create a “one-stop shop” for businesses filing sales tax returns (Sealover 2021). In addition, five home-rule municipalities approved a Colorado Municipal League model ordinance designed to create a uniform economic nexus threshold for home-rule municipalities.

APPENDIX: TECHNICAL SUPPORT TEAM

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