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Sustainable Colorado Budget to Help Eliminate State Income Taxes

by Vance Ginn, Ph.D. and
Ben Murrey, Fiscal Policy Center Director

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EXECUTIVE SUMMARY

- Colorado's Taxpayer's Bill of Rights (TABOR) has been the gold standard for a state's fiscal rule for over thirty years. Unfortunately, policymakers and courts have weakened it over time, reducing its effectiveness as a tool to control the growth in government and taxes.
- The Independence Institute proposes supplementing TABOR's spending limits with the Sustainable Colorado Budget (SCB), which state lawmakers should start following until the state adopts statute or constitutional changes to enforce the original intent of TABOR . The SCB sets a maximum limit for all state spending from state funds (excluding federal funds) at the rate of population growth plus inflation.
- For FY 2024-25, the SCB sets a maximum amount of government spending (i.e., appropriations) at $27.70 billion in all state funds (i.e., all funds minus federal funds) based on a 5.9% increase in the rate of population growth plus inflation per the TABOR's growth calculations. Higher spending than this amount would excessively raise inflation-adjusted government spending per capita, thereby overburdening taxpayers across the state.
- With projected surpluses of $1.77 billion in TABOR funds and more in all state funds for FY 2024-25, an SCB would provide paths to substantially reduce the state's total income tax rate of 4.4%. Using current TABOR surplus to buy down the income tax rate would not influence state spending on government programs, as the state must now return tax revenue collections above the current TABOR limit to taxpayers. The current projected TABOR surplus could reduce the income tax rate from 4.4% to 3.81%. If lawmakers follow the SCB, the state could further reduce its income tax rate to 2.96%.
- This approach would put Colorado on a path toward zero income taxes if the state government follows the Sustainable Colorado Budget and continues using tax revenue surpluses to reduce the total income tax rate over time.

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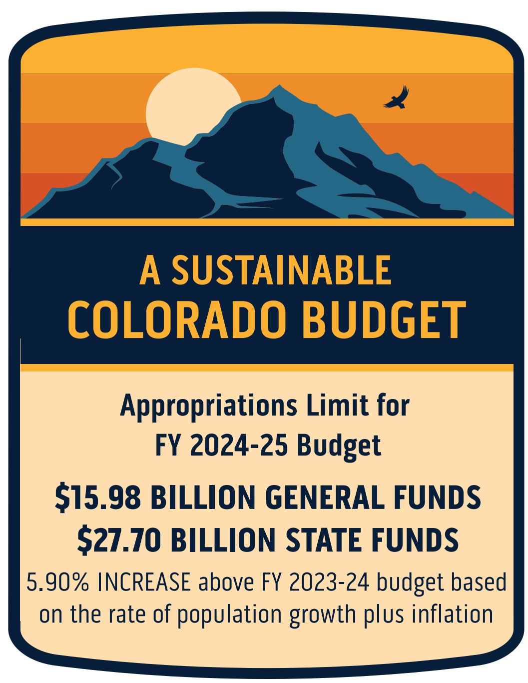

COLORADO'S ECONOMY

Colorado had the eighth-highest inflation-adjusted (real) gross domestic product per capita in 2022 at $66,068,[1] or the 15th-largest economy in the country at $385.8 billion.[2] The state's economy had the seventh fastest economic growth rate last year,[3] and median household income was the eighth highest that year.[4] The Fraser Institute's index of economic freedom—based on measures in categories of government spending, taxation, and labor market regulation—ranks Colorado 21st.[5] The Tax Foundation's business tax climate index, which considers different types of taxes in the state, ranks it 27th.[6] These factors contribute to the state's economic performance. The American Legislative Exchange Council (ALEC)[7] ranks the state's overall performance as 5th best in the nation from 2011 to 2021. However, ALEC ranks Colorado 25th for its economic outlook, leaving much room for improvement.

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Table 1 compares Colorado with the largest four states in the country: California, Texas, Florida, and New York.[8] Two of those states, Florida and Texas, have no personal income tax.[9] The other two, California and New York, have the nation's highest marginal income tax rates.[10] The table also includes the neighboring states of Kansas and Utah as regional reference points for comparison's sake. The states are ordered according to the Fraser Institute's economic freedom ranking, from highest on the left to lowest on the right.

Table 1. Colorado vs. Other States: Economic Freedom, Government Burdens, and Economic Variables

Measure	U.S.	FL	TX	UT	KS	CO	CA	NY
Economic Freedom of North America (2021)[11]	5th (World)	2nd (7.80)	4th (7.64)	16th (6.67)	14th (6.79)	21st (6.60)	49th (4.27)	50th (4.09)
State Migration Trends, Net Migration (2022)[12]	--	1st (+1.9%)	4th (+1.6%)	10th (+1.2%)	33rd (0.0%)	19th (+0.5%)	41st (+0.5%)	50th (-0.9%)
State Business Tax Climate (2024)[13]	--	4th (6.84)	13th (5.48)	8th (5.62)	26th (5.10)	27th (5.09)	48th (3.64)	49th (3.57)
State Economic Outlook (2023)[14]	--	9th	13th	1st	30th	25th	45th	50th
State & Local Spending Per Capita (2022)[15]	--	46th ($10,228)	37th ($11,507)	25th ($12,557)	30th ($12,185)	13th ($14,258)	4th ($18,760)	2nd ($20,761)
S&L Spending on Public Welfare Per Capita (2021)[16]	($12,923)	48th ($1,524)	42nd ($1,741)	44th ($1,639)	40th ($1,841)	32nd ($2,047)	4th ($3,870)	1st ($4,249)
S&L Tax Burden Share of Income (2022)[17]	(11.2%)	11th (9.1%)	6th (8.6%)	40th (12.1%)	33rd (11.2%)	19th (9.7%)	46th (13.5%)	50th (15.9%)
S&L Property Tax Collections Per Capita (2020)[18]	($1,810)	29th ($1,541)	11th ($2,216)	34th ($1,209)	24th ($1,712)	14th ($1,956)	15th ($1,995)	4th ($3,118)
Composite Cost of Living Index (2023:Q3)[19]	(100)	30th (101.0)	18th (93.0)	34th (104.5)	4th (87.4)	35th (106.9)	48th (136.4)	47th (126.5)
Avg. U-3 Unemployment Rate (2003-22)[20]	6.0%	5.6%	5.6%	4.2%	4.8%	5.3%	7.3%	6.2%
Avg. Labor Force Participation Rate (2003-22)[21]	64.0%	60.6%	65.2%	69.2%	68.7%	69.7%	63.5%	61.5%
Avg. Annual Nonfarm Payroll Growth (2003-22)[22]	0.8%	1.4%	1.8%	2.3%	0.3%	1.4%	1.0%	0.6%
Official Poverty Rate (2020-22)[23]	11.5%	13.1%	13.7%	7.1%	9.0%	8.5%	11.4%	12.4%
Supplemental Poverty Rate (2020-22)[24]	9.8%	12.7%	12.3%	5.7%	7.1%	8.9%	13.2%	11.9%

Notes: Dates in parentheses are for that year or the average of that period. Data shaded in blue indicate "best," and in red show "worst" per category by state.

These data show that states with less economic freedom, higher marginal income tax rates, and higher burdens of government on taxpayers (e.g., New York and California) tend to perform worse regarding employment, job growth, and poverty. Colorado tends to run in the middle of the pack among these states and other states nationwide. Colorado has much room for improvement to be more competitive and provide more opportunities for human flourishing.

Another critical measure is Colorado's per capita income which has increased from $47,404 in 2013 to $74,167 in 2022.[25] This 56% increase was substantially faster than the 31.9% increase in inflation measured by the consumer price index (CPI) for all urban households to purchase items in the Denver-Aurora-Lakewood, CO area[26] over that decade. Colorado's population rose by an average of 1.2% annually over the last decade. This increase was more rapid from 2013 to 2019 at an average annual growth of 1.5% compared with just 0.5% in the previous three years. These factors contribute to the state's increasing economic potential.[27]

To improve Colorado's economy and make it a more attractive place to live, start a family, and do business relative to other states, lawmakers should implement a Sustainable Colorado Budget.

While there are reasons for optimism in Colorado's economy, burdens imposed by the government on taxpayers make the state less economically competitive than it could be.[28] To improve Colorado's economy and make it a more attractive place to live, start a family, and do business relative to other states, lawmakers should implement a Sustainable Colorado Budget. This ought to be combined with strengthening TABOR and using the resulting surpluses to provide substantial income tax relief until the state's income tax is phased out entirely.

COLORADO'S TAXPAYER BILL OF RIGHTS (TABOR)

Fiscal rules are important to help rein in the growth of government, as every dollar the government spends must be taken from the productive private sector. Constitutional limits keep the increase in government spending within the average taxpayer's ability to pay for it.[29] To that end, the people of Colorado adopted the Taxpayer's Bill of Rights (TABOR) in 1992. The constitutional amendment serves as a robust tax and expenditure limit (TEL) that has helped limit the growth in state government spending for the last 30 years.[30]

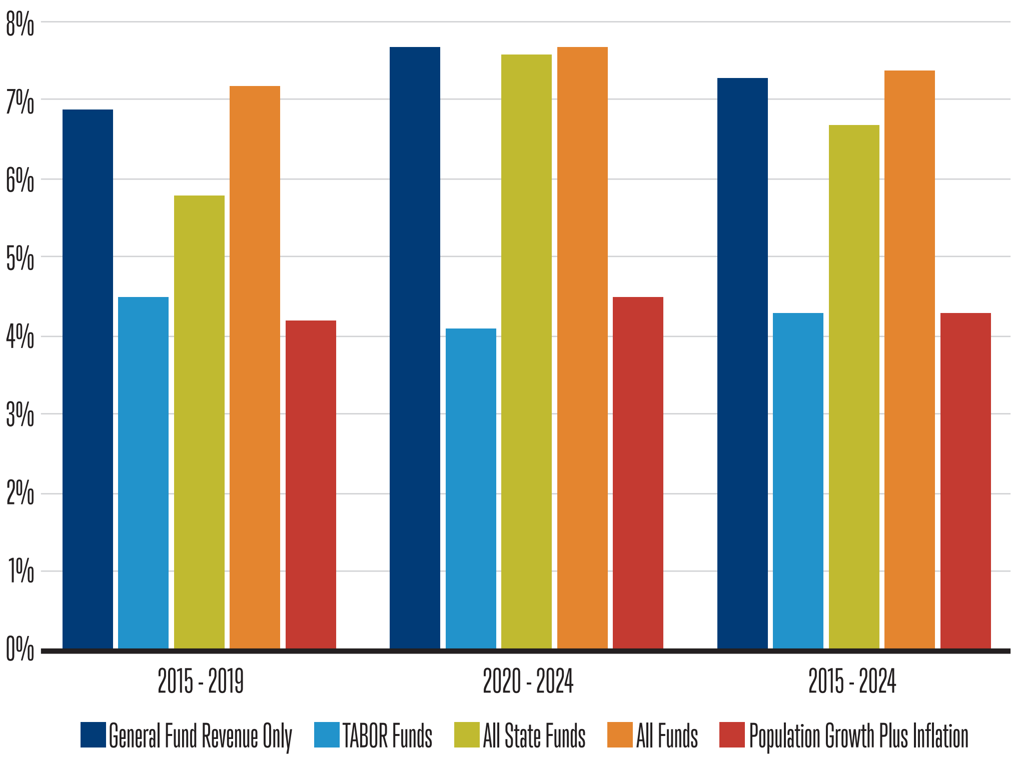
TABOR limits growth in a portion of state spending to the rate of population growth plus inflation in the calendar year ending six months before the start of the fiscal year.[31],[32] This rate of population growth plus inflation is a good measure of the average taxpayer's ability to pay for government spending and has been supported by many fiscal experts.[33]

Unfortunately, progressive policymakers and courts in Colorado have weakened TABOR over time. When TABOR became law, about 67% of the state budget was subject to the constitution's spending limit. Today, only 46% are subject to the limit. As the state pulls a larger portion of its budget from Colorado's households and the private economy beyond the TABOR limit, the cost burden of government on them becomes larger in real terms. This hurts economic growth, employment, and income for everyone.

HISTORICAL BUDGET TRENDS

Figure 1 shows similar spending growth rates over the last decade from 2015 to 2024 when considering general fund revenue only (39% of all funds budget), TABOR funds (46%), all state funds (67%), and all funds.

Figure 1. Colorado's Average Annual Growth for Budget Areas Per Period



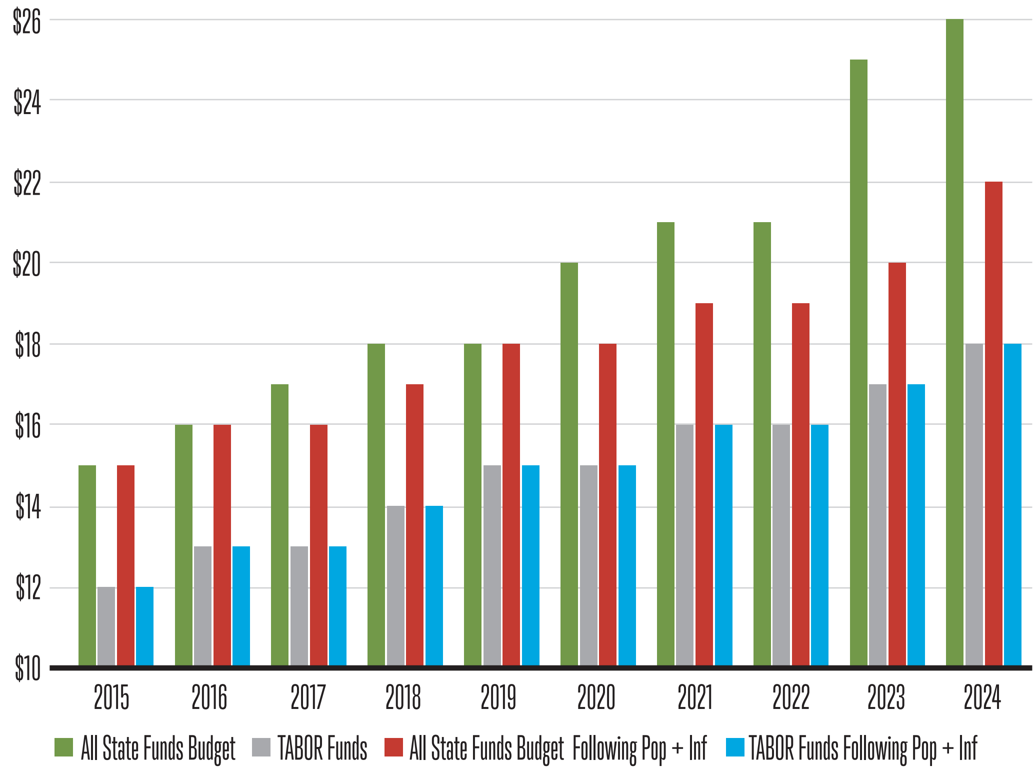
When TABOR became law, about 67% of the state budget was subject to the constitution's spending limit. Today, only 46% is subject to the limit.

Note: Budget amounts are based on data from Colorado's state budget publications[34], Fed FRED for Colorado's resident population growth and consumer price index (CPI) for all urban consumers: all items in Denver-Aurora-Lakewood, CO[35], and authors' calculations.

While the spending of TABOR funds remained about the same as the rate of population growth plus inflation as outlined in the fiscal rule, the other budget measures were well-above this limitation.

Figure 2 shows the actual state budget separated by type of revenue source (i.e., TABOR funds and all state funds) compared with what the budget would have been had it followed a fiscal rule based on the rates of population growth plus inflation in each year from 2014 to 2023.

Figure 2. Trends of Colorado's Budget (Billions of $)



Note: Budget amounts are based on data from Colorado's state budget publications,[36] Fed FRED for Colorado's resident population growth and consumer price index (CPI) for all urban consumers: all items in Denver-Aurora-Lakewood, CO,[37] and authors' calculations.

For just FY 2023-24, the state budgeted $4.2 billion more in all state funds than if limited to population growth plus inflation. The difference is about $800 more per person or $3,300 per family of four that year.

Note that all state funds, which is about two-thirds of the budget and closer to what voters approved with TABOR in 1992, include revenue both subject to and not subject to the TABOR spending limit. The TABOR funds increased by $5.7 billion or 46.2% to $18.1 billion for the decade from FY 2014-15 to FY 2023-24, which is within the compounded rate of population growth plus inflation of 46.5% over the decade.

All state funds increased at a faster rate. This larger share of the budget increased by $11.1 billion or 74.2% to $26.2 billion over this period. For just FY 2023-24, the state budgeted $4.2 billion more in all state funds than if limited to population growth plus inflation. The difference is about $800 more per person or $3,300 per family of four that year. The cumulative difference in all state funds over the decade amounts to $16.3 billion more than this key metric, or about $2,800 per person this year or $11,300 per family of four over the last decade. These are excessive burdens of government on taxpayers that should be addressed soon to improve Colorado's economic situation.

The Colorado Legislature should ensure that spending does not grow more than the average taxpayer's ability to pay for that spending. Failing to do so increases the real cost burden of the state government on households and businesses. Ideally, to compensate for these excessive tax burdens placed on taxpayers from overspending, actual spending ought to be much lower than this fiscal rule until state spending comes back in line with the trajectory of the fiscal rule shown in Figure 2.

FISCAL RULE: CALCULATING A SUSTAINABLE COLORADO BUDGET

To honor the will and intent of voters in adopting TABOR, the Independence Institute proposes the Sustainable Colorado Budget starting with FY 2024-25. This will better limit the spending of all state funds using the same fiscal rule as TABOR and used as a benchmark by other states.[38] This report offers a Sustainable Colorado Budget using all state funds spending, because these are what Colorado's state leaders have the most discretion over and are therefore the most directly responsible for in the annual state budget.

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The Sustainable Colorado Budget sets a ceiling on the upcoming appropriations of all state funds using TABOR's growth calculation of the sum of the state's resident population growth and consumer price index (CPI) for all urban consumers: all items in Denver-Aurora-Lakewood, CO,[39] in the calendar year ending six months before the start of the fiscal year.

The maximum spending is based on the fiscal rule calculated with the following:

- All state funds appropriations in FY 2023-24, and
- Rate of population growth plus inflation.

Table 2 shows the growth rates for the fiscal rule to provide a 5.90% rate of population growth plus inflation in 2022.

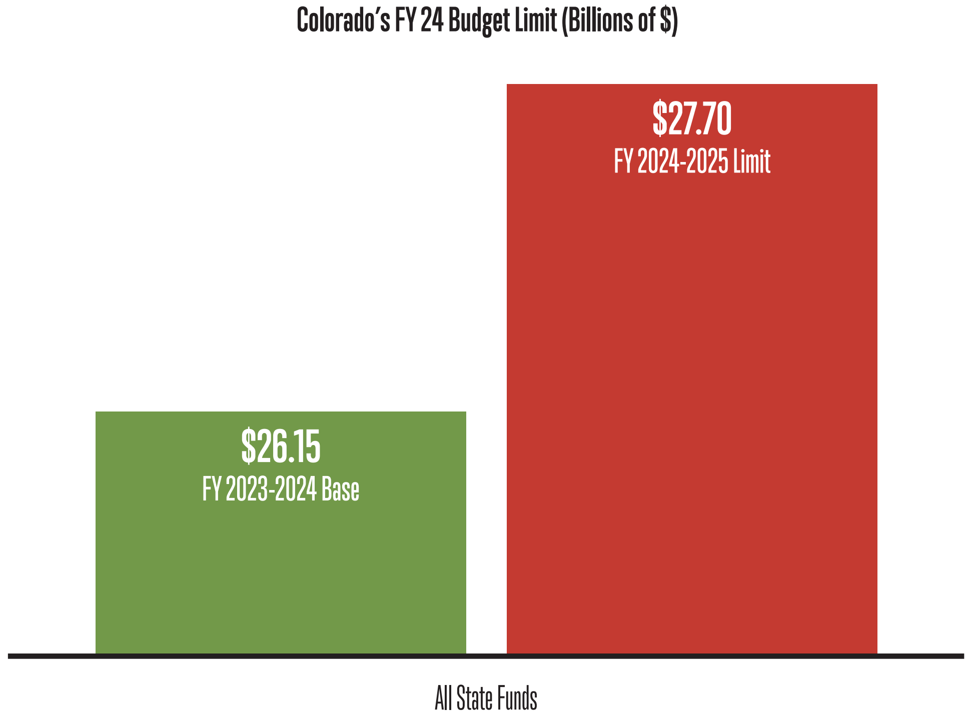
Table 2. Calculation of the Rate of Population Growth Plus Inflation

Year	Colorado Resident Population Growth	CPI-Colorado Inflation	Population Growth + Inflation Limit
2022	+1.0%	+4.9%	+5.9%

Note: Data are from the Legislative Council Staff's September 2023 forecast report.[40]

Figure 3 provides the FY 2024-25 Sustainable Colorado Budget for general fund revenue only and all state fund appropriations that increase by no more than 5.9%.

Figure 3. FY 2024-25 Sustainable Colorado Budget



Note: Budget amounts are based on data from Colorado's state budget publications,[41] Fed FRED for Colorado's resident population growth and consumer price index (CPI) for all urban consumers: all items in Denver-Aurora-Lakewood, CO,[42] and authors' calculations.

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Any increase in the rate of spending above the rate of population growth plus inflation necessarily means an increase in inflation-adjusted (i.e. "real") state government spending per person. Whether such an excessive increase in spending is financed by higher taxes, fees, or debt, this increases the tax burden on Coloradans and should be avoided. Ideally—given past spending excesses—the actual budget should grow by less, if it grows at all, to offset past excess spending and provide the maximum benefit to taxpayers.

POTENTIAL SURPLUS

The Legislative Council Staff (LCS) in Colorado, the nonpartisan economists for Colorado's Legislature, provides an economic and revenue forecast for the upcoming FY 2024-25.[43] This forecast estimates that there will be $20.9 billion in TABOR revenue and $19.1 billion in allowable spending for an expected surplus of $1.77 billion. This includes TABOR surpluses only, not surpluses generated by fidelity to the SCB.

Looking at general fund revenue only, this portion of the budget is expected to be $18.5 billion with a limitation of $15.98 billion under the Independent Institute's Sustainable Colorado Budget, resulting in a $2.5 billion surplus. While LCS does not forecast all state funds, there would be an even larger projected surplus if considering all state funds. The LCS projects a 6.6% increase to $18.5 billion in income tax collections from FY 2023-23 to FY 2024-25. The budget surpluses, which are mostly structural rather than cyclical and are excess collections of taxpayer money, should be used to reduce income tax rates to put them on a path to elimination.[44]

There will be no shortage of lawmakers eager to spend these excessive tax collections, but doing so would be a mistake. Rather than using surplus revenue to grow the government, increasing the tax burden on families and businesses, Colorado should use that surplus to permanently reduce the state's income tax rate. This will make the state more economically dynamic and competitive with other states now and in the future.

Permanently reducing the income tax rate rather than waiting each year to find out what the legislature will do with surpluses of TABOR funds or all state funds will provide more certainty for businesses looking to invest in the state. It will also provide more certainty and stability for families who each year have excess taxes withheld from their paychecks while they wait for the legislature to decide how to refund it. A permanent reduction in the rate will help prevent the legislature from continuing its practice of distributing surpluses to special interests via tax expenditures rather than refunding them to the taxpayers whose tax payments result in the surplus. In case of unforeseen revenue shortfalls, these tax rate cuts can be kept permanent through additional spending restraint and using cash funds of approximately $3 billion.

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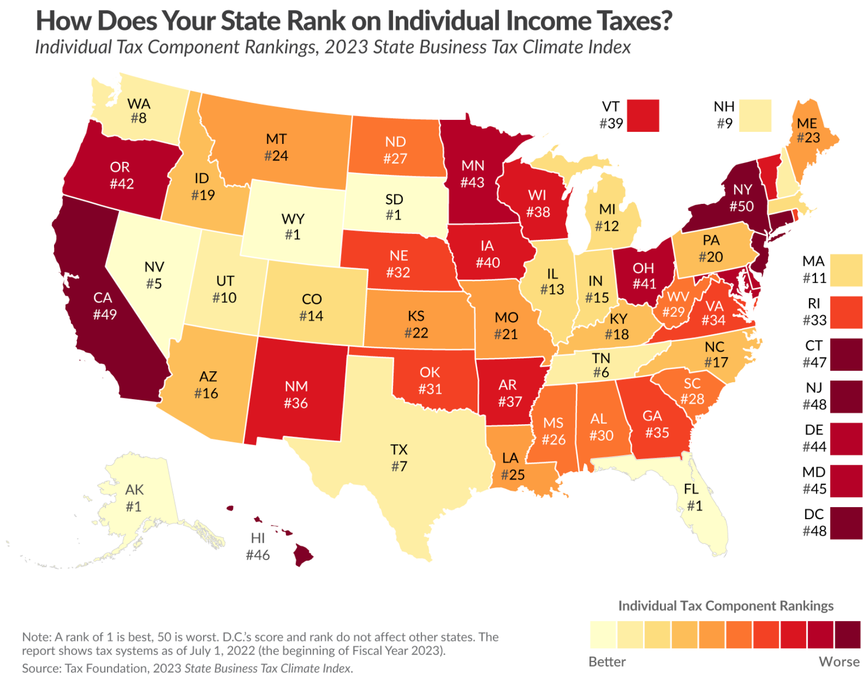
PATH TO ZERO: ELIMINATING COLORADO'S INCOME TAX

Colorado's state government has a spending problem, not a revenue problem. Median household income in Colorado rose by 32.4% in the ten-year period from 2013 to 2022, the most recent year for which the U.S. Census Bureau has published data.[45] Over the same period, the state budget grew by 59.3%, from $20.6 billion to $32.8 billion. This year, the state of Colorado passed a FY 2023-24 budget that is a staggering 26.7% larger than the FY 2021-22 budget adopted by the legislature just two years ago. Though income data does not exist to show the change in income from 2022 to 2024, there is no indication from preliminary data that Coloradans will see a similar increase in income over those two years. Moreover, the state budget has more than doubled over the last ten years.

The Sustainable Colorado Budget would place a stronger fiscal rule on legislators that represents the initial intention of TABOR–limiting the growth in most of government to the rate of population growth plus inflation. This stronger fiscal restraint would allow Colorado to deliever substantial tax relief and place sustainable controls on the future rate of increase in the tax burden and in state spending.

The first place that legislators should look for tax relief is the burdensome total income taxes with a flat tax rate of 4.4%, for which Colorado ranks 14th in the country (see Figure 4).[46] The lowest flat income tax rate could soon be in North Carolina at 2.49% after legislative changes this year.[47]

Figure 4. Colorado Ranks 14th in Personal Income Taxes



Source: Tax Foundation.[48]

To increase the state's competitiveness and, more importantly, advance the economic well-being of Coloradans, the state should put state income taxes on a path to elimination. As noted above, the state's budget of all state funds has increased substantially more than the rate of population growth plus inflation over the last decade. Based on the latest LCS economic forecast, it would take about $28.87 million in surplus funds to buy down each .01-percentage point of the 4.4% income tax rate on a static basis.[49]

Here are the tax relief options, based on the latest LCS economic forecast,[50] that were missed for TABOR surpluses or all state funds above the rate of population growth plus inflation:

- TABOR surpluses:
  - » Without requiring any reductions to the current state budget or future budgets, Colorado could have reduced its income tax rate by 0.59-percentage points to 3.81% using the $1.7 billion surplus in FY 2023-24 and by 0.615-percentage points to 3.785% using the $1.77 billion surplus in FY 2024-25.
- All State Funds:
  - » The less spending of $4.2 billion for FY 2023-24 could have cut 1.44-percentage points in the flat tax rate to 2.96%.
  - » The cumulative less spending over the last decade of $16.3 billion could have substantially reduced income taxes over time.

Without requiring any reductions to the current state budget or future budgets, Colorado could have reduced its income tax rate by 0.59-percentage points to 3.81% using the $1.7 billion surplus in FY 2023-24.

These savings to families and businesses would be substantial and support more economic activity across the state, making it more competitive with neighboring and other states. Eliminating the income tax would save the average Colorado tax filer over $5,000 annually. How long would it take for the state to eliminate income taxes over time if the state follows the Sustainable Colorado Budget and uses surplus revenue to buy down the income tax?

Using data available for general fund revenue only of $15.1 billion, it has increased by about 8% per year over time and the rate of population growth plus inflation has increased by about 4.5%, for a surplus of 3.5%. Total income taxes of $12.7 billion in FY 2023-24 has grown historically by about 3.3%. By using 75% of the expected surplus each year to permanently reduce the total income tax rate, these taxes would be eliminated by 2042. These projections, however, are based on a "static" analysis without incentive effects from lower income tax rates that would support more economic activity. This increased economic activity from "dynamic" effects would support more job growth and higher wages that would in turn result in increased state tax revenue. This would then contribute to offsetting the static revenue decline from lower income tax rates.[51,52] Moreover, we are suggesting the use of all state funds, which have a higher amount of the state's budget and, therefore, could result in substantially larger surpluses above the SCB. Including this pro-growth fiscal policy and all state funds would most likely eliminate total income taxes much faster than in 2042.

CONCLUSION

By limiting the growth of the state's budget, the Independent Institute's Sustainable Colorado Budget provides a path forward for the state which would help Coloradans to flourish.

First, Colorado should lower its income tax rate to prevent tax collections above the current TABOR limit. Rather than taking money out of taxpayers' paychecks throughout the year and returning a portion to them later, Colorado should provide certainty and stability to taxpayers by reducing the income tax rate. But because TABOR's tax and expenditure limitations have been weakened over the past three decades, it's time for Colorado to consider a more holistic approach to limiting the growth in government spending that gets back to what voters originally intended when they added TABOR to the state constitution in 1992.

State budgeters should restrict the growth in "all state funds" spending to no more than the rate of population growth plus inflation. Then the state should use surplus funds to reduce the income tax rate until it reaches zero. Had the budget been limited to this metric over time, Colorado's income tax rate could be much lower today, if not eliminated entirely. If the state legislature now adopts the Sustainable Colorado Budget, these taxes could be eliminated in less than two decades.

State budgeters should restrict the growth in "all state funds" spending to no more than the rate of population growth plus inflation. Then the state should use surplus funds to reduce the income tax rate until it reaches zero.

This pro-growth approach will provide an opportunity for substantial tax relief that will increase economic freedom and opportunity in Colorado, thereby making it a more attractive place to live, do business, and raise a family.

ENDNOTES

1 https://www.statista.com/statistics/248063/per-capita-us-real-gross-domestic-product-gdp-by-state/
2 https://www.statista.com/statistics/248053/us-real-gross-domestic-product-gdp-by-state/
3 https://www.statista.com/statistics/248058/percent-change-in-us-real-gross-domestic-product-gdp-by-state/
4 https://www.statista.com/statistics/233170/median-household-income-in-the-united-states-by-state/
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JON CALDARA is President of the Independence Institute.

DAVID KOPEL is Research Director of the Independence Institute.

BEN MURREY is Director of the Fiscal Policy Center.

VANCE GINN, PH.D., is a free-market economist who extensively evaluates policies to let people prosper while equipping lawmakers and leaders nationwide with frameworks for practical solutions to modern problems.

Ginn is the founder and president of Ginn Economic Consulting and host of his Let People Prosper Show podcast. He is also chief economist of the Pelican Institute for Public Policy and senior fellow of Americans for Tax Reform and other think tanks across the country. In these roles, he provides high-quality research and trusted insights on how to improve human flourishing with policy considerations at the federal, state, and local levels.

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