CONNECTICUT VOICES FOR CHILDREN

Funding Our Future: Child and Family Friendly Revenue Options

Nicholas Defiesta and Ellen Shemitz, J.D.

March 2015

Proposed cuts to Connecticut's budget will hurt many: among them children who need good teachers, pregnant women and parents who need health insurance, and disabled and elderly residents who need caring services. While the Governor tried to reduce the need for some budget cuts by decreasing tax benefits for businesses, and while he has proposed modest tax relief for low and middle income families by cutting the sales tax rate, his proposal fails to protect critical programs and services for children and families. Over half ($316 million) of the $590 million in total proposed cuts reduce state investment in the health, education, well-being and prosperity of children and families across Connecticut.[1]

In addition to the harm caused by direct program cuts, the budget further falls short by failing to take bolder steps to redress existing inequities in Connecticut's tax system. A recent tax incidence report by the Connecticut Department of Revenue Services found that Connecticut's lower-income families pay more than three times the share of their income in state and local taxes as the state's high-income residents. Households making between $5,533 and $16,245 pay an effective overall tax rate of over 26 percent while the wealthiest households, with incomes over $165,394, pay an effective overall tax rate of only 8.18 percent.[2] Simply put, our tax system imposes a greater burden on those families who have less.

Better choices exist. Strategic tax reforms would allow us to avoid deep cuts to essential services and improve the equity of the existing state and local revenue system. The reforms listed below address both tax expenditures and tax revenues.

1. **"Sunset" tax expenditures.** The term "tax expenditure" refers to special tax treatment given to some taxpayers through exemptions, deductions and credits. These tax expenditures currently total over $6 billion in lost state revenue every year, nearly one-third of our state's annual appropriations. Yet, unlike spending through the appropriations process that is reviewed each and every year, tax expenditures are not reviewed annually, or even periodically, and only rarely are they repealed. Without such review, there is no way to assess whether the revenue that policymakers have chosen to exempt from taxation might be better used for some other purpose.

   Many tax expenditures, such as those exempting groceries from the sales tax, are consistent with principles of a high quality state revenue system. [3] Others, however, may advance no clear public benefit. Rather than allowing existing tax expenditures to remain on the books without review, the General Assembly could enact a universal

---

[1] Connecticut Voices for Children, "Impact of the Governor's FY 2016 Budget on Children," (February 2015) http://www.ctvoices.org/sites/default/files/bud15impactgovbudgetfy16.pdf.

[2] Department of Revenue Service, "Connecticut Tax Incidence," (December 2014), http://www.ct.gov/drs/lib/drs/research/drstaxincidencereport2014.pdf.

[3] As defined by the National Conference of State Legislatures. See: National Conference of State Legislatures, "Principles of a High-Quality State Revenue System," (June 2007), http://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx.

"sunset" provision to terminate all current tax expenditures and require re-authorization of those the General Assembly deem to have current merit. Universal sun-setting would increase transparency in the tax system, provide a means to eliminate tax expenditures providing no ongoing public benefit, and raise significant revenue to fund programs that do provide broad public benefit.

Other states sunset or regularly review their tax expenditures. In Oregon, for example, tax expenditures expire after six years unless legislators vote to renew them.[4] In Washington, legislators hold annual committee meetings with the purpose of reviewing all tax expenditures.[5] And in Rhode Island, the Governor's budget proposal is required to include recommendations on the continuation of all tax expenditures, which are then debated by the Legislature.[6] By adopting some variation of sun-setting, our Legislature could advance both equity and transparency while raising significant revenue without any new taxes or changes to existing tax rates.

2. **Eliminate specific tax expenditures**. In addition to, or in lieu of automatic sun-setting, the General Assembly could repeal specific tax expenditures. The Office of Fiscal Analysis' 2014 Tax Expenditure report lists the rationale behind the passage of each current tax expenditure. For many, the rationale OFA states is either political expediency[7] or economic incentive (too often for goods or services that no longer require special treatment). Eliminating such tax expenditures – including nearly $140 million to foster the computer and data processing industry enacted in 1994, roughly $70 million to benefit amusement and recreation enterprises passed in 1993, and over $60 million to support Internet services at the start of the internet revolution in 1999 – would provide significant state revenue and eliminate state expenditures inconsistent with the public interest.

   Connecticut Voices for Children has reviewed the OFA report and identified a total of over $470 million in individual tax expenditures that could be eliminated to provide additional state revenue without any downside to the public interest. See Appendix 1 for a detailed list.

3. **Broadening the base of the sales tax on services.** While Connecticut's sales tax (currently 6.35%) applies to the sale of all goods unless exempted, it does not apply to the sale of services unless enumerated. By amending the statute to treat the sale of goods and services comparably – that is, to tax services unless exempted – Connecticut could broaden the tax base and decrease the tax rate *significantly,* without any negative impact on sales tax revenue. Decreasing the state sales tax rate would increase our competitiveness in relation to Massachusetts (6.25%), New Jersey (7%), and Rhode Island (7%) and spur cross-border sales, creating a boon to area businesses, putting more dollars in the local economy and possibly supporting job growth. An ITEP analysis found that broadening the sales tax base to include all consumer services not currently taxed would increase the taxable base from $68 billion to $101.5 billion. Factoring in this expanded base, **Connecticut could lower its sales tax rate to just 4.26% without any decrease in revenue.** Such a change would have the additional benefit of improving the progressivity of state taxes, as the bottom 99% of taxpayers would experience an effective small tax cut while the top 1% would see a marginal increase in overall sales tax payments. See Appendix 2 for a detailed breakdown.

4. **Adjust top marginal rates on the state's highest incomes.** Connecticut's personal income tax is progressive for families making less than half a million dollars a year; but for those making more, the tax becomes flat. The result is that the state asks less from those who can afford to pay more. Significant revenue could be raised by extending progressivity further up the income ladder, with the precise amount of revenue depending on the specific corrections. The state holds substantial room to raise top income rates due to Connecticut's relatively low top marginal rate of 6.7%, compared to New York (8.82%), New Jersey (8.97%), and Vermont (8.95%).[8]

---

[4] Oregon House Bill 2067, Regular Session (2009).
[5] Revised Code of Washington § Chapter 82.32.808 (Washington State Legislature 2014)
[6] State of Rhode Island General Laws § Section 44-48.2-5 (State of Rhode Island General Assembly 2014).
[7] Defined in the report as "Expenditures of this type violate one or more of the principles of a high-quality revenue system without any apparent counterbalancing or compensating precept."
[8] CCH Editorial Staff. *2015 State Tax Handbook*. Commerce Clearing House, Dec. 2015. Web. 23 Feb. 2015.

Moreover, the state's personal income tax is deductible from a taxpayer's federal income tax, meaning that an increase in state rates will be partially offset by a decrease in federal tax liabilities. By leveraging federal dollars, increased progressivity would cost taxpayers significantly less than the net benefit to the state.

An analysis[9] by the Institute of Taxation and Economic Policy (ITEP) of Washington, D.C. found that adjusting top rates to the levels in the table below would impact only two percent of state taxpayers, generate $300 million in state revenue, enable taxpayers with increased state taxes to deduct $114 million from federal tax returns, leaving only $186 million borne by Connecticut taxpayers.

Increased Progressivity at High Incomes			
MFJ	Single/MFS	HOH	Rate
$0	$0	$0	3%
20K	10K	16K	5%
100K	50K	80K	5.5%
200K	100K	160K	6%
400K	200K	320K	6.5%
500K	250K	400K	7%
1M	500K	800K	7.5%

Additional information, including a detailed breakdown of the distribution of this tax change, can be found in Appendix 4.

5. **Enact combined reporting.** Connecticut is the only state in the Northeast that does not require combined reporting – a fix of an existing tax loophole that allows corporations that conduct business in multiple states to use accounting gimmicks to avoid paying state taxes. Enacting combined reporting legislation would require companies to report multistate income and expenses together, closing this loophole. Doing so eliminates an unfair advantage for multistate corporations over small businesses that only conduct business in Connecticut and increases the state tax base using newly reported state corporate profits.

   While official revenue estimates from enacting combined reporting are difficult to produce, official revenue estimates from other states that have recently adopted or considered combined reporting[10] have indicated that combined reporting increases net corporate tax revenue by an average of 16.6 percent — $129.8 to $149.5 million annually in Connecticut, depending on whether the Governor's proposed changes to the corporation tax are enacted.[11]

6. **Raise the cigarette tax.** Supported by 70 percent of voters in a 2013 poll[12], raising the cigarette tax by 95 cents would promote public health while generating an estimated $60 million in revenue, according to an ITEP analysis. At $3.40, Connecticut's cigarette tax lags behind neighboring states, including $3.51 in Massachusetts, $4.35 in New York, and $3.50 in Rhode Island.[13] See Appendix 3 for a detailed breakdown of the tax impact.

7. **Introduce a sugar-sweetened beverage and candies tax.** As originally introduced, Proposed Bill No. 5461 would have imposed a tax on soft drinks (of one cent per ounce) and candy, dedicating the money raised to

[9] Analysis performed by ITEP at the request of Connecticut Voices for Children.
[10] Iowa, Maryland, Massachusetts, New York, Wisconsin
[11] According to the Governor's FY 2016-17 Budget Proposal, Connecticut received $782.2 million in its Corporation Tax in 2013-14 and can expect to receive $900.5 million in 2015-16 given recommended policy changes.
[12] "Poll: 70 Percent of Connecticut Voters Support Raising the Tax On Cigarettes." PR Newswire. N.p., 15 May 2013. Web. 23 Feb. 2015.
[13] CCH Editorial Staff. *2015 State Tax Handbook*. Commerce Clearing House, Dec. 2015. Web. 23 Feb. 2015.

childhood obesity prevention efforts, municipalities, and the Governor's scholarship program. According to an ITEP analysis, the bill as initially introduced would create a large public health benefit while raising an estimated $179 million: a figure that will need to be recalculated based on the final language of any legislation. See Appendix 5 for a detailed tax impact breakdown of the original proposal.

Appendix 1: Proposed Tax Expenditures to Eliminate

Connecticut Voices for Children reviewed the OFA report and highlighted tax expenditures based on four bases.

- First, Voices identified tax expenditures with a cited rationale of "incentive" which were found to be outdated, as in the case of the "Computer and Data Processing" tax expenditure.
- Second, Voices identified expenditures rationalized as "incentive" which lack sufficient offsetting public benefit, as in the case of "Winter Boat Storage."
- Third, Voices highlighted those expenditures enacted for "Expediency," defined in the Tax Expenditure Report as violating one or more principles of a high-quality revenue system without offering sufficient offsetting public benefit.
- Finally, Voices identified tax expenditures enacted for "perceived equity" for which sufficient public benefit could not be identified.

Tax Expenditure	Year Enacted	Revenue gain from repeal (millions)	Cited Rationale
Computer and Data Processing	1994	$137.7	Incentive
Diesel Fuel First Sale	2007	$93.0	Expediency
Amusement and Recreation Services	1993	$70.0	Expediency
World Wide Web (Internet services)	1997	$62.2	Incentive
Motor Vehicles & Vessels Purchased by Non-Residents to use Out of State	1987	$43.4	Incentive
Renovation & Repair for Residential Property	1999	$25.2	Expediency
Health and Athletic Club Services	1994	$10.7	Expediency
Car washes	1993	$6.8	Expediency
Digital Animation Production	2007	$6.7	Incentive, Expediency
Sale of Certain Credits	1999	$6.2	Expediency
Charges for Athletic Instruction	1975	$2.7	Expediency
Massage Therapist and Electrology Services	1992	$2.6	Perceived Equity
Winter Boat Storage	1993	$2.4	Incentive
Carnival or Amusement Rides	1994	$1.6	Expediency
Media Payroll Services	2007	$1.2	Expediency
Health Club Charges	1975	$1.2	Expediency
Ocean Marine Insurance	1967	$0.8	Expediency
Charges for Instruction	1975	$0.8	Expediency
Vessels Brought in to the State for Storage, Maintenance or Repair	1983	$0.7	Incentive
Lawn Bowling Clubs	1999	$0.4	Expediency
Total:		**$476.3**	

Source: CT Department of Fiscal Analysis 2014 Tax Expenditure Report

Appendix 2: Detailed Broader Sales Tax Base Impact

2014 Income level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $26,000	$26,000 – $47,000	$47,000 – $79,000	$79,000 – $129,000	$129,000 – $296,000	$296,000 – $1,423,000	$1,423,000 – Or More
Average Income	$14,000	$36,000	$61,000	$100,000	$178,000	$568,000	$3,751,000

Option 3: Expand the Sales Tax Base to All Consumer Services (see below) and Drop Sales Tax Rate to 4.26% for a revenue neutral change							
Tax Change as % of Income	–0.2%	–0.2%	–0.1%	–0.1%	–0.1%	–0.0%	+0.1%
Average Tax Change	–28	–73	–85	–121	–116	–47	+2,633

Sales tax base expansion includes adding all consumer services currently not taxed, including professional services (listed on the tax expenditure report). It does not include taxation of education, health care, rental housing, or business to business services. The gross revenue projections for a 4.26% tax rate does not include any exemption for clothing.

Without the inclusion of all consumer services, the sales tax base is around $68 billion, yielding annual revenues of approximately $1.42 billion. By expanding that base to include consumer services, the base expands to about $101.5 billion, increasing revenues by around $2.1 billion. Lowering the tax rate to 4.26% with the expanded base, the state would still bring in approximately $1.42 billion without any loss in revenue.

While this is a **revenue neutral change**, the average taxpayer in all income groups other than the top 1% would see a small tax cut from this change. This is largely due to 2 factors:
1. While in-state residents receive 82% of the benefit of cutting the sales tax rate, they pay only 76% of the increase from the base expansion.
2. The share of in-state sales taxes paid by the top 1% increases from 10% to 14% under this proposal.

Source: Institute on Taxation and Economic Policy, March 2015

Appendix 3: Detailed Cigarette Tax Increase Impact

2014 Income Level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $26,000	$26,000 – $47,000	$47,000 – $79,000	$79,000 – $129,000	$129,000 – $296,000	$296,000 – $1,423,000	$1,423,000 – Or More
Average Income	$14,000	$36,000	$61,000	$100,000	$178,000	$568,000	$3,751,000

Option 6: Increase Cigarette Tax by 95 cents							
Tax Change as % of Income	+0.2%	+0.1%	+0.1%	+0.0%	+0.0%	+0.0%	+0.0%
Average Tax Change	+25	+26	+33	+37	+43	+53	+64
Share of Tax Hike	14%	15%	18%	21%	18%	6%	1%

State Tax Change ($1000)
+60,000

Appendix 4: Detailed Income Tax Rate Adjustment Impact

2014 Income Level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $26,000	$26,000 – $47,000	$47,000 – $79,000	$79,000 – $129,000	$129,000 – $296,000	$296,000 – $1,423,000	$1,423,000 – Or More
Average Income	$14,000	$36,000	$61,000	$100,000	$178,000	$568,000	$3,751,000

Option 4: Higher Marginal Income Tax Rates and New Tax Bracket							
Tax Change as % of Income	—	—	—	—	+0.0%	+0.1%	+0.5%
Average Tax Change	—	—	—	—	+0	+499	+19,271

% with Income Tax Increase	—	—	—	—	+0%	+29%	+100%
Avg. Tax Increase for those with increase	—	—	—	—	+30	+1,735	+19,342
Share of Tax Increase	0%	0%	0%	0%	0%	12%	88%

State Revenue Change ($1000)
+300,000

Fed Offset	Federal Tax Change ($1000)
-38%	–114,000

Total Tax Change to Taxpayers ($1000)
+186,000

% of Taxpayers w/Increase	2%
Share of Bottom 80% with Increase	0%
Share of Top 20% with Increase	10%

Share of Hike Paid by Bottom 80%	0%
Share of Hike Paid by Top 20%	100%

Appendix 5: Detailed Sugary Beverage and Candy Tax Impact

2014 Income Level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $26,000	$26,000 – $47,000	$47,000 – $79,000	$79,000 – $129,000	$129,000 – $296,000	$296,000 – $1,423,000	$1,423,000 – Or More
Average Income	$14,000	$36,000	$61,000	$100,000	$178,000	$568,000	$3,751,000

Option 7: Add a 1 cent per ounce consumption tax to Added Sugar Beverages and Candy							
Tax Change as % of Income	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%	+0.0%	+0.0%
Average Tax Change	+45	+83	+94	+126	+166	+199	+279
Share of Tax Hike	8%	15%	17%	24%	23%	8%	2%

State Tax Change ($1000)
+179,000