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Connecticut Takes a Stand for Progressive Tax Policy and a Balanced Budget Approach

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Five months into 2011, a glimmer of hope for progressive tax policy and a balanced, sensible approach to state budget woes has emerged in Connecticut. Lawmakers in all but a handful of states are continuing to grapple with historic budget shortfalls as they craft and finalize their budget plans for next year. State revenues continue to lag, many of the temporary tax increases put in place in 2009 are set to expire, and federal stimulus assistance is no longer available, yet the need for quality education, safe communities, affordable health care, public transit and well-maintained roads has not diminished. Despite these fiscal realities, most state leaders have chosen to pursue a cuts only approach. Not only have they proposed reducing state spending to historically low and damaging levels, many states are also considering (or have enacted) harmful cuts in corporate, personal income, and property taxes further limiting resources available to adequately fund state and local government services next year and for years to come.

Connecticut Governor Dan Malloy and other state leaders bucked the anti-tax, anti-government, and deep spending and tax cut trend rampant in most states. Instead, they enacted a budget plan that not only raises substantial new revenue, but does so in a progressive and reform-minded manner. Connecticut's budget for the next two fiscal years combines a variety of tax increases with reductions in state spending and some union concessions still to be determined. This brief will describe the major components and attributes of the tax package passed by Connecticut lawmakers.

Connecticut's Tax Package

Connecticut's tax package includes increases in personal income taxes for the state's best-off residents, a new 30 percent refundable state Earned Income Tax Credit, a reduction in the state's property tax credit, an increase and expansion of the sales tax, a new 'Amazon' tax, a corporate income tax surcharge, a lowered threshold for the estate tax, and increases in cigarette and alcohol taxes (see Appendix I for a detailed list of tax changes). Another noteworthy aspect of Connecticut's budget is that it shares some the revenue generated from the tax increases with municipalities. For the first time local governments will have additional revenue resources available and will no longer have to rely nearly exclusively on the property tax.

Malloy believes his 'shared sacrifice' approach will pay off for Connecticut residents in the short and long-term. More than

Major Components of Connecticut's Tax Package

- Upper-Income Personal Income Tax Increases
- 30% Refundable State Earned Income Tax Credit
- Expanded Sales Tax Base and Small Rate Increase
- Amazon Law
- Reduction of Estate Tax's Taxable Threshold
- Increased Local Revenues

$1.4 billion[1] in additional revenue generated for next fiscal year will put the state on a path towards fiscal sustainability while also protecting critical and core public services Connecticut residents depend on daily.

A Progressive Approach

Connecticut lawmakers primarily relied on the state's personal income tax to raise $1.4 billion in new taxes next fiscal year. Around $970 million will come from a combination of an improved tax rate structure, phaseout of the bottom marginal rate for upper-income taxpayers, a reduction in the property tax credit and an additional benefit recapture applied to the state's wealthiest residents. The reduction of the taxable threshold of the state's combined gift and estate tax from $3.5 to $2 million and the increased sales tax on luxury goods also enhance the progressivity of the overall package.

Lawmakers did not only use the personal income tax to raise taxes on wealthy Connecticut residents- they also cut taxes for low- and moderate-income households through the introduction of a 30 percent refundable Earned Income Tax Credit (EITC) (A total tax cut of $110 million next fiscal year). This move shows that Malloy and other lawmakers understand the important role tax systems can play in alleviating hardship and boosting the incomes of low-income families in their state. State EITCs are an effective, targeted, and time-tested anti-poverty tool that help to level the tax fairness playing field and provide additional income to help families pay for food, housing, transportation and other necessities. This commitment to Connecticut's low-income households is especially striking given that many states are currently considering raising taxes on the poor by eliminating or scaling back their state EITCs.

Despite positive changes to the state's sales tax base, the small increases in sales and excise tax rates were regressive on the whole, disproportionately impacting low- and moderate-income households. However, the two-fold approach of asking the state's wealthiest residents to pay more in personal income taxes while reducing tax liability for the most vulnerable households was more than enough to offset the effects of the sales tax changes.

As a result, an ITEP analysis found that Connecticut lawmakers succeeded in their goal of putting together a progressive tax package. The poorest 20 percent of Connecticut taxpayers will receive a net tax cut, paying 0.3 percent less of their incomes on average in state taxes. The richest 1 percent will pay on average 0.8 percent more of their incomes in state taxes (see Appendix II for a detailed distributional analysis of the tax package and various components).

Reform-Minded Changes

The Connecticut tax package also made important changes to the state's sales tax that will help bring it more in line with our 21st century economy and improve long-term stability. Recognizing that services have come to constitute a substantially larger share of consumption than goods, lawmakers agreed to add a handful of services to the sales tax base including spa and beauty treatments, pet grooming and boarding, motor vehicle storage, and cosmetic medical procedures. Unfortunately, Connecticut hand selected a few services rather than comprehensively adding most services consumed by individuals. However, this move should still be viewed as a small, positive step in the right direction.

[1] This number excludes the $585.6M in revenues in FY12 from the increased provider fee on nursing homes and the new provider fee on hospitals and intermediate care facilities being adopted to draw down additional federal Medicaid reimbursements.

Lawmakers also repealed some current exemptions for items such as hazardous waste removal, airport valet services and yoga instruction. Clothes and non-prescription drugs will also be fully taxed. Connecticut joined New York, Rhode Island, North Carolina, Arkansas and Illinois in enacting an 'Amazon law'. In most states, Amazon and other online retailers are not currently required to collect sales taxes unless they have a "physical presence" in the state, though consumers are still required to remit the tax themselves. The so-called "Amazon laws" are designed to limit this form of tax evasion by broadening the class of online retailers that must collect sales taxes on purchases made by their state's residents. This change will help to narrow the massive sales tax gap that has been created in Connecticut in part by the intransigence of remote sellers like Amazon.

Missed Opportunity

Lawmakers missed an opportunity to implement needed reforms to business taxation in the state. The original tax package proposed by Governor Malloy included a throwback rule for the corporation business tax, but was left out of the final agreement. This important reform would have mandated that sales into other states or to the federal government that are not taxable be "thrown back" into the state of origin for tax purposes. The tax package includes a doubling of a temporary surtax on the corporate income tax, however, most Connecticut corporate entities do not pay that tax. Current business tax breaks and subsidies were also left unexamined.

Have Other States Embraced Revenues?

Connecticut is not entirely alone in a short list of states that have either enacted or are considering raising some revenue to address their budget shortfalls. Illinois lawmakers temporarily raised the state's flat personal and corporate income tax rates in January. Hawaii's budget includes around $400 million in new revenues, some reform-minded, but the most substantial revenue comes from a temporary suspension of sales tax exemptions for businesses. Rhode Island Governor Lincoln Chafee has proposed an overhaul of his state's sales tax that would also raise some revenue to mitigate state budget cuts. And, governors in California, Minnesota, and North Carolina have voiced support for either extending or implementing new temporary taxes, but all three states face an uphill battle in those efforts.

What makes Connecticut truly unique among states in its revenue raising approach this year, was the care given to make the tax changes progressive and reform-minded rather than simply relying on quick or one-time fixes that postpone fundamental decisions and ignore the more significant structural and fairness flaws in state and local tax systems. Also, unlike most every other state where state cuts to local spending have forced local governments to consider property tax increases, Connecticut boosted local revenues and preserved local aid.

Conclusion

In a year when most state leaders across the country have embraced an anti-tax, cuts-only approach to addressing short- and long-term budget woes, Connecticut lawmakers boldly took a stand both for the vital role of government and progressive tax policy. Connecticut's approach addresses current fiscal challenges and is forward-looking, putting the state on a path towards fiscal and economic recovery. The enacted changes to the state's tax system will improve tax fairness and stability. Perhaps most importantly, unlike residents in most every other state, Connecticut residents will not experience deep and damaging cuts to education, health care, or public safety thanks to the significant, progressive, and broad-based tax increases championed by their new leaders.

Appendix I: Detailed Description of Connecticut Tax Package

Personal Income Tax

Changes that primarily impact upper-income households:

- Changes to Tax Brackets and Rates:

OLD RATE STRUCTURE			
MFJ	Single/MFS	HOH	Rate
$0	$0	$0	3.0%
20K	10K	16K	5.0%
$1 m	500K	800K	6.5%

NEW RATE STRUCTURE			
MFJ	Single/MFS	HOH	Rate
$0	$0	$0	3.0%
20K	10K	16K	5.0%
100K	50K	80K	5.5%
200K	100K	160K	6.0%
400K	200K	320K	6.5%
500K	250K	400K	6.7%

- Phaseout of bottom 3.0 percent marginal tax rate between $56,500 and $101,500 AGI for single filers ($105,500 and $145,500 for married filing jointly filers)

- Additional benefit recapture starting at $200,000 AGI for single filers ($400,000 for married filing jointly) with a maximum additional tax of $2,250 for single filers ($4,500 for married filing jointly)

Changes that primarily impact middle-income households:

- Scale-back of Property Tax Credit

    - Maximum credit reduced from $500 to $300.

    - Faster phaseout of credit. Credit phases out for single filers between $56,500 and $116,500 AGI (previously phased out at $146,500). Credit phases out for married filing jointly filers between $100,500 and $160,500 (previously phased out at $190,500)

Change that primarily impacts low-income households:

- Introduction of 30 percent refundable EITC. Connecticut became the 25th state to offer a state version of the federal Earned Income Tax Credit.

Sales Tax

Changes that Modernize the Sales Tax:

- Introduction of 'Amazon' tax law

- Services added to the base:

    - Barber, beauty, spa services (no haircuts), manicure/pedicure

- Yoga
- Pet grooming
- Auto storage
- Limo service/airport valet
- Packing and crating, towing

Changes that Broaden the Sales Tax Base:

- Addition of previously exempted goods:
    - Clothing and shoes under $50
    - Non-Prescription drugs

Changes that Increase Rates:

- Sales tax rate increased from 6 to 6.35 percent (.10 of increased sales tax will go to a municipal fund)
- New Luxury tax
    - A 7 percent rate (rather than 6.35 percent) will apply to the total purchase of cars above 50K, boats above 100K, clothes above 1K, and jewelry above 5K
- Rates on rental cars and hotel rooms were also increased

Other Significant Tax Changes

Estate Tax

- Lowered taxable threshold from 3.5 million to 2 million

Corporate Tax

- Continue surcharge on corporate profits and increase from 10 to 20 percent

Excise Taxes

- Increase cigarette tax form $3.00 to $3.40
- Increase all alcohol tax rates by 1/5

Appendix II: ITEP Distributional Analysis of Select Connecticut Tax Package Components

All Connecticut Residents, 2012 income levels

2012 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $25,000	$25,000 – $44,000	$44,000 – $74,000	$74,000 – $119,000	$119,000 – $277,000	$277,000 – $1,257,000	$1,257,000 – Or More
Average Income in Group	$14,000	$34,000	$57,000	$93,000	$166,000	$423,000	$2,683,000

Impact of Combined Personal Income Tax Changes							
Tax Change as % of Income	–0.8%	–0.3%	+0.3%	+0.3%	+0.4%	+0.7%	+0.6%
Average Tax Change	–109	–119	+147	+245	+689	+2,991	+17,423
% of Income Group w/ Tax Increase	+14%	+45%	+74%	+89%	+98%	+99%	+100%
Avg. Tax Increase for those with Increase	+14	+127	+205	+275	+701	+3,013	+17,423
Share of Increase	+0%	+2%	+6%	+9%	+20%	+22%	+41%
% of Income Group w/ Tax Cut	+18%	+23%	+2%	+1%	—	—	—
Avg. Tax Increase for those with Increase	–606	–769	–267	–91	—	—	—

State Tax Change ($1000)
$ +762,000

Federal Offset	Federal Tax Change ($1000)	Total Tax Change
11%	$ –81,000	$ +681,000

Total Share w/ Tax Cut	9%
Total Share w/Tax Increase	64%

Total Share of Cut to Bottom 40%	98%
Total Share of Increase to Top 20%	82%

Impact of Sales Tax Base Expansion, Luxury Tax, and Rate Increase							
Tax Change as % of Income	+0.4%	+0.3%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%
Average Tax Change	+57	+114	+161	+225	+306	+570	+2,365

State Tax Change ($1000)	$ +343,000

Impact of Cigarette, Alcohol, and Vehicle Fee Increase							
Tax Change as % of Income	+0.1%	+0.1%	+0.0%	+0.0%	+0.0%	+0.0%	+0.0%
Average Tax Change	+18	+23	+28	+33	+38	+42	+59

State Tax Change ($1000)	$ +47,000

Combined Impact of Tax Package (Components Modeled)							
Tax Change as % of Income	–0.3%	+0.02%	+0.6%	+0.5%	+0.6%	+0.8%	+0.8%
Average Tax Change	–34	+18	+336	+503	+1,033	+3,603	+19,847

State Tax Change ($1000)	$ +1,152,000

Source: Institute on Taxation and Economic Policy Microsimulation Model, May 2011