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Handful of Proposals Would Push Colorado Away From the Proper Tax Base

By Mark Robyn

With state tax revenues in decline across the nation due to the economic downturn, lawmakers have been left scrambling for new sources of revenue. At the same time, elected officials are hesitant to raise broad-based taxes in bad economic times. This has led some lawmakers to pick through the tax code in search of less politically perilous tax increases.

Reexamining some of the nitty-gritty tax policies buried deep within state statutes is a good idea. State tax codes are littered with targeted tax provisions for special interests. These breaks, called "tax expenditures," are really just government spending funneled through the tax code. And they cost state governments tens of billions of dollars in revenue each year. A good example of this is the nearly ubiquitous use of tax incentives to lure film productions into states.[1]

Taxing Business Inputs Leads to Double Taxation

While state tax codes are filled with many unjustifiable special interest carve-outs, all tax scholars agree that business-to-business transactions should be exempt from the general sales tax.[2] A properly structured sales tax, which is really a form of consumption tax, applies to all consumer purchases but not to business purchases. The purpose of this exemption is not to promote business in general but rather to avoid the double taxation of some products. The retail price of every product includes the price of all the inputs used to create that product, so a retail tax hits all the inputs. It makes little sense, and in fact is economically damaging, to tax the inputs once on their way through the production line and again at the retail level.

Colorado lawmakers have proposed a handful of tax changes as revenue raisers. Unfortunately, many of the proposals fall short of sound tax policy. Several of the proposals would expand the

[1] William Luther, *Tax Foundation Special Report,* No. 173, "Movie Production Incentives: Blockbuster Support for Lackluster Policy," January 2010, at www.taxfoundation.org/publications/show/25706.html.
[2] John L. Mikesell, Thomas S. Neubig, Robert J. Cline, and Andrew Phillips , "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," *State Tax Notes,* Vol. 35, No. 7, February 14, 2005. Available at SSRN: http://ssrn.com/abstract=665702.

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sales tax base to include various business inputs, including direct mail advertising materials (HB 1189), fuels and electricity used in manufacturing (HB 1190), fast food containers and bags (HB 1194), and various agricultural inputs (HB 1195). All of these proposals represent a departure from the proper and universally agreed upon retail sales tax base and should not be enacted. Together these tax increases would raise around $68 million of revenue in FY 2012.

Other Sales Tax Changes Are Less Straightforward

The appropriateness of two of the tax changes is a little more ambiguous. One bill would apply sales tax to candy and soda by rewriting tax law so that they no longer qualify for the sales tax exemption for groceries (HB 1191). Since all end-user purchases should be subject to the sales tax, of course that includes candy, soda and all groceries. Expanding the tax base to include these retail purchases would reduce economic distortions, make sales tax collections more predictable and avoid more damaging types of tax increases. The regressivity of applying sales tax to groceries is often exaggerated; the vast majority of groceries are purchased by middle- and upper-income people. But low-income households do spend a larger share of their income on groceries, so instead of a blanket exemption for groceries, states should consider a targeted way to help them, such as increasing food stamps.

Unfortunately, while HB 1191 would broaden Colorado's sales tax base, the fact that it singles out individual products for taxation shows that the change is motivated not by a desire for sound tax policy but by a desire to punish consumers of a specific politically unpopular product. Such tinkering with the tax base yields complex, arbitrary or counterintuitive tax rules, such as Illinois's 2009 rule that products containing flour, like Kit Kat bars and licorice, are not technically candy and therefore deserve a tax exemption. The proposal to tax soda and candy in Colorado would raise $18 million in FY 2012.

Another proposal would reclassify certain types of standardized software as tangible personal property and thereby subject them to the sales tax (HB 1192). The newly taxed software would include software downloaded from the internet as well as software manually installed on a customer's computer by a third party. In an ideal world, all standardized software that was both sold to an end user and sold by a retailer with nexus in the state would be subject to the retail sales tax. In practice, it may be that both of these conditions are rarely met. In that case, taxing all standardized software purchases, whether they meet the conditions or not, in order to get at the minority of purchases that should be taxed would be more harmful than helpful.

Amazon Taxes Signal Business Unfriendliness and Will Not Help Short-Term Budget Problems

Another proposal in the bunch would enact a so-called "Amazon tax" (HB 1193). Amazon taxes have become a hot topic in state taxation in recent years due to the growth of interstate commerce. The tax is named after online retailer Amazon.com, which was targeted by New York lawmakers in 2008. The tax was designed to force online retailers like Amazon.com to collect New York sales tax on purchases made by New Yorkers, even though Amazon has no property or employees in New York. The law requires retailers that have contracts with "affiliates"—independent persons within the state who post a link to Amazon.com on their website and get a share of revenues—to collect New York sales tax.

In reaction to the suit, Amazon terminated all its affiliate agreements in New York, but the principle established by the suit applies broadly. Amazon taxes greatly expand the power of state government to collect taxes from out-of-state businesses and should be avoided. These taxes represent the latest in a series of efforts to eliminate the long-standing "physical presence" standard and replace it with a nebulous, arbitrary standard of "economic presence," where businesses can be taxed in every state where they have customers.

Businesses throughout our nation's history could always practice their trade across state lines. Today, with new technologies, even the smallest businesses can more easily reach across geographical borders to sell their products and services in all fifty states. If such sales can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states. The Colorado proposal would supposedly raise $4.6 million annually, but in reality it would probably prompt challenges to its constitutionality and be tied up in court for years.[3]

Eliminating AMT Is an Inexpensive Tax Simplification, and Limiting Alternative Fuel Vehicle Credits Is a Move in the Right Direction

There are two good proposals being considered. One bill would eliminate the state's alternative minimum tax (AMT), a parallel tax system that piggybacks off the federal AMT (HB 1198). The federal AMT was created in 1970 as a way to keep millionaires from using multiple deductions and credits to wipe out or greatly reduce their tax liability. Since 1970 taxpayers have been required to calculate what they owe two ways, under the regular tax system and the AMT, and then pay the greater of the two.

Colorado's AMT works the same way. It is a complicated tax that requires taxpayers to calculate their tax twice under two different systems, but unlike the federal AMT, it does not raise a great deal of revenue. According to the Legislature's official estimate, the Colorado AMT only raised $5.5 million in FY 2009. Considering the state's income tax raised $4.4 billion last year, the AMT is not worth the administrative trouble. Permanently repealing Colorado's AMT will not cost the state much and seems like a smart move.[4]

There is also a proposal to limit an alternative fuel vehicle credit (HB 1196), which is a move in the right direction. If fuel-efficient cars are really worthy of government subsidization, the subsidy should be treated as spending and subject to the appropriations process where the cost of the subsidy will have to be justified as a government expenditure.

Conclusion

Jean-Baptiste Colbert, the French minister of finance under King Louis XIV, is reported to have once declared, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing." While this is often true of lawmakers' approach to taxes today, it is not the proper principle on which to base tax policy choices. We encourage Colorado's lawmakers to evaluate these and all tax proposals not based simply on how much revenue they can raise without irritating constituents, but based on sound tax

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[3] For more information on Amazon taxes, see *Tax Foundation Fiscal Fact*, No. 187, "Amazon Tax Unconstitutional and Unwise," September 2009, at http://www.taxfoundation.org/news/show/25120.html.
[4] For more information on the AMT, see *Tax Foundation Special Report*, No. 155, "Fixing the Alternative Minimum Tax," May 2007, at http://www.taxfoundation.org/news/show/22400.html.

policy principles. And sound policy would require that the proposals to tax certain business inputs be dropped.