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33 Whitney Avenue
New Haven, CT 06510
Voice: 203-498-4240
Fax: 203-498-4242
www.ctvoices.org

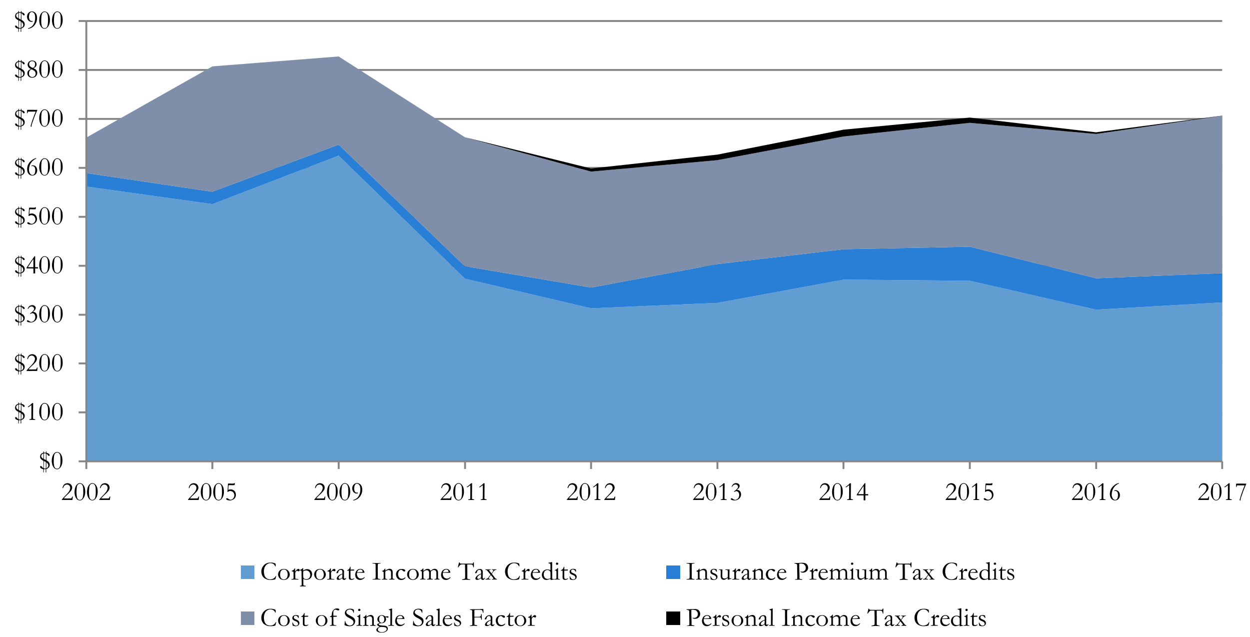
The Cost of Business Tax Breaks in Connecticut

Derek Thomas, M.P.A. April 2017

Connecticut, like all states, employs two primary sets of tools to develop its economy: strategic investments and financial incentives. The first toolkit focuses on people, places, and things: strategic General Fund investments in human capital and infrastructure that provide businesses with an educated workforce, roads to transport their goods, and other benefits.[1] The second, perhaps more obscure to most citizens, consists of financial incentives that states allocate to grow or retain jobs in existing industries and spur investment in and development of new ones. These incentives come in the form of direct aid, such as discounted loans and grants, and business tax breaks, such as tax credits, which reduce the tax liability for investors, industries, and individual firms.

This report examines the cost of business tax breaks, which unlike spending on education and health care, are not subject to regular review and public scrutiny. A more efficient, transparent, and fair budget process would require regular review of all economic development incentives, a fully transparent Tax Expenditure Report from the Office of Fiscal Analysis (OFA), and corporate tax disclosure. Such changes would enable policymakers and the public to determine if all tax expenditures are yielding the promised economic development benefits. According to available data, over the last 15 years, **the cost of business tax breaks increased by 7 percent — from $661 million to $707 million (2017 dollars).**[2]

Cost of Business Tax Breaks, FY 2002 through FY 2017 (millions)



CT Voices analysis of state budget trends and OFA tax expenditure reports (2017 data are estimated). Missing years on x-axis due to no tax expenditure report produced. Business tax breaks peak in FY 2009 following enactment of tax credits for film production in 2006. Inflation-adjusted using CPI-AUC seasonally adjusted annual averages 2008 - 2016. 2017 based on estimate growth of 0.5% and 2.1%

CONNECTICUT'S WORKFORCE INVESTMENTS PAY

When business organizations assess the business climate of any given state, they look to a broad range of economic measures, from taxes to workforce preparedness to infrastructure. Because labor costs account for a much higher share of the cost of doing business than taxes, state policies aimed at creating an educated and productive workforce may provide a greater return on investment than tax breaks. Indeed, according to a report prepared by Ernst & Young for the Council on State Taxation, a trade association consisting of more than 600 multistate corporations, Connecticut businesses reap the benefits of high quality public systems, including the public education system.[3] The report found that for every dollar of government spending that benefits business in Connecticut, business pays only 80 cents, which represents the third best return on investment for tax dollars in the nation and compares favorably with the national average of $1.12 and the $1.20 paid in Massachusetts and New York.[4]

Businesses in Connecticut Benefit from Government Spending

FY15 Business taxes per dollar of state and local government spending benefiting business (billions)

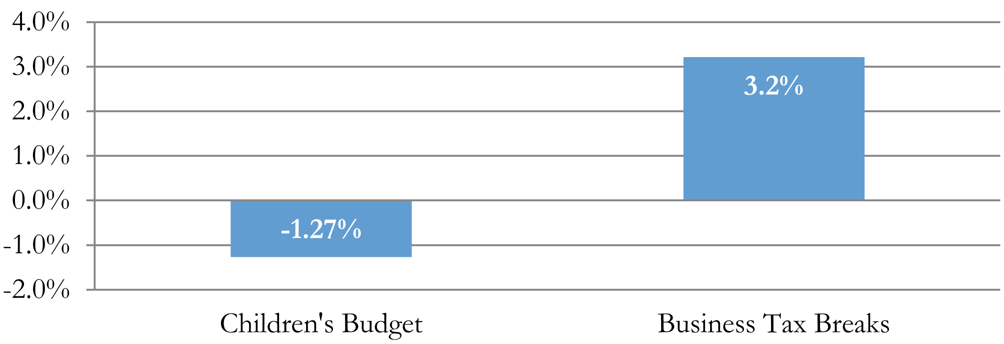
	Assuming 25% of education spending benefits business		Assuming 50% of education spending benefits business	
	Total state and local spending benefitting businesses	Tax-benefit ratio	Total state and local spending benefitting businesses	Tax-benefit ratio
CT	$6.5	1.2%	$10	0.8%
ME	$1.5	2.2%	$2.2	1.5%
MA	$9.3	1.8%	$14.6	1.2%
NH	$1.6	1.7%	$2.4	1.1%
NJ	$14	1.8%	$22.4	1.1%
NY	$40.1	1.8%	$61.1	1.2%
RI	$16.6	1.7%	$24.4	1.1%
VT	$1.2	2.1%	$1.9	1.4%
U.S.	$432.2	1.64%	$633.5	1.12%

Council on State Taxation

Yet, when resources have been most scarce, the percentage change in business tax credits and deductions for economic development purposes outpaced that of spending on children. In absolute dollars, **spending on children[a] decreased by $81.2 million from FY 2016 to FY 2017 while the cost of business tax breaks increased by $12 million**.

Business Tax Breaks Grew While Spending On Children Declined

Change in Spending, 2016 to 2017



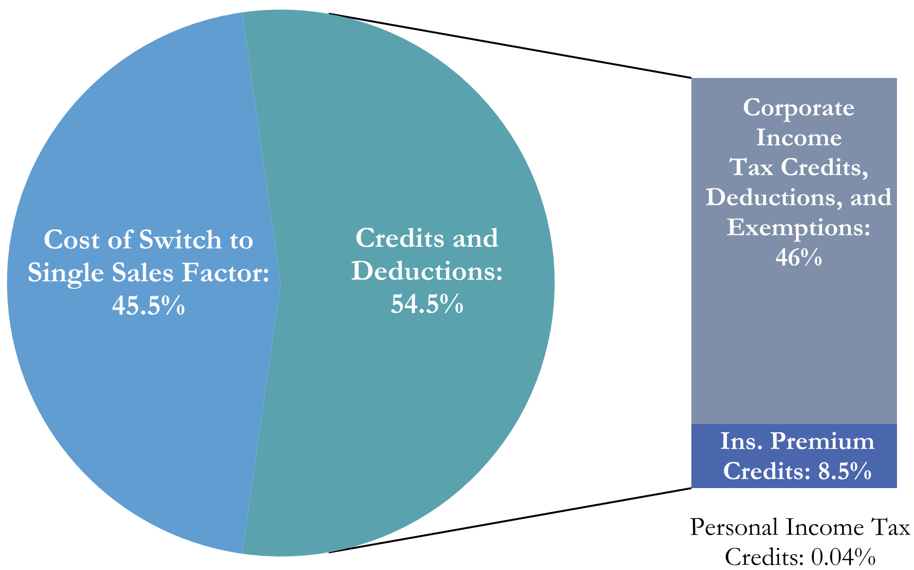
CT Voices analysis of state budget trends and OFA tax expenditure reports. The chart excludes the cost of single sales factor (described below) to better reflect recent-year budget prioritizations.

[a] To determine if the state has met its responsibility to children and families, our Children's Budget tracks state investments such as early care and K-12 education, health care, and health and human services. In FY 1992, Connecticut spent nearly 40 percent of its General Fund on the Children's Budget; now, that share has decreased to a record-low 29.5 percent: http://www.ctvoices.org/issue-areas/budget-and-tax-fiscal-policy-center/tracking-childrens-budget

WHO BENEFITS FROM BUSINESS TAX BREAKS?

Business tax breaks come in numerous forms, aimed at reducing the tax liabilities of investors, industries, and individual firms. Tax credits reduce an individual or firm's tax bill dollar for dollar, while deductions reduce taxable income (which in turn reduces tax liability). Of the $707 million in business tax breaks in the current fiscal year (FY 2017), 46 percent ($325 million) are being delivered by way of credits and deductions to reduce corporate income tax liability, 8.5 percent ($60 million) are credits that offset the insurance premium tax paid by insurance companies or health maintenance organizations, and 45.5 percent ($322 million) is attributable to single sales factor (SSF), a provision of the corporate income tax law that allows multi-state corporations to assign their profits for tax purposes to other states. The chart below reflects the relative revenue loss through different tax breaks.

All Business Tax Breaks, FY 2017



Voices analysis of state budget trends and OFA tax expenditure reports

Reducing Tax Liability on Corporate Profits – The vast majority of credits and deductions (85 percent) and nearly half (46 percent) of all business tax breaks included in our analysis are administered through more than twenty corporate income tax credits and deductions. The number of credits offered through the corporate income tax code is higher in Connecticut than it is in other states (30 credits compared to an average of just over 25 across all states[5]) and contributes to the erosion of corporate income tax revenue.[6] The following represent the largest of these credits and deductions:

> *Net Operating Loss (NOL) Carryforwards ($90.1 million in FY 2017)*: The NOL deduction allows firms to "carry forward" their net operating losses to offset future profits in order to reduce total tax liability. In general, allowing NOL carryforward deductions is a perfectly reasonable policy; businesses are able to avoid the volatility of normal business cycles by smoothing out income over time. We include them in this report, however, for two reasons. The first relates to concerns about legislation creating an unfair advantage to big corporations over smaller businesses. In 2000, Connecticut lawmakers extended the carryforward period from 5 years to 20 years to mirror the federal standard. In theory, this means that a firm that experienced losses during the Great Recession could apply those losses to its profits until 2028. Last year, however, lawmakers imposed limits on NOLs, such that most firms could only reduce tax liability by 50 percent in any one year, thus reducing the annual cost of NOLs.[7] Exempt from that limitation are firms with $6 billion or more in losses: those firms may continue to eliminate 100 percent of their state tax bill.[8]

Our second concern relates to the impact of Connecticut's conformity with the federal accelerated depreciation deduction — a tax expenditure that allows Connecticut firms to write off (i.e., deduct) the cost of machinery and equipment more rapidly during the first few years of an asset's life. The extent to which Connecticut businesses use accelerated depreciation deductions is not known because it is not included in OFA's Tax Expenditure Report.

Research and Development (R&D) Tax Credit ($26.1 million in FY 2017): Businesses may claim this credit for "spending a business incurs in the state to develop or improve a product and qualifying research payments it makes to nonprofit organizations."[9] According to a 2011 report on Connecticut's economic development subsidies, the credits are structured as uncapped and "as-of-right" (unlike a discretionary subsidy, an as-of-right subsidy is a tax break to which a company is automatically entitled).[10]

Like many states, Connecticut allows certain credits to be "carried forward" for use in future years. For example, if a corporation has a $1 billion profit in 2016, but, using the aforementioned net operating losses, deducts against that a $1 billion loss it had in 2015, thus wiping out any taxable profit in 2016, any credits the firm earned in 2016 by investing in research and development will not be useable in the current year. The R&D Tax Credit is responsible for $2.2 billion of the current $2.5 billion in carryforward credits that, according to research presented to the State Tax Panel, will "put downward pressure on corporate income tax collections for the foreseeable future."[11] The fact that only $342 million of these credits have been used since 2002 — or, in other words, $2.2 billion have *not* been used — seems to suggest that the credit is excessively generous and raises questions about its cost effectiveness.

Exemptions for S-Corps (unknown): Since 2002, businesses that file as S-corporations, partnerships, and limited liability companies have been exempt from the corporate income tax, and instead required to pay only an annual flat $250 Business Entity Tax. Furthermore, the $250 tax was cut in half in 2011 when businesses were required to pay only biennially.[12] In FY 2014/2015, nearly 165,700 taxpayers were subject to the Business Entity Tax (compared to more than 41,000 corporate income tax filers in 2014).[13] OFA's Tax Expenditure Report properly classifies the corporate income tax exemption for S-corporations as a tax expenditure, but the cost is "indeterminate."[14] Moreover, the report does not identify the corporate income tax exemption for partnerships and limited liability companies as a tax expenditure at all, even though many of them share most or all of the legal benefits of corporations (for example, limited liability of the owners for debts of the business). The growth in the number of all types of "pass-through" businesses relative to the growth in the number of taxable "C-corporations" has contributed to the decline in corporate income tax revenue. The exemption from the corporate income tax for these types of businesses should be treated as a tax expenditure and the associated revenue loss should be estimated.

Reductions to Personal Income Tax Liability – Personal income tax breaks are also used as a tool for economic development. The personal income tax revenue loss stated in OFA's Tax Expenditure Report is substantially underestimated because (as was the case with the corporate income tax), the revenue loss from Connecticut's conformity with the federal accelerated depreciation deduction for pass-through businesses (partnerships, limited liability companies, and S-corporations) is not included in the report.

Angel Investor Tax Credit: Available to taxpayers who invest in "emerging technology businesses" in Connecticut.[15] The credit has been capped at $3 million over the last several years, and because it was scheduled for sunset in July 2016, the Tax Expenditure Report cites no cost to taxpayers in FY 2017. However, the credit was utilized in full the last two fiscal years, and the sunset was extended to June 2019 during the Special Legislative Session in May 2016, meaning the cost may be underreported.[16] The credit is estimated to benefit 150 taxpayers in FY 2016 and 2017, but no information is available regarding the role the tax credit has played in spurring these investments.[17]

Out-of-State Allocation of Profits

Single Sales Factor (estimated $321.6 million in FY 2017): Because tax policies differ state by state, businesses that operate in more than one state benefit if they can allocate their profits for tax purposes to lower tax jurisdictions. Prior to 2000, corporations in Connecticut were required to allocate profits based on a formula that took into account the location of a firm's sales, wages paid, and property value. In 2000, Connecticut enacted a law allowing specific industries — manufacturers, financial services companies, and broadcasters — to use what is known as single sales factor (SSF) tax apportionment. SSF allocates profits based solely on in-state sales, hardly an accurate depiction of the full scope of business for many non-retail businesses, thus allowing businesses that operate facilities (and rely on educated workers) in Connecticut to deem profits earned in Connecticut as earned outside the state. For example, if 90 percent of a Connecticut's manufacturer's sales are in New York, Connecticut only taxes 10 percent of the firm's profits, even if 90 percent of the firm's capital and workforce is in Connecticut. The effect is that in-state firms with property and payroll pay less in state taxes, while out-of-state firms pay more. The initial cost of the policy was $72 million in 2002 (real dollars), which represented a full third of corporate income tax collections in 2002, and may have cost the state more than $320 million in tax collections in FY 2017.[18, 19] Beginning in FY 2016, the state extended the SSF formula to all firms.[20]

RECOMMENDATIONS: SHED MORE LIGHT ON BUSINESS TAX BREAKS

Unlike General Fund appropriations intended to boost the business environment, business tax breaks lack transparency. Once on the books, they can remain for years, or even decades, without scrutiny. A more efficient, transparent, and fair budget process would require regular review of all economic development incentives, a fully transparent Tax Expenditure Report from the Office of Fiscal Analysis (OFA), and corporate tax disclosure.

The state — to its credit — has taken steps in the right direction: its Open Data website has been acknowledged for leading the way in transparency of economic development data;[21] the state has passed legislation that limits tax credits to 50.01 percent (down from 70 percent) of pre-credit tax liability;[22] and the passage of combined reporting legislation in 2015 closed a number of corporate loopholes.[23] The current fiscal challenges, however, demand nothing less than full transparency for all future business tax breaks. We recommend the following:

Require Regular Review of Business Tax Breaks: Just like spending on education, roads, and other building blocks to a healthy economy, business tax breaks should undergo regular scrutiny to determine their effectiveness.[24] Rhode Island, cited by Pew Research as "one of a few states that regularly review the costs and benefits of tax credits meant to grow jobs and business,"[25] has a process that provides an opportunity for evaluators to report on the lack of data that may have prohibited their analysis, giving lawmakers an opportunity to remove roadblocks to evaluation.[26] Strengthening data collection aligns with the commitment to transparency that has earned the state acknowledgment for its open data website.[27]

Prepare for GASB 77: Beginning this year, all of Connecticut's 169 municipalities will be required to report the total cost of many business tax breaks, such as property tax abatements and income tax credits — "enabling massive new bodies of analysis and reform policymaking" on the cost of all local tax breaks.[28] The new disclosure requirements follow Statement No. 77 from the Governmental Accounting Standards Board (GASB), a private and independent organization that sets accounting standards for local governments. State data is expected to be available in the Comptroller's Comprehensive Annual Financial report (CAFR) in late 2017[29] and for several of the state's largest cities early in 2018. **To prepare for the transition, the state should create a centralized portal on the state's website to collect local government financial reports *and* to compile all local subsidy data into one database; it should also offer technical assistance to local governments.**

Upsize the Tax Expenditure Report: As noted throughout this report, Connecticut's Tax Expenditure Report does not disclose the full cost of tax breaks allocated for economic development purposes. The Office of Fiscal Analysis should be given additional funding to include the following in OFA's biennial Tax Expenditure Report:

- *Cost of Federal Conformity:* Connecticut's conformity with the federal accelerated depreciation deduction contributes to the use of carryforwards, but the extent to which Connecticut businesses use accelerated depreciation deductions is not known because it is not included in OFA's Tax Expenditure Report. As of 2011, 17 states required full or partial costs of federal conformity, including New York and all New England states except for New Hampshire and Connecticut.[30]

- *Cost of Single Sales Factor:* Our estimates above assume corporate income tax collections are reduced by one-third, based on the initial cost reported after the law's passage. While reasonable, a more precise estimate based on data available to the Department of Revenue Services should be included in OFA's Tax Expenditure Report.

- *Cost of Pass-through Exemptions*: OFA's Tax Expenditure Report classifies the exemption for S-corporations as a tax expenditure, but the cost is listed as "indeterminate"; it should be estimated. The same is true with respect to the corporate income tax exemption for partnerships and limited liability companies, since these types of businesses often share many of the legal attributes and protections of corporations.

Require Corporate Tax Disclosure: The income tax on corporate profits has eroded over the past few decades in part due to the growth in business tax credits and other tax incentives and sophisticated corporate tax avoidance strategies. As noted above, Connecticut already provides exemplary disclosure of how much specific corporations receive in tax savings from each major incentive program.[31] Nonetheless, lawmakers who enact business tax breaks do so with no information about how these incentives affect the bottom-line corporate tax payments of individual corporations. To better gauge the effectiveness of tax breaks, and to ensure that corporations are paying a fair share of taxes after claiming these incentives, Connecticut should enact a law requiring corporations to publicly disclose their bottom-line corporate tax payments, together with sufficient information with which to assess the major tax provisions determining this amount. Corporate tax disclosure bills that could serve as a model for Connecticut have been introduced in Maine, Illinois, and Oregon[32], among other states.[33]

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