

THE IMPACT OF TAX POLICY ON RETAIL AND ECONOMIC DEVELOPMENT

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Director's Note: This report is the first publication of the newly formed Center for Tax Policy, a collaboration between the Colorado Public Expenditure Council and the Daniels College of Business, University of Denver. One of the objectives of this collaboration is to provide Daniels College graduate business students with the opportunity to participate in research projects of interest to the business community in Colorado. In the future, many other Center publications will be the result of student research. This collaboration should greatly enrich the range of topics and research perspective of our publications. We are looking forward to a rewarding collaboration.

INTRODUCTION

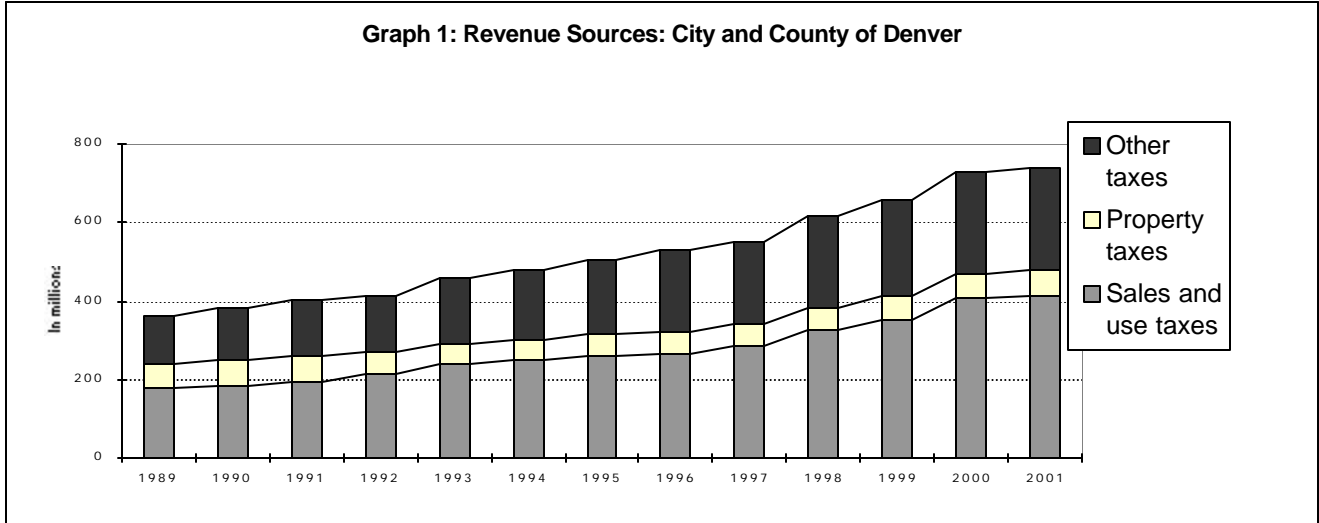
Initially, the question for this research was to investigate the effectiveness of public sector incentives on private economic development. As we soon discovered, that specific topic is as nebulous as it is complicated with roots in politics, law, and tax policy. This analysis begins by providing the reader with functional overviews of relevant municipal taxes, distinctions between retail and economic development, as well as the TABOR and Gallagher Amendments. Retail and economic development incentives are heavily influenced by Colorado's tax policy, especially since the enactments of the TABOR and Gallagher Amendments. We will illustrate that these amendments clearly have had a profound impact on retail and economic development incentives. Lastly, we pose a question: Does Colorado's tax policy encourage sprawl?

OVERVIEW OF SALES, PROPERTY AND USE TAX

Sales Tax The sales tax structure in Colorado comprises three portions: the state, city and county tax.¹ The state sales tax rate is currently 2.9%, while the city and county tax rates vary. For example, the city and county of Denver and the cities of Boulder and Aurora currently impose 3.5%, 3.26% and 3.75% respectively. Other minor components of the sales tax include the Regional Transportation District, the Scientific and Cultural Facilities District, and the Football Stadium District. For example, Denver levies a 7.2% tax on purchase price as sales tax.² The revenue structure of the city and county of Denver is detailed in Graphs 1 and 2. In looking at these statistics, we made the following observations:

¹ Colorado Department of Revenue, January 2001 [Online], available: <http://www.revenue.state.co.us/PDF/drp1002.pdf>

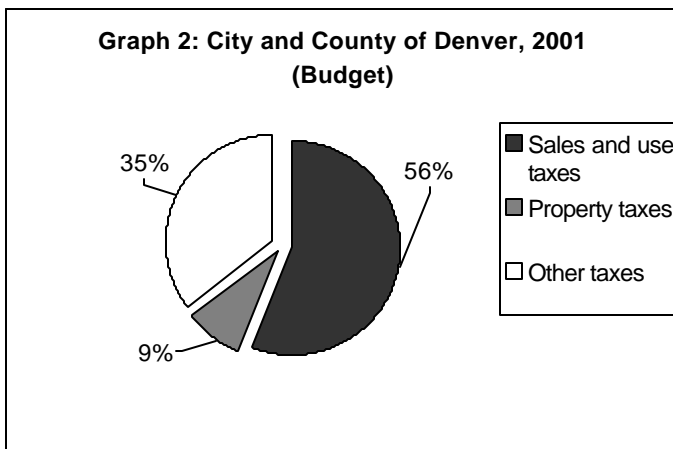
² 2.9% (state) + 3.5% (city) + 0.6% (RTD) + 0.1% (CD) + 0.1% (FD) = 7.2%



- The growth rate of sales tax revenue is higher than that of total revenue growth. The compounded annual growth rate (CAGR) of sales tax from 1993 through 2001 is 7.4% while that of total revenue in the same period is 6.2%.
- Sales tax revenue comprised 48.9% of total revenue in 1989, and increased to 56.0% in 2001. On the other hand, the fraction of property tax over total revenue decreased from 17.2% in 1989 to 8.6% in 2001.

In comparison, the tax structure of Seattle³ is found to have two major differences with that of Denver (See Graph 3). First, the proportion of sales tax to total tax revenue in Denver is more than twice that of Seattle, while its property tax is less than half of the latter⁴. We can thus conclude that sales tax revenue is of greater significance to the financial condition of Denver. Secondly, the revenue from sales tax in Washington is distributed by the state on the basis of population or per capita income; not so in Colorado, as sales tax rates are set and collected by individual cities and counties.

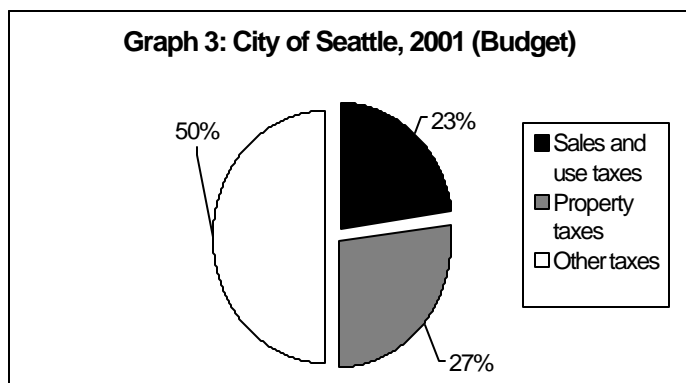
Property Tax The tax on a property in Colorado is the product of the assessed value of the property and a mill levy (tax rate). According to the city and county of Denver tax guide, the county assessor uses the market approach when assessing residential property, while all other property is valued using the cost, market and income approach. It should be noted that each



³ Seattle was chosen for its similar population and comparable budget level in terms of government funds.
⁴ The state of Washington imposes a sales tax rate (6.5%) on the sale of most goods and services, and provides Seattle with its share of this revenue on a monthly basis. Also, the proportion of sales and property tax of total taxes in Seattle is 23% and 27% respectively. Source: City of Seattle, 2001 Adopted Budget [Online], available: <http://www.cityofseattle.net/budget/0102Adopted/City%20Revenue%20Overview.pdf>

county is responsible for setting its own mill levy based on budgetary needs and applicable law⁵.

Use Tax Similar in purpose to sales tax, the use tax is generally incurred from a sale delivered into Denver by a vendor located outside the city. Consumer use tax is imposed upon the use, storage, distribution or consumption of taxable personal property and services purchased within the city.



RETAIL VERSUS ECONOMIC DEVELOPMENT

Before delving into the analysis of various incentives, it is important to understand the differences between economic and retail development. Economic development seeks to create wealth by attracting primary jobs.⁶ The Jefferson Economic Council defines a primary job as “one that produces goods and/or services predominantly for consumption outside the community. This creates outside dollars that are redistributed within the community in the form of wages. Not only does economic development create individual wealth, but it also bolsters the local tax base. Economic development is long-term in focus.

In contrast, retail development pursues wealth that has already been created. In other words, retail development targets existing disposable

income. Retail development focuses on siphoning tax revenue from other jurisdictions. For example, shoppers at the Park Meadows Mall leave their tax dollars in Douglas County despite the fact that they reside in neighboring cities and counties. Retail development is short-term in focus: life spans of malls are finite, and at some point they become obsolete. Retail development creates secondary jobs, jobs that result from supporting primary jobs. Interestingly, one local economic developer estimated the “breakeven salary” to be \$32,000: jobs that pay under \$32,000 do not generate sufficient taxes to cover the benefits received, and actually constitute liabilities to municipalities. At the risk of oversimplifying the difference, retail development pursues wealth that economic development creates.

RETAIL INCENTIVES

TIF Historically, the main retail incentive has been tax increment financing (TIF). A TIF is an additional sales tax levied over and above the standard sales tax, used to subsidize the new retail development. To issue TIFs, municipalities float coupon bonds, with coupon payments that are secured by future sales tax revenues. In order to qualify for a TIF package, the development must be located within a tax increment district (TID). Creating a TID requires municipal action to create a special district. As TIF schemes become more complicated and TIDs more arduous to create, we find that Colorado municipalities have increasingly turned to the enhanced sales tax incentive program (ESTIP).

ESTIP An ESTIP is a simplified TIF, an annually appropriated sales tax rebate. Instead of issuing bonds and providing cash payments to the developer, an ESTIP is nothing more than a rebate of a portion of the sales tax generated from the project. An ESTIP can be awarded arbitrarily regardless of location or amount, subject to local legal constraints. Essentially, the vast majority of retail incentives are derivatives of the basic sales tax rebate.

⁵ City and County of Denver Tax Guide, Department of Revenue, Treasury Division, Topic No. 65.

⁶ Jefferson Economic Council, 2001 Economic Development 101 for Government Officials [Online], available::www.jeffco.org

ECONOMIC INCENTIVES

Economic incentives can be loosely grouped into three categories: non-cash and cash equivalent, and cash incentives.

Non-cash Incentives In the words of a local economic developer, "Non-cash incentives add real value." Two non-cash incentives municipalities can offer are expedited permitting and use of existing infrastructure. Expedited permitting can significantly reduce construction time and costs. In large construction projects, municipalities have been willing to place inspectors on site, reducing the inspection process from as long as two weeks to several hours. Indeed, time is money.

Municipalities can also offer the use of existing infrastructure to induce companies to expand or relocate. For example, Fort Collins offered Anheuser-Busch the use of its waste treatment plant, saving Anheuser-Busch several million dollars.⁷ Often as was the case in the aforementioned example, municipal facilities are underutilized and therefore cost the city nothing in real terms; prior to Budweiser opening a brewery in Fort Collins, Fort Collins' wastewater plant was running well below capacity and as a result was woefully inefficient. Budweiser's use of excess capacity actually increased the plant's efficiency. Wastewater plants are only one example of existing infrastructure that might add real value to a relocating or expanding business.

Cash Equivalent Incentives Training is a cash equivalent incentive from an economic development perspective. The Neoplan bus plant in Lamar is one such example. With a combination of state and local funding, trainees were sent to Europe to learn how to assemble buses. In fact, their final exam was to build the bus that would take them to the airport.⁸

Obviously, this training ultimately represented a significant cost savings to Neoplan.

Cash Incentives These incentives include personal property and use tax rebates. Personal property taxes primarily fund school districts, but municipalities do receive a portion of the proceeds. Recall that property taxes are the product of the assessed property value and a mill levy. Property tax distribution is a function of the number of mills a particular district is entitled to. For example, a county may receive 25 mills of the property tax and a school district 56 mills. Assuming there 100 mills outstanding, the county would receive 25% of the personal property tax, and the school district would receive 56% of the personal property tax. County commissioners and school districts are allowed to rebate half of their mill allotments as an economic development incentive for a maximum of four years. One former legislator we spoke with suggested that the property tax rebate has proven to be an effective economic development tool.

Another tax rebate that municipalities can utilize is the use tax. The use tax is a tax that is applied to personal property like desks, computers, chairs etc. The use tax is often immaterial in a substantial economic development package. Furthermore, accurate use tax assessments often require extensive auditing. However, its rebate can be offered to prospective businesses to encourage relocation.

We will now examine the impact that the Gallagher and TABOR amendments have had on the retail and economic development incentives discussed above.

THE GALLAGHER AND TABOR AMENDMENTS

The Gallagher Amendment, passed by voters in 1982 in an effort to limit property taxes, limits the assessed value of residential property to 45% of the total assessed value of all the property in Colorado. Gallagher is intended to maintain the 45:55 ratio between property taxes paid by

⁷ Interview with Tom Clark, President of the Jefferson Economic Council on May 8, 2001

⁸ Interview with Tom Clark, President of the Jefferson Economic Council on May 8, 2001

residential and business taxpayers. To maintain that ratio, the state issues a new statewide assessment formula for the two classes of property every two years. However, the real value of Colorado's residential property has since then continued to grow to over 65% of the total value of state property. That fact means that the "residential assessment ratio," the value of residential property that counties are actually allowed to tax, has fallen steadily, from 21% in 1982 to about 9.7% this year. The amendment effectively subsidizes residential property owners at the expense of commercial property owners as they have correspondingly found that the "commercial assessment ratio" has increased over the years.

The Taxpayer Bill of Rights (TABOR)⁹ Amendment, narrowly adopted by Colorado voters in 1992, established tax and spending limits on state and local governments. The chief author of TABOR was taxpayer activist Douglas Bruce, and it has two key parts. One required state and local governments to ask voter approval for tax increases. Actually, most governmental units had been doing that for years anyway, either because of legal requirements or political realities. The more important part of TABOR essentially limited the growth of government budgets to the increase in population plus an allowance for inflation as calculated by the consumer price index. This formula fails to take into account a number of important factors that affect the cost of state government. These include increases in measures of workload such as school enrollment, highway usage, or other services that may exceed the growth rate of the overall population; growth in the wages and salaries paid to government employees or in the cost of contracted services after adjustment for inflation; health care inflation greater than the general rate of inflation; and other factors.

There are several other noteworthy TABOR provisions:

- Any revenue collected above the spending limits had to be refunded to the taxpayers - unless voters specifically authorized spending it. Such votes have come to be called de-Brucing elections - a rather inaccurate term since they don't undo the amendment; they merely carry out one of its provisions. As of 1998, 91% of all such elections have passed¹⁰.
- Municipalities could no longer engage in the creation of any multiple-fiscal year direct or indirect district debt or other financial obligation without adequate present cash reserves.
- Each district shall reserve for 3% or more of its fiscal year spending for emergency reserves to use for declared emergencies only.

IMPACTS ON RETAIL DEVELOPMENT

After interviewing several retail developers, we realized that the Gallagher and particularly TABOR amendments had significant impacts on retail development.

Alternative Financing Schemes The TABOR amendment's prohibition of municipalities engaging in multiyear financial obligations meant that municipalities could no longer issue bonds secured by future sales tax revenue without voter approval. Essentially, TABOR eliminated traditional TIF packages. As a result, municipalities created some alternative financing schemes. To comply with the multi-year financial obligation provision in the TABOR amendment, municipalities have had to rely on the annual appropriation of sales tax rebates. Instead of providing an upfront amount, as was the case in a traditional bond issue, municipalities now make annual payments to the retail developer.

⁹ Colo. Const. Art. X, Section 20

¹⁰ TABOR: A Guide to the Taxpayer's Bill of Rights, 1999 Edition, Colorado Municipal League.

Theoretically, those payments come from some portion of the sales tax generated from the new project. It is important to note that the above financing scheme is often not subject to voter approval or any special district requirements.

Elimination of Small Retail Developers Two retail developers we spoke with suggested that the above financing scheme had several impacts. First, we have anecdotal evidence that retail developers must have deep pockets to compete in Colorado. With the passing of TABOR, developers could no longer obtain bond issue subsidies to cover the massive upfront construction costs, but instead have to rely on promised annual payments from municipalities. For example, the city of Broomfield agreed to reimburse Wescor, a retail developer, for infrastructure improvements to the Flatiron Crossing Mall. Those improvements are estimated to cost at least \$279 million, costs that will be repaid to the Wescor over the next 21 years from sales tax receipts.¹¹ Wescor would naturally need to have the initial capital to pay for those improvements. Question to ponder: How many regional developers have that kind of money to invest? Furthermore, as a condition of the sales tax rebates, municipalities demand greater input into the development process in terms of tenant mix and project design. Often, this involvement stretches the project completion time adding to the increased cost.

Secondly, the annual appropriations are not guaranteed and therefore increase the retail developer's risk. Consider the impact of the spending growth provision in TABOR, that expenses cannot exceed inflation plus growth rate. A slowdown in growth or an under-performing retail project will result in smaller municipal budgets, budget cuts that could come in the form of eliminating sales tax rebates. In the Flatiron Crossing Mall example, payments to mall developers must be approved each year by

¹¹ Article: "Mall Subsidy Tops \$279 million", The Denver Post, April 6, 2001.

Broomfield elected officials; there is no guarantee that this will happen for the next 21 years. Financial theory states that "increased risk demands increased returns." Was TABOR intended to boost the returns of large retail developers?

IMPACTS ON ECONOMIC DEVELOPMENT

Gallagher's "Small-town" Dilemma With Gallagher's fixed property tax ratio, businesses do not find it as attractive to establish operations in mainly residential counties like Arapahoe and Jefferson compared to those that have lots of commercial property, like Broomfield and Boulder, as they have to shoulder a greater portion of the tax burden. Western slope communities that depend on one or two major employers face significant economic development challenges. "Come to our town and shoulder the majority of the property tax burden!" is not an effective economic development pitch.

Emergency Reserves While the emergency reserve provision in TABOR is a healthy fiscal measure and promotes financial responsibility among government officials, the problem remains that TABOR does not define an emergency, so governments are not sure when they can tap it. That the law requires governments that use the money to quickly replenish it renders the reserve effectively useless. The result of this is that huge amounts are sitting unused in reserve accounts: \$49 million in metro Denver¹² and \$120 million in Colorado school districts¹³ - money which could be well used for economic development purposes.

Lose-Lose Situations Former Jefferson County Commissioner John Stone has been quoted stating that the county has experienced revenue losses as a result of tax limitation measures. Stone linked the effects of the TABOR and the

¹² Article: "Public Cash Stands Idle. Voter-approved TABOR Holds Millions Hostage in Government Reserves", The Rocky Mountain News, Feb 19, 2001

¹³ Source: Phil Fox, Deputy Director of the Colorado Association of School Executives.

Gallagher Amendment, saying, "We have a really dysfunctional state tax policy."¹⁴ The effect of the Gallagher/TABOR amendments is reflected in flat residential tax assessments. Because no one county has the exact mixture of business and commercial properties that the state does, the state's 'one size fits all' formula divides them into winners and losers based upon their exact mix of retail and residential properties. But districts that gain valuation under the Gallagher formula cannot collect higher taxes - because the TABOR amendment forces them to refund the windfall. Yet districts that lose assessed valuation by the artificial shift in the Gallagher formula are stuck with the resulting revenue loss - because TABOR also prevents them from raising mill levies to offset the artificial loss in assessed valuation.

The then-governor candidate, Bill Owens, in response to The Denver Post question on his tax policy in October 98, has been quoted on the excess tax revenue that "the state should proportionately lower the sales and income tax rates to reduce the surplus." As to revising Colorado's tax structure, "Yes, particularly in regard to the Gallagher Amendment." And on public expenditure for economic development, "Yes, I think the state should play a positive role in terms of economic development."¹⁵

SUMMARY AND CONCLUSIONS

The Gallagher-TABOR vise makes Colorado municipalities increasingly reliant on retail sales tax. In turn, the quest for sales taxes fuels the bidding wars that often pit cities and counties against each other in fierce struggles to annex or develop shopping centers and other lucrative revenue sources. This chase translates into a zero-sum game, polarizing cities that have and do not have substantial retail sales. As proof of evidence, refer to the recent Broomfield vs. Boulder County court case¹⁶, which challenged

the constitutionality of Broomfield's retail financing package. In other words, the quest for retail sales creates a "mutually-assured premature obsolescence". Municipalities are encouraged to outdo the latest and greatest development. Westminster Mall, Crossroads Mall in Boulder, Aurora Mall and Villa Italia are all examples of casualties of a brutal sales tax war. It is a vicious cycle, and any form of municipal cooperation and master growth plans are inadvertently eliminated. These tugs-of-war often cause economic development plans to be shredded in hot pursuit of retail development.

Finally, we revisit the question we posed at the onset: Does Colorado's tax policy encourage sprawl? The question warrants serious consideration and further study. Colorado municipalities are overly dependent on retail sales tax. Recall the differences in revenue structure between Denver and Seattle. It is no mystery that the Denver metro area is second in the nation in retail space per person - the TABOR-Gallagher vise perpetuates that dependence. Gallagher caps the assessed value and TABOR effectively caps mill levy increases. As a result, property tax is artificially low. In other words, cities have no choice other than to chase retail projects with retail incentives. Our initial endeavor was to examine the effects of public sector incentives on economic development. What we have discovered is summarized in the opinion of a local economic developer: "Colorado's tax policy prevents effective economic development and encourages retail development." Evidence of this is found in the gross imbalance between the packages offered to Flatiron Crossing Mall and that recently proposed to Boeing - the difference is astounding. Colorado's tax policy is the issue, not public sector inducements on private economic development.

This report was prepared by graduate students at the Daniels College of Business, University of Denver.

¹⁴ Article: "Jeffco Delays Decision on Residential Project", The Rocky Mountain News, January 14, 1998.

¹⁵ Article: "What the Candidates Say", The Denver Post, October 29, 1998.

¹⁶ Boulder v Broomfield, No. 00SC73 Supreme Court of Colorado.