REGIONAL HOME OFFICE INSURANCE PREMIUM TAX RATE REDUCTION

JANUARY 2020
2020-TE7

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1959
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$89.7 million (TAX YEAR 2018)
NUMBER OF TAXPAYERS	85 (from 31 different insurance groups)
AVERAGE TAXPAYER BENEFIT	$1.1 million
IS IT MEETING ITS PURPOSE?	Yes, but only to a limited extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Regional Home Office Rate Reduction allows insurers who maintain a qualifying regional or home office in Colorado to reduce their insurance premium tax rate from 2 percent of premiums to 1 percent.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

We inferred, based on the operation of the provision and Division of Insurance Regulations, that its purpose is to increase employment in the state by encouraging insurance companies to locate regional and home offices in Colorado.

WHAT DID THE EVALUATION FIND?

We found that the Regional Home Office Rate Reduction is likely meeting its purpose of increasing employment in the State's insurance industry, but only to a limited extent. It has also likely had a positive economic impact to the state. However, its revenue impact has increased substantially in recent years without a proportionate increase in employment.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether:

- The Regional Home Office Rate Reduction is meeting its intent and establish performance expectations.
- The tax benefit that the tax expenditure provides should be tied to in-state premiums rather than other metrics more closely correlated with employment.

REGIONAL HOME OFFICE RATE REDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risks in the state. The Regional Home Office Rate Reduction [Section 10-3-209(1)(b), C.R.S.] allows insurers to reduce their premium tax liability by 50 percent if they maintain a "home office" or "regional home office" in Colorado. In 1913, the General Assembly created the initial version of this tax expenditure, which exempted insurers from premium tax if they invested 50 percent or more of their assets in Colorado property or the bonds of Colorado public sector entities. In 1959, this provision was split into two separate tax expenditures, which eventually became the In-State Investment Deduction (reviewed separately) and the Regional Home Office Rate Reduction, and the eligibility requirements underwent substantial changes in subsequent years.

Under current statute and Division of Insurance Regulations, there are two ways that an insurer can qualify as having a "home office" or "regional home office" in the state:

1 When its Colorado office "substantially performs" actuarial, medical, legal, application review, issuance of policies, information and service, advertising and publications, public relations, hiring, testing, and training of sales/service forces (or "substantially equivalent functions") for its business in three or more states in which it is licensed, or in all states in which it is licensed (if less than three). These functions comprise most insurance business operations and Division of Insurance (Division) Regulation 3 CCR 702-2-1-2 further specifies that insurers must perform at least two-thirds of these operations in Colorado in order to be eligible through this test.

2 Maintain "significant direct insurance operations" in Colorado that are supported by "functional operations which are both necessary for and pertinent to" their in-state business. Division Regulation 3 CCR 702-2-1-2 specifies that this test can be met if insurers abide by two of the following three requirements: (1) maintaining a Colorado workforce of at least 150 full-time employees (excluding agents and their staff), (2) owning or leasing at least 30,000 square feet of office space in Colorado (excluding off-site storage of claim files), and (3) spending at least $5 million in Colorado on salaries, administration, operating expenses, etc., (excluding commissions and travel/entertainment allowances).

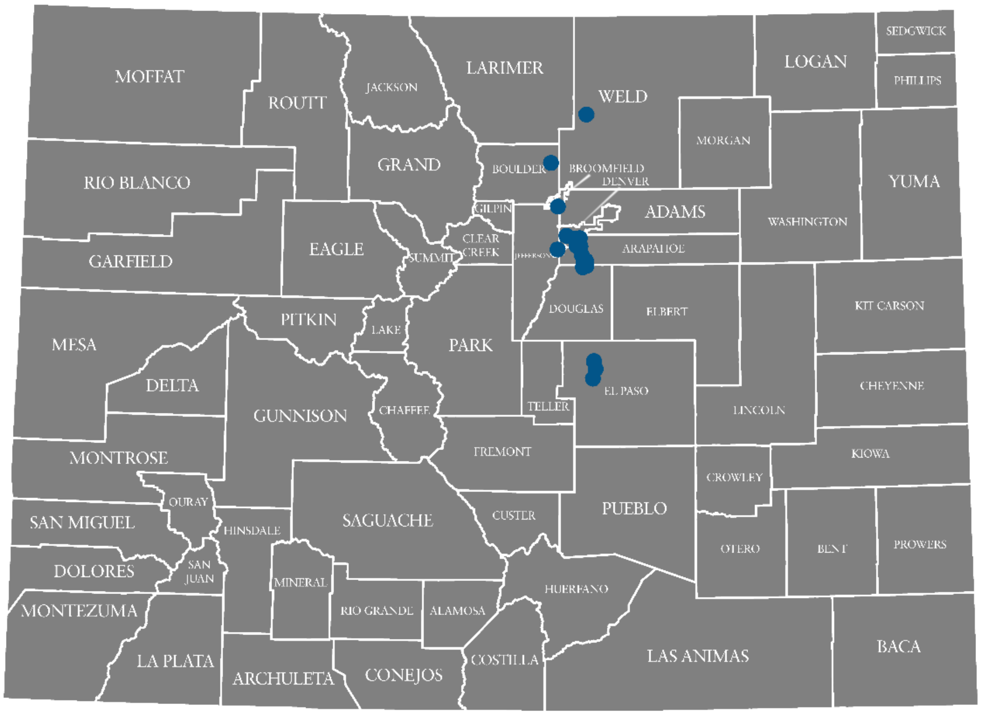
Insurers must apply for the Regional Home Office Rate Reduction every year using Division application forms, which require that they provide information about their operations showing that they qualify. There is no limit on how many insurers can be approved for the rate reduction, and insurance groups, which are typically composed of parent, subsidiary, and other affiliated insurers that each specialize in different markets, are allowed to submit one application per year for all of their affiliated insurers, as long as the performance of their affiliate insurers does not substantially vary and each individual affiliate insurer can independently meet one of the above two tests. If an insurance group is applying to qualify via the "significant direct insurance operations" test, then each of its individual insurers must uniquely meet the employee, square footage, or in-state expenditure subtests. Division staff conduct an on-site visit of each insurer's premises at least once every 5 years to ensure compliance with the eligibility requirements. Once qualified, insurers claim the rate reduction by applying a 1 percent insurance premium tax rate to their in-state insurance premiums when calculating and reporting their premium tax liability to the Division.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Regional Home Office Rate Reduction. Based on statute, legislative history, and similar provisions in other states, we inferred that the direct beneficiaries of the deduction are insurers who maintain offices in Colorado and have a significant business presence in the state. In addition, to the extent that the rate reduction encourages insurance companies to expand employment in Colorado, the workers they hire are indirect beneficiaries. According to Bureau of Labor Statistics' Occupational Employment Statistics data, in 2018, the average insurance sector employee (not including independent agents) in Colorado earned a median hourly wage of about $31 and a median annual salary of about $64,400, which was well above the median 2018 Colorado hourly wage of $20 and median 2018 Colorado annual salary of about $42,300.

In Tax Year 2018, the Division approved 85 individual insurers (74 property and casualty insurers, six life insurers, four title insurers, and one health insurer) to claim the rate reduction. Eight of these insurers qualified because their national headquarters is located in Colorado, while the rest qualified because they have regional offices in Colorado. Together, these insurers (from 31 different insurance groups) wrote $9.6 billion of the $39.3 billion in premiums (24 percent) that insurers operating in Colorado wrote in 2018, and reported hiring about 14,808 Colorado employees. EXHIBIT 1.1 shows a map of these 31 insurance groups' "regional home offices," which are all located along the Front Range.

EXHIBIT 1.1. LOCATION OF REGIONAL HOME OFFICES OF INSURERS THAT CLAIMED THE RATE REDUCTION
TAX YEAR 2018



SOURCE: Office of the State Auditor created map using Division of Insurance data.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Regional Home Office Rate Reduction. We inferred, based on the operation of the provision and Division regulations, that its purpose is to increase employment in the state by encouraging insurance companies to locate regional and home offices in Colorado. This aligns with Division regulation 3 CCR 702-2-1-2, which specifies that the rate reduction's intent is "to provide a tax incentive for insurance companies to bring employment to the State of Colorado through the establishment of home or regional home offices…in the state."

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Regional Home Office Rate Reduction is meeting its purpose, but only to a limited extent, based on our review of insurance industry economic data, information from stakeholders, and academic research on insurers' employment and location decisions.

Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measures to determine the extent to which it is meeting its inferred purpose:

PERFORMANCE MEASURE #1: *Has the **REGIONAL HOME OFFICE RATE REDUCTION** caused insurers to increase the number of insurance industry employees in Colorado?*

RESULT: We found that the rate reduction may be increasing the number of insurance company employees in Colorado, but to a limited extent. As discussed, insurers who claimed the rate reduction reported employing about 14,808 employees in Colorado as of Calendar Year 2018, which represents 66 percent of insurance industry employees in the state. Employment in the insurance industry (not including brokerages and agencies) has grown by about 26 percent in the state from 1990 through 2018, which is less than overall job growth of 82 percent across all private sector industry sectors. We lacked information necessary to quantify how many of the insurance industry jobs were created or maintained due to the Regional Home Office Rate Reduction, as opposed to being jobs that insurers would have provided regardless of the rate reduction. However, we identified several factors indicating that, although the rate reduction may increase employment to some degree, its impact appears relatively small in comparison to the total jobs reported by participating insurers.

First, we found that the rate reduction has not caused Colorado to have a significantly higher concentration of insurance industry employees than other states. To assess the concentration of insurance industry jobs in Colorado, we used "location quotients," as compiled by the Bureau of Labor Statistics. Location quotients are a measure of the relative size of a particular industry in a state compared to the average concentration of that industry in the U.S. Location quotients that are:

- *Greater than 1*—mean that the particular industry characteristic (i.e., employment, number of business establishments, wages, etc.) is relatively more highly concentrated in the state than the national average.

- *Exactly 1*—mean that the industry characteristic is concentrated at the same rate in the state as the national average.
- *Less than 1*—mean that the industry characteristic is concentrated in the state below the national average.

EXHIBIT 1.2 compares the employment location quotients of Colorado's insurance sector from 1990 (as far back as state-level data exists) to 2018. As shown, Colorado has had only a slightly higher concentration of insurance sector employees than the national average and this level has remained relatively constant over the last three decades. The 2018 employment location quotients of the "Insurance Carriers" sector in other states vary considerably, from 0.23 in the District of Columbia and Alaska to 2.26 in Iowa and 3.26 in Connecticut. Notably, among neighboring states, Nebraska has a higher employment location quotient than Colorado (1.98) yet it does not have a similar tax expenditure.

EXHIBIT 1.2. EMPLOYMENT LOCATION QUOTIENTS OF COLORADO'S INSURANCE SECTOR CALENDAR YEARS 1990 THROUGH 2018

Year	Employment Location Quotient of Insurance Sector in Colorado
1990	1.04
1995	1.03
2000	1.10
2005	1.10
2010	1.02
2015	1.05
2018	1.05

SOURCE: Bureau of Labor Statistics data.

Second, our review of insurance industry employment in the states surrounding Colorado indicates that there is not a clear relationship between employment growth in surrounding states and whether those states have a similar rate reduction. Specifically, we reviewed insurance industry growth in Colorado and neighboring states from Calendar Years 1990 to 2018, as a percentage of overall population growth in each state.

We found that New Mexico had the largest insurance industry growth during that period (292 percent), but does not have a similar tax expenditure, while Oklahoma, a state with a similar rate reduction, saw a significant decline in insurance sector employment (-58 percent). While Colorado and Arizona, which both offer a rate reduction, performed relatively better than surrounding states, the extent to which the rate reductions drove this performance is unclear. Furthermore, with the exception of New Mexico, the growth in insurance industry employment lagged significantly behind overall population growth in each state. EXHIBIT 1.3 shows the increase in insurance sector employees in Colorado and neighboring states between Calendar Years 1990 and 2018, based on data from the U.S. Bureau of Labor Statistics' *Quarterly Census of Employment and Wages*, as a percentage of overall population growth reported by the U.S. Census Bureau. This method of comparison accounts for fluctuations in employment that would be attributable to population growth in each state.

EXHIBIT 1.3. INSURANCE INDUSTRY GROWTH IN COLORAD AND NEIGHBORING STATES AS A PERCENTAGE OF POPULATION GROWTH RATE CALENDAR YEARS 1990 THROUGH 2018

STATE	DOES STATE HAVE A SIMILAR TAX EXPENDITURE?	PERCENTAGE GROWTH: CHANGE IN NUMBER OF INSURANCE INDUSTRY EMPLOYEES AS A PERCENTAGE OF POPULATION GROWTH (1990-2018)
New Mexico	No	292%
Arizona	Yes	50%
Colorado	Yes—RHO	35%
Utah	No	24%
Wyoming	No	16%
Nebraska	No	3%
Oklahoma	Yes	-58%
Kansas	No	-152%

SOURCE: Office of State Auditor analysis of data from the U.S. Census Bureau and Bureau of Labor Statistics.

Third, because state premium taxes are a relatively small cost to insurers, in comparison to their overall employment costs, it is likely that the rate reduction was not the deciding factor for most insurers' employment decisions. For example, based on the 2018 average insurance industry salary of $88,000 in Colorado and average U.S. insurance industry employee benefits (which are equivalent to 34.5

percent of total compensation based on Bureau of Economic Analysis data), we estimate that the average annual cost to hire an insurance industry employee in Colorado is about $134,000. Based on this amount, we estimate that total labor costs for the 14,808 employees employed by qualifying insurers are about $2 billion annually. In comparison, the $89.7 million in premium taxes we estimate these insurers saved in Tax Year 2018 due to the rate reduction is about 5 percent of employee costs.

Although we found evidence that the Regional Home Office Rate Reduction has had a relatively small impact on hiring, we found academic research indicating that it may influence some insurers' employment decisions to some degree. Specifically, one study that examined the relationship between premium tax liabilities and the size of states' insurance sectors found that a higher insurance premium tax rate has a negative effect on state employment in the property-casualty insurance industry (*The Effect of Insurance Premium Taxes on the Interstate Differences in the Size of the Property-Casualty Insurance Industry*, by Grace/Sjoquist/Wheeler). One reason for this is that the insurance premium tax generally imposes a larger tax burden on insurers than if they were subject to their state's corporate income tax, and thus, insurers may be more responsive to interstate differences in tax rates. Two other studies—*The Effect of Premium Taxation on U.S. Life Insurers*, by Grace and Yuan; and *The Impact of State Taxation on Life Insurance Company Growth*, by William Wheaton) examined the effect of the premium tax on life insurers, and both found that increases in a state's effective premium tax rate led to modest reductions in some life insurers' asset growth. The Grace and Yuan study further found that premium tax increases also led to small reductions in some life insurers' employee salaries. This evidence suggests that premium tax rates might have an effect on their employment levels as well.

Our survey of insurance companies that claimed the rate reduction also indicates that it has an impact on some insurers' employment decisions. Specifically, we surveyed the 31 insurance groups that account for all 85 insurers who claimed the exemption. Of the 12 groups that responded, 10 indicated that the rate reduction had a meaningful impact on their operations in Colorado, and two were not sure. Furthermore, four of eight insurers who responded to the question: "Has the Regional Home Office Rate Reduction increased the number of net new employees that your company has hired in Colorado?" indicated that the rate reduction resulted in them hiring additional employees, three said no, and one was unsure. Similarly, several of the insurance stakeholders we spoke to indicated that the rate reduction is beneficial and provides an incentive for maintaining or increasing insurers' employees based in Colorado. One Colorado stakeholder said that the rate reduction is a "critical piece" for the industry, although another had not heard about it and was unsure about whether such tax incentives are necessary.

PERFORMANCE MEASURE #2: *Has the **REGIONAL HOME OFFICE RATE REDUCTION** increased the number of insurers who establish home or regional home offices in Colorado?*

RESULT: We found that the rate reduction may increase the number of insurers who establish home or regional home offices in Colorado, but only to a small extent. As of Calendar Year 2018 there were 85 insurers with qualifying home or regional home offices in Colorado. Although we lacked data to quantify how many of these insurers chose Colorado or maintained their regional or home office in Colorado due to the Regional Home Office Rate Reduction, we found evidence that other factors are likely more important to insurers in making location decisions.

We found that Colorado has a lower concentration of insurance business establishments than other states, many of which do not have a similar rate reduction, which suggests that the rate reduction has not made the state more competitive relative to other states in attracting insurance business establishments. Specifically, to assess the concentration of insurance offices in Colorado compared to other states, we reviewed the location quotients that correspond to the average number of insurance sector establishments in the state, as measured by the Bureau of Labor Statistics' *Quarterly Census of Employment and Wages*, from 1990 (as far back as state-level data exists) to 2018. Overall, as shown in EXHIBIT 1.4, we found that since

1990, the relative concentration of insurance-sector business establishments in Colorado has decreased substantially, and that in 2018, Colorado had a lower concentration of insurance establishments than the average state, and the 10th lowest out of all states.

EXHIBIT 1.4. AVERAGE NUMBER OF BUSINESS ESTABLISHMENTS LOCATION QUOTIENTS OF COLORADO'S INSURANCE SECTOR CALENDAR YEARS 1990 THROUGH 2018	
YEAR	AVERAGE NUMBER OF BUSINESS ESTABLISHMENTS LOCATION QUOTIENT OF INSURANCE SECTOR IN COLORADO
1990	1.51
1995	1.06
2000	1.01
2005	1.12
2010	1.09
2015	0.87
2018	0.80
SOURCE: Bureau of Labor Statistics data.	

Although we could not quantify the impact of the Regional Home Office Rate Reduction on the concentration of insurance establishments in the state, Colorado's below average location quotient for the insurance sector in Calendar Year 2018, coupled with the fact that 31 states with higher insurance business establishment location quotients in 2018 do not have a similar tax expenditure, indicates that factors other than tax incentives are driving insurance companies' location decisions. Other states' 2018 location quotients varied significantly, from 0.56 in California to 2.52 in Iowa. Among neighboring states, Colorado had the lowest 2018 location quotient.

Nebraska, Arizona, Texas, and Iowa have become known as insurance hubs, partly due to a number of high-profile insurer relocations and/or expansions within those states. Based on a review of publications, stakeholders attribute a variety of reasons for the insurance sector's growth in these four states, including not only low tax burdens but also regulatory systems viewed as favorable by industry, a lower cost of living for staff, educated workforces, a perceived high quality of life, and, in Iowa's case, rules that allow life insurers to draw down their reserves without being liable for federal income tax.

We also compared Colorado's growth in the number of insurance industry establishments with growth in surrounding states. As shown in EXHIBIT 1.5, since 1990, Colorado, as well as most surrounding states, has experienced a decrease in the percentage growth in the number of insurance industry establishments, though Colorado's decrease has been larger than most surrounding states. Furthermore, although Arizona has experienced the most growth in establishments and has a similar tax expenditure, Colorado and Oklahoma have seen substantial decreases despite providing a rate reduction for insurers with in-state regional home offices.

EXHIBIT 1.5. INSURANCE INDUSTRY BUSINESS ESTABLISHMENT GROWTH IN COLORADO AND NEIGHBORING STATES
CALENDAR YEARS 1990 THROUGH 2018

STATE	DOES STATE HAVE A SIMILAR TAX EXPENDITURE?	PERCENTAGE GROWTH IN NUMBER OF ESTABLISHMENTS
Arizona	Yes	76.6%
Nebraska	No	24.7%
Utah	No	23%
New Mexico	No	-1.1%
Wyoming	No	-30%
Oklahoma	Yes	-33.1%
Colorado	Yes—RHO	-38.9%
Kansas	No	-44.7%

SOURCE: Office of the State Auditor analysis of data from the U.S. Census Bureau and Bureau of Labor Statistics.

In addition, because most insurers in Colorado operate across multiple states and Colorado's premium tax only applies to in-state premiums, the rate reduction may be less meaningful to insurers that receive most of their premiums outside the state. According to data from the Division and the National Association of Insurance Commissioners, only about 4 percent of the total U.S. premiums of the 85 insurers that claimed the rate reduction in 2018 came from Colorado business. Thus, most of these insurers appear less likely to be incentivized to move their offices to Colorado or expand their existing Colorado offices by a rate reduction since it only applies to a small fraction of their overall business.

We also reviewed academic studies, which have generally found that tax levels do affect firm location choices in the insurance industry, but that firms do not necessarily locate to minimize their taxes. A 2006 analysis of life insurers by Michael McNamara, Stephen Pruitt, and David Kuipers found that lower premium taxes was a significant reason that drove insurers to re-domesticate in a new state between 1980 and 2004. Similarly, a 1995 analysis of state tax rates and locational decisions of property and casualty insurers by Kathy Petroni and Douglas Shackelford, published in the *Journal of Accounting and Economics*, found that a reduction in a state's premium tax rate does result in a small number of additional multistate insurers domiciling in the state. However, the study also found that other factors, such as a state's insurance regulatory stringency or population, were relatively more important. A more recent 2019 analysis by Martin Grace and David Sjoquist, published in the journal *Risk Management and Insurance Review*, found that only about 5 percent of property and casualty insurers were domiciled in the state that minimizes their premium taxes (domiciling in a state usually also involves opening up an office and maintaining a certain level of operations there), indicating that tax rates are likely not the most important factor for insurers when deciding their state of domicile.

Also, even though Colorado's state-level premium tax rate of 2 percent is near the national average premium tax rate that states levy on insurers, in the Grace and Sjoquist study mentioned previously, the study found that when including state premium taxes, local government premium taxes, licenses, and fees, Colorado has the fifth lowest effective premium tax rate in the nation. This suggests that, even for insurers with a greater portion of their premiums coming from Colorado, the rate reduction may not have a large effect on insurers' decisions on whether to stay or expand in Colorado or open an office in the state, because the State's taxes on insurance premiums are already relatively low.

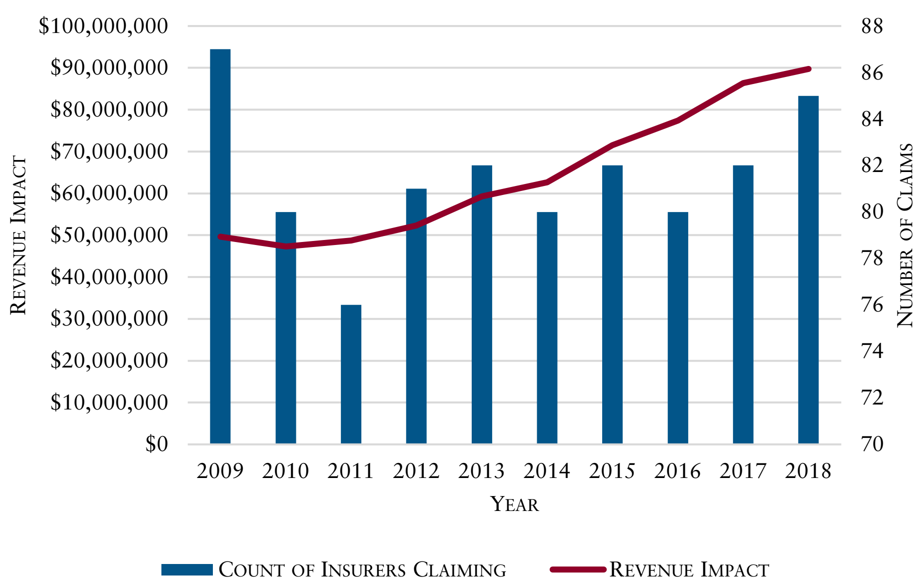
Overall, stakeholders indicated that the Regional Home Office Rate Reduction encourages insurance companies' to locate, expand, or maintain operations in Colorado to a limited extent, though other factors may be more important. For example, the Division highlights the benefits of the rate reduction when it speaks to insurers considering moving to or expanding in Colorado and says it has had a beneficial effect. However, the Division also indicated that the rate reduction is only one of several factors it uses to bring about such moves or expansions, and it is not the biggest factor. In addition, one insurance industry representative we spoke to mentioned the importance of the rate reduction in a business incentive landscape where other states in the region—particularly Arizona—are also competing for the regional or home offices of many of the same insurers. However, another stakeholder did not stress as much the importance of any one tax expenditure geared towards influencing insurers' locational decisions, such as the rate reduction, but instead the "cumulative effect" of it in conjunction with other tax credits. A third stakeholder indicated that while the rate reduction is "great in the conversation," it might not be large enough to "push the needle."

This feedback corresponded with some of the results of our survey, to which 12 of the 31 insurance groups that claimed the rate reduction in 2018 responded. Respondents indicated that the rate reduction is only one of many factors that insurers consider when deciding where to locate an office, as well as how many employees to hire. Other factors insurers consider when making such decisions include the location of policyholders/insureds whose accounts they must service, how geographically beneficial a new location would be in relation to the company's other offices, the level of qualifications and education of the workforce, and the insurer's relationship with the state's insurance regulator. Overall, none of the survey respondents said that the rate reduction encouraged them to locate in Colorado, three indicated that it encouraged them to expand their Colorado regional home office and seven indicated that it encouraged them to maintain their Colorado regional home office.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

In Tax Year 2018, the Regional Home Office Rate Reduction reduced the insurance premium taxes collected by the State by $89.7 million, which is equivalent to the amount that the 85 different insurers (representing 31 different insurance groups) claimed. The amounts claimed per insurer varied depending on the amount of their Colorado business, and ranged from $6,800 to $8.9 million, with an average of $1.1 million in tax savings per insurer and $2.9 million per insurance group. EXHIBIT 1.6 shows that the number of insurers claiming the rate reduction has remained generally consistent between Tax Years 2009 and 2018, ranging from a low of 76 (from 30 different insurance groups) in 2011 to a high of 87 (from 38 different insurance groups) in 2009. However, the rate reduction's revenue impact has nearly doubled since Tax Year 2011, when it was $48.7 million. This is because insurers claiming it have increased their Colorado business significantly since then, from $6.5 billion in premiums in 2011 to $9.6 billion in 2018.

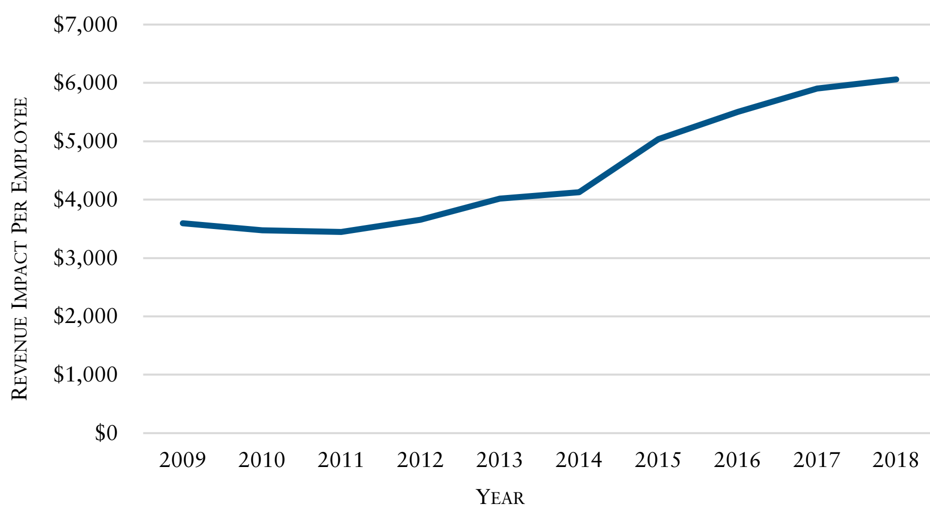
EXHIBIT 1.6. NUMBER OF CLAIMS AND REVENUE IMPACT OF REGIONAL HOME OFFICE RATE REDUCTION CALENDAR YEARS 2009 THROUGH 2018



SOURCE: Office of the State Auditor analysis of Division of Insurance data.

Furthermore, although the benefit insurers receive from the rate reduction has increased substantially in recent years, the number of their in-state employees has grown more slowly, from 14,003 in 2009 to 14,808 in 2018 (6 percent), an average of 20 new employees for each participating insurance group during the period. In addition, this modest increase in employees of insurers claiming the rate reduction has not been consistent across insurers, with 8 of the 28 (29 percent) insurance groups that received the rate reduction throughout those years reducing employment. This has resulted in a substantial increase in the revenue impact to the State relative to the total number of employees insurers claiming the rate reduction reported, indicating that the rate reduction has become less cost effective for the State. EXHIBIT 1.7 shows the Regional Home Office Rate Reduction's revenue impact to the State for every employee reported by insurers claiming the rate reduction for Calendar Years 2009 through 2018; the revenue impact per employee increased from $3,543 in 2009 to $6,060 in 2018, a 71 percent increase.

EXHIBIT 1.7. REGIONAL HOME OFFICE RATE REDUCTION'S REVENUE IMPACT PER REPORTED EMPLOYEE, CALENDAR YEARS 2009 THROUGH 2018



SOURCE: Office of the State Auditor analysis of Division of Insurance data.

In addition, due to the substantial increase in the rate reduction's revenue impact from Calendar Year 2009 through 2018, with relatively modest job gains, the growth in jobs reported by participating insurers has come at a relatively high cost to the State. Specifically, insurers reported an additional 805 employees during this period while increasing the rate reduction amount claimed by $40.1 million, which is equivalent to an increased cost of about $49,800 per additional job reported over the period.

Further, because most of the jobs reported by participating insurers would likely exist regardless of the rate reduction, we assessed the cost effectiveness of the rate reduction by calculating the potential cost to the State for every additional Colorado employee hired or maintained by insurers due to the Regional Home Office Rate Reduction (i.e., employees who would not have been hired or maintained but for the incentive provided by the rate reduction). Although we could not quantify the percentage of insurance sector activity caused by the Regional Home Office Rate Reduction, our review of economic studies indicates that business incentives that provide a tax benefit similar to the rate reduction can increase long-term business activity while tax incentives tied directly to investment or employment increases are generally more economically impactful than rate reductions that do not require increases in these business activities, such as the Regional Home Office program. For this reason we performed our analysis based on the assumption that between 5 and 20 percent of the 14,808 jobs reported by insurers that claimed the rate reduction would not exist in Colorado if the rate reduction had not been available.

EXHIBIT 1.8. REGIONAL HOME OFFICE RATE REDUCTION COST-EFFECTIVENESS ANALYSIS BY INCENTIVIZATION LEVEL TAX YEAR 2018

Percent of RHO Insurers' Reported Jobs Attributable to the Rate Reduction	Number of Colorado Jobs Attributable to Rate Reduction	Amount of Rate Reduction Claimed (in millions)	Annual Cost to State Per Job
5%	740	$89.7	$121,216
8%	1,185	$89.7	$75,696
10%	1,481	$89.7	$60,567
12%	1,777	$89.7	$50,478
15%	2,221	$89.7	$40,387
20%	2,962	$89.7	$30,284

SOURCE: Office of the State Auditor analysis of Division of Insurance data.

As shown the Regional Home Office Rate Reduction can be seen as more or less cost effective depending on the percentage of insurers' Colorado employment attributable to the rate reduction, with the rate reduction being more cost-effective the more it incentivizes hiring and maintaining Colorado employees.

Additionally, to assess the broader impact of the rate reduction on the

State's economy, we conducted an economic impact analysis of the rate reduction for each incentivization scenario in EXHIBIT 1.8 above using IMPLAN, an input-output economic modeling software. For each scenario, we calculated the potential number of jobs supported (including jobs indirectly supported, which may not be within the insurance industry) and additional economic output created due to the additional employees hired or maintained as a result of insurers being incentivized by the rate reduction. We also included the value of the rate reduction itself, discounted based on the assumption that insurers would spend the same portion of their tax savings in Colorado as the percentage of their overall U.S. premiums which come from Colorado business. We arrived at the figures shown by modeling the economic impact of insurers increasing their Colorado operations by an amount proportional to the amount of employees they hired or maintained because of the rate reduction shown in EXHIBIT 1.8. The results of our analysis are shown in EXHIBIT 1.9.

EXHIBIT 1.9. IMPLAN ANALYSIS OF ECONOMIC IMPACTS OF REGIONAL HOME OFFICE RATE REDUCTION, TAX YEAR 2018

PERCENTAGE OF EMPLOYEES INCENTIVIZED BY RATE REDUCTION	IMPACTS OF RATE REDUCTION	
	TOTAL JOBS SUPPORTED[1]	ECONOMIC VALUE-ADDED (IN MILLIONS)
5%	2,564	$324.1
8%	4,102	$518.5
10%	5,127	$648.1
12%	6,153	$777.7
15%	7,691	$972.2
20%	10,254	$1,296.2

SOURCE: Office of the State Auditor analysis of Division of Insurance data.
[1] "Total Jobs Supported" does not necessarily represent new permanent jobs added to the state because the IMPLAN model combines both jobs created and jobs maintained.

As shown even at relatively low incentivization levels the Regional Home Office Rate Reduction appears to provide a substantial economic impact. To provide a point of comparison, we used IMPLAN to estimate the economic impact if instead of offering the rate reduction, the State collected these funds and provided a general refund to taxpayers. We found that this would result in about $63.6 million in economic value-added and would support about 716 jobs. However, these models do not reflect the lost economic activity as a result of the State receiving less revenue and spending less due to the rate reduction because we lacked data to provide a comparable model showing the impact of state spending. Additionally, it is important to note that some of the job growth reported by participating insurers may have come at the expense of job losses at non-participating insurers and businesses in other sectors. However, we could not quantify this potential impact and did not include it in our analysis above; therefore, it is possible that our analysis overstates the cost effectiveness of the rate reduction to some extent.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Regional Home Office Rate Reduction would result in a higher tax burden for the 85 insurers claiming the rate reduction, who would have seen their overall Colorado premium tax liability double from $89.7 million to $179.4 million, based on Tax Year 2018 data.

The impact to insurers would be reduced to the extent that the insurers pass part (or all) of their additional premium tax payments on to policyholders. As mentioned above, several respondents to our insurer survey indicated that the rate reduction has allowed them to offer policyholders lower rates, and staff from three different insurance companies indicated that without the rate reduction, policyholders would pay higher rates. However, based on our review of economic indicators showing market concentration, Colorado's property-casualty and life insurance markets are competitive, so insurers would likely face pressure to maintain their rates and would have to instead, absorb some of the additional tax cost instead of passing it on to consumers.

In addition, to the extent that the rate reduction encouraged insurers to create or maintain jobs in the state, eliminating it could result in insurers reducing their staffing levels in Colorado. However, many of the insurers who take the rate reduction have been established in the state for many years and would incur significant expenses in shifting operations to other states, so it is likely that any impact to employment in the state would occur gradually.

Eliminating the rate reduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the rate reduction would increase the effective tax rate of these 85 insurers, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled insurers. By similar logic, eliminating the rate reduction might additionally result in Colorado receiving less retaliatory tax from out-of-state insurers since the effect of removing it would be to reduce the difference between Colorado's effective tax rate for out-of-state insurers and other states' effective tax rate for Colorado insurers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 other states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, 23 jurisdictions have tax expenditures for businesses that make required levels of in-state hiring and/or capital investment (not including place-based economic development tax incentives), with 12 of them specifically targeted towards insurers. Of these 12 other states, Alabama, Arizona, Arkansas, Delaware, Florida, Hawaii, Nevada, North Dakota, Oklahoma, and South Dakota have tax expenditures similar to the Regional Home Office Rate Reduction. Alabama's and South Dakota's are structured as deductions, and Arizona's, Arkansas', Delaware's, Florida's, Hawaii's Nevada's, North Dakota's, and Oklahoma's are structured as credits. In addition, Delaware's is limited to insurers domiciled in the state, and North Dakota's applies to property tax paid on the insurer's in-state office.

There have been some recent efforts to make changes to similar expenditures in other states. Due to cost concerns, the Arkansas Legislature recently limited its credit to 50 percent of insurers' premium tax liability (reduced from 80 percent) to be phased in from 2020 to 2023. In addition, Nevada's credit, which is capped at $5 million, sunsets at the end of 2020. Finally, during the last decade there have been several unsuccessful attempts to repeal Florida's credit, which is equal to 15 percent of salaries paid to insurers' in-state employees and likely the biggest in the country, with an annual revenue impact of nearly $300 million.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE IN THE STATE?

In 1986, the General Assembly created the Enterprise Zone Program, which is comprised of a number of tax credits and a sales tax exemption for businesses that locate, invest, and hire in parts of the state with relatively high unemployment rates, low per capita income, and low population growth rates. Even though they are not liable for state income tax, Colorado insurers are also able to claim these tax expenditures and use them to reduce their premium tax liability. However, insurers have not frequently claimed enterprise zone credits in recent years. Since 2005, there have been only 35 separate claims by insurers that have reduced their collective premium tax liability by about $664,000, or about $19,000 annually on average, through enterprise zone credits.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Division's data on employment by participating insurers, which is drawn from insurers' rate reduction applications, application reviews, and site visits, did not have complete information on the number of employees hired by insurers claiming the rate reduction in all years for four of the 87 insurers, impacting four of the 10 years in our analysis. As a result, though this is unlikely to have a major impact on the job figures we used for our analysis, the data we present on the in-state employee counts of insurers claiming the rate reduction was based on incomplete job totals for some years.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE

REGIONAL HOME OFFICE RATE REDUCTION IS MEETING ITS INTENT AND ESTABLISH PERFORMANCE EXPECTATIONS TO ASSESS ITS EFFECTIVENESS. As discussed above, although Division regulations indicate that the purpose of the rate reduction is to encourage insurers to locate offices in the state and increase employment, statute does not state the purpose of the rate reduction or provide performance measures to define the General Assembly's intent regarding the provision's impact. Overall, we found evidence that the rate reduction likely has a relatively small impact on employment in the insurance industry in the state, but that due to the size of the State's insurance industry, even a small increase in employment is likely to lead to a significant positive economic impact. On the other hand, we found that the provision had a revenue impact to the State of about $89.7 million and a revenue impact per employee of $6,060 in Calendar Year 2018, which has grown substantially in recent years. Because of this, the General Assembly may want to review this provision to ensure that it is meeting its intent and consider amending statute to clarify its intent and include performance measures for the provision, which would aid future evaluations.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE TAX BENEFIT PROVIDED UNDER THE REGIONAL HOME OFFICE RATE REDUCTION SHOULD CONTINUE TO BE TIED TO IN-STATE PREMIUMS RATHER THAN OTHER METRICS MORE CLOSELY CORRELATED WITH EMPLOYMENT. As discussed above, the provision's revenue impact to the state has grown by 81 percent from Calendar Years 2009 to 2018, while insurers who took the reduction increased employment in the state by 6 percent during the same period. This has occurred because, as a rate reduction, the provision's revenue impact to the State and the benefit provided to insurers is tied to overall insurance premiums collected and not increases in employment or employee payroll. Our review of other states found that Arizona, Arkansas, Delaware, Florida, and Oklahoma structure similar tax expenditures for insurers as credits, tied to the number of insurers' employees or employee payroll they have in the state. This structure may provide a closer link between the tax benefit provided by the provision and the intended outcome of increased employment.