



Stability of State and Local Tax Revenues

by Nancy McCallin

One of the considerations typically taken into account when altering tax structures is the underlying stability of a revenue source. Stability, however, means different things to different people. Taken literally, a stable tax source would not grow at all, even with growth in the economy. Many would argue that a tax source is stable if its long-term growth is commensurate with economic activity, so that revenues are sufficient to accommodate the demands that growth places on government services. Meanwhile, others argue that stability of specific revenue sources is less important than having a diverse tax base so that interaction among the various revenue streams counterbalances individual weaknesses. This *Issue Brief* analyzes both the growth patterns and volatility of the following major government revenue sources: state sales and use taxes, state individual and corporate income taxes, and local property taxes.

What Revenue Streams Display the Strongest Growth?

Table 1 displays the average annual growth rates in the revenue streams for FY 1982-83 through FY 1996-97 and for FY 1992-93 through FY 1996-97. The latter time period is included to show the effect that the TABOR amendment has had on property taxes since its passage in 1992. Prior to the passage of TABOR, local governments were able to increase their tax rates (mill levies) without a vote of the people. Thus, when assessed values declined, local governments were able to maintain or increase their revenue streams by increasing mill levies without voter approval. The TABOR Amendment's voter approval provision for mill levy increases significantly curbed the revenue capacity of the property tax.

Table 1: Average Annual Revenue Growth

| Revenue Source | FY 1983 through FY 1997 | FY 1993 through FY 1997 |
|-----------------------------------|-------------------------|-------------------------|
| State Sales and Use Taxes: | 6.0% | 9.3% |
| Sales | 6.2% | 9.0% |
| Use | 4.1% | 13.8% |
| State Income Taxes: | 9.7% | 10.3% |
| Individual Income | 9.7% | 10.0% |
| Corporate Income | 9.5% | 14.4% |
| Local Property Taxes: | 5.3% | 3.7% |

| | | |
|----------------------------|-------------|-------------|
| School Property | 3.5% | 2.3% |
| Non-School Property | 7.0% | 4.8% |

Table 1 shows that, on average, the state's **income tax** has registered the strongest growth over the last 15 years, 9.7 percent per year since FY 1983. Whereas growth in individual income taxes has been relatively consistent throughout the time period, corporate income taxes accelerated significantly in the last four years.

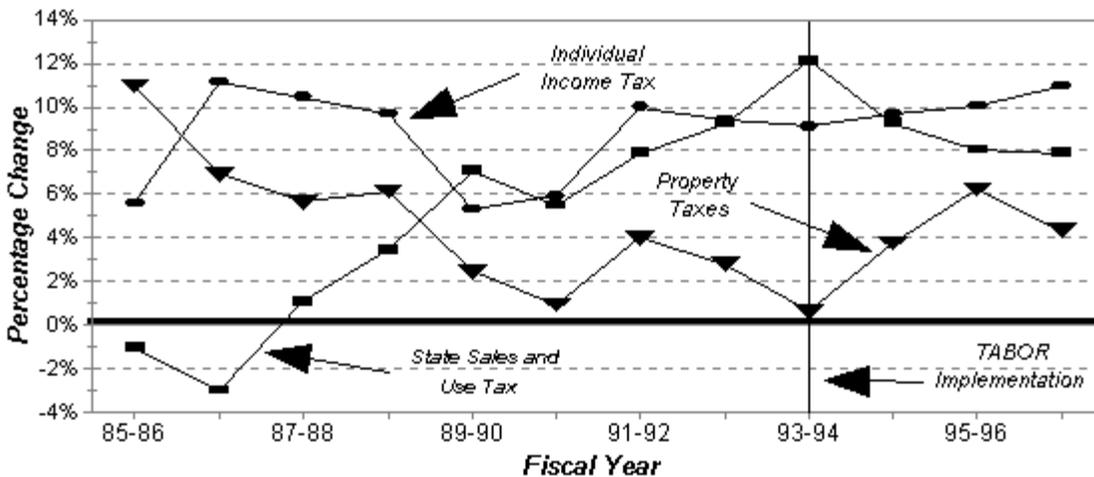
Sales and use taxes registered average growth of 6.0 percent per year since FY 1983, and, commensurate with strong economic activity, growth significantly accelerated since FY 1993, to a 9.3 percent annual pace. Sales taxes grew at a 9.0 percent pace per year during the last four years, while use taxes registered a 13.8 percent annualized gain. In general, sales and use taxes react noticeably and swiftly to changing economic activity, with use taxes reacting in a more exaggerated fashion than sales taxes.

Finally, **property taxes** registered the slowest growth among the revenue streams, increasing at a pace of 5.3 percent per year during the last 15 years, with property taxes for schools logging the slowest gain, 3.5 percent per year. Meanwhile, contrary to the trend in the other major revenue sources, property tax growth slowed significantly in the last four years (overall property taxes increased at a 3.7 percent annualized pace and school finance property taxes grew 2.3 percent per year), despite strong growth in the economy. The combination of the declining residential assessment rate (RAR) because of the Gallagher Amendment and the inability of local governments to increase mill levies to recoup revenues lost from the declining RAR contributed to the weaker growth in property taxes.

Which Revenue Streams are the Most Volatile?

Graphs 1 and 2 compare annual growth among the various revenue sources. Graph 1 displays annual growth in state sales and use, individual income, and local property taxes. Graph 2 analyzes the volatility of corporate income taxes.

Graph 1: State Sales/Use Tax, Individual Income Tax, and Property Tax Growth



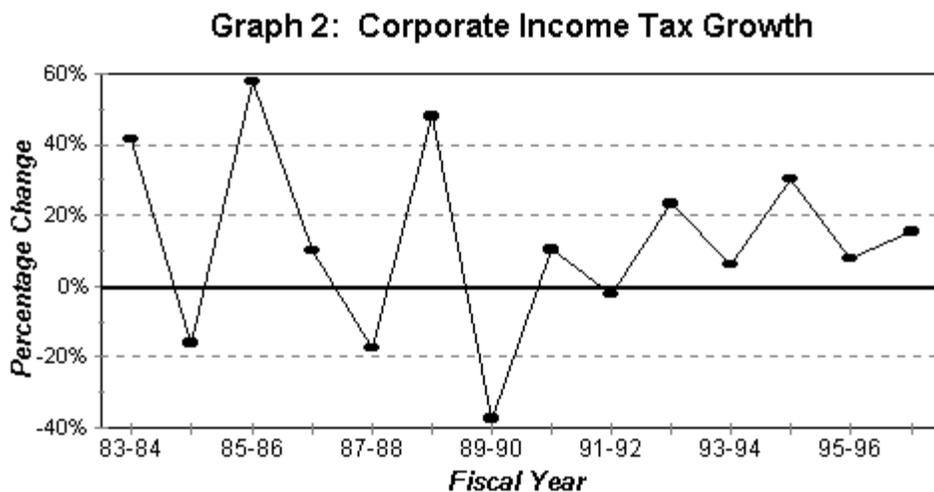
In all but one year displayed in Graph 1, **individual income tax** growth outpaced that of property taxes, while it outpaced sales and use taxes in all but two years. Annual individual income tax growth typically averaged between five and ten percent. Because of its progressive nature, the Colorado individual income tax tends to grow at a faster pace than overall income. Meanwhile, federal tax law changes also affect Colorado income tax receipts because federal taxable income is the starting point for the state's income tax base. This explains why growth in income tax receipts was strong in the mid-1980s even given the state's recession. The Federal Tax Reform Act of 1986 broadened the income tax base, thus keeping income tax receipts strong even given the weak economy.

Property tax growth lagged both income and sales tax growth since FY 1989 and has generally trended lower throughout the time period displayed. Average total property tax growth was generally between zero and ten percent,

while property tax growth for schools ranged between a five percent decline and a five percent increase since FY 1985. As previously noted, the combination of the Gallagher and TABOR amendments are structural constraints on the future revenue capacity of this tax source. Because of these constitutional constraints, revenue growth in strong economic times is muted. Meanwhile, the property tax is the revenue source that reacts most slowly to economic changes. Because of the assessment and collection cycles, there is approximately a two-year lag in how property taxes respond to the economy. For example, property taxes collected in 1998 reflect assessed values for 1997, which in turn reflect market values for the 18-month period ended June 30, 1996.

As previously noted, state **sales and use taxes** were more volatile than individual income or property taxes. Since FY 1989-90, however, sales and use taxes grew at a stronger pace than did property taxes. Sales and use tax growth was exceptionally weak during the state's mid-1980s recession, then has rebounded strongly during the state's recovery.

Sales and use taxes respond swiftly and notably to economic changes because of sales tax exemptions and the nature of the use tax. Colorado exempts many items typically necessary for sustenance in order to lessen the burden of the sales tax on low-income individuals. For example, food for home consumption and fuel used for residential heating are exempted from the sales tax. Thus, the sales tax is levied on more "discretionary" purchases, which tend to be curbed in difficult economic times. Meanwhile, use taxes are primarily paid by the construction, defense, and transportation, communication, and public utilities industries. The construction industry, in particular, is very cyclical. Thus, use taxes have vacillated wildly since FY 1985, registering a 19.0 percent drop in FY 1988 and a 19.4 percent gain in FY 1994.



The most volatile tax among those examined is the **corporate income tax** (Graph 2). During the period examined, annual corporate income tax growth ranged from a 58 percent increase to a 38 percent drop. During this period, corporate tax rates changed eight of the 14 years, but only three of these changes were significant. On average, corporate tax receipts registered strong, but cyclical growth.

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