
CT BUDGET CHOICES

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Enhancing State Investments Through Smart Budget Choices

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Executive Summary

In the past year, the “bottom line” of Connecticut’s General Fund budget has moved from a surplus in SFY 01 of nearly \$600 million to a potential deficit in SFY 02 of this much, *or more*.

Like a family faced with a budget crisis, CT has a variety of options to balance its budget. They include increasing its revenue, borrowing, using its savings, collecting on debts (here, maximizing federal revenues), and cutting non-essential spending. To date, nearly all of the action taken by the Governor and General Assembly to balance the SFY 02 budget has involved cutting spending. The \$200 million in implemented cuts already have reduced CT’s essential investments in education, health, mental health and other human service programs and services.

This report provides a number of concrete, budget-balancing alternatives to additional spending cuts. These alternatives rest on two premises:

1. CT must consider long-term solutions, and not only quick fixes.
2. The budget choices CT makes need to *be smart* – particularly in times like these. Our failure to make these essential investments now will cost CT *even more* in the long-term (in less productive and skilled workers, greater illness and more costly types of care).

Thus, rather than continuing to cut state spending on essential state investments, CT should *be smart* –and consider *other* options for balancing the budget.

Alternative Budget-Balancing Measures

Criteria used in selecting the options in this alternative plan include that the options:

- increase the progressivity and stability of CT’s tax code;

- contribute to CT’s recovery from the recession by fueling consumer demand; and
- allow CT to continue to make essential investments in its future, including both in economic and human development.

Using these criteria, CT Voices for Children has identified a variety of alternatives for balancing the budget to be used in some combination:

- Maximize CT’s receipt of federal funds.
- Transfer certain funds and revenues between the General Fund and the Transportation Fund.
- Impose a temporary income tax surcharge on taxpayers with AGI >\$1 Million, raising this rate from 4.5% to 5.0%.
- Delay phase-out of the Inheritance Tax.
- De-link the Estate Tax from federal estate tax changes.
- Rescind or freeze the Gift Tax phase-out.
- Sunset selected exemptions to the Sales/Use tax.
- Sunset selected tax expenditures under state business taxes.
- Increase the Cigarette Tax.
- Sunset exemptions from the Admissions Tax.
- Tap the Budget Reserve (“Rainy Day”) Fund to cover the remaining SFY 02 deficit.

The recent economic downturn has created both the obligation and the opportunity to look more closely at CT’s tax and budget priorities, procedures, and structures. As we do so, it becomes evident that CT – the nation’s wealthiest state – can do better. To look *only* at ways to cut appropriated spending, and not also at ways to increase state revenues, including by cuts to state spending through the tax code, is to consider only half the puzzle. It is to sell short CT’s future.

I. Background

In the past year, the “bottom line” of Connecticut’s General Fund budget has moved from a surplus in SFY 01 of nearly \$600 million to a potential deficit in SFY 02 of this much, *or more*.

Last fall, the Governor and the General Assembly reduced SFY 02 General Fund expenditures by more than \$200 million. Since the November Special Session, the Governor has proposed additional spending cuts of more than \$185 million,¹ nearly all of which require legislative approval. However, even if all these new cuts were approved, a SFY 02 deficit would remain – with projections ranging from \$120 million (Comptroller) to \$379 million (OFA).² In addition, a deficit of \$650 million is projected by OPM for SFY 03³ (and of \$710-795 million by OFA).⁴ CT’s Transportation Fund, on the other hand, is enjoying a projected cumulative surplus in SFY 02 of more than \$160 million, *more* than the surplus that was anticipated when its budget was adopted.⁵

Concurrently, CT’s economy – like the nation’s – has faltered. Fortunately, CT’s unemployment rate remains below national averages (3.6% in December, 2001, compared to 5.8% nationally), and CT’s total personal income continues to grow. Nonetheless, CT’s slowing economy has contributed greatly to its projected SFY 02 General Fund deficit. Revenues in the current fiscal year are falling short of the budget plan by as much as \$680 million, while the spending of some agencies is expected to exceed appropriated amounts (as revised after the November Special Session) by about \$70 million.⁶ While some of these agency deficiencies result from the terrorist attack and its aftermath, most result from rising medical costs, overtime pay, higher costs incurred in serving special need clients, implementation of wage settlements and a delay in the sale of workers’ compensation claims.⁷

Options exist. Like a family faced with a budget crisis, CT has a variety of options to balance its budget. They include increasing its revenue, borrowing, using its savings, collecting on debts (here, maximizing federal revenues), and cutting non-essential spending.

¹ \$12.7 million in allotment rescissions in December 2001 and \$157.3 million in additional surplus appropriation reductions and \$15.4 in additional forced lapses and carry-forward reductions in January 2002.

² The Comptroller’s projected SFY 02 deficit is as of February 2, 2002, and OFA’s as of January 31, 2002.

³ This is a projected estimated deficit for SFY 03 as reported by Secretary Marc Ryan on January 8, 2002 at CT Voices for Children’s Budget Forum. Economists at the Forum thought that the estimate was based on an overly pessimistic picture of the CT economy; the deficit, they believe, would be less than this. This report uses this “high-end” estimate, as any revenues in excess of appropriated spending in SFY 03 generated using some of the options presented here could then be used to begin to replenish the Rainy Day Fund.

⁴ OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

⁵ OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

⁶ OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

⁷ OFA indicates, however, that \$70.7 in General Fund deficiencies can be offset by nearly \$61 million in available funds (e.g., from PS/OE holdbacks, allotment reductions) resulting in a *net* deficiency of about \$9.8 million). OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

To date, nearly all of the action taken by the Governor and General Assembly to balance the SFY 02 budget has involved cutting spending. The \$200 million in *implemented* cuts already have reduced CT's investments in education, health, mental health and other human service programs and services. In December 2001 and January 2002, the Governor proposed an additional \$173 million in cuts in many of the same areas; most, however, require legislative approval. (The General Assembly also delayed the continued phase-out of CT's inheritance tax, as discussed below.)

This report provides a number of concrete, budget-balancing alternatives to additional spending cuts. These alternatives rest on two premises:

1. CT must consider long-term solutions,⁸ and not only quick fixes.⁹
2. The budget choices CT makes need to *be smart* – particularly in times like these. They must maintain – and whenever possible enhance – the state's investments in mental health services, in early care and education, K-12 education, and higher education, in health services, in job training, in housing and the like, since all are *essential* investments. Our failure to make these investments now will cost CT *even more* in the long-term (in less productive and skilled workers, greater illness and more costly types of care). It also will reduce CT's capacity to remain economically competitive in a global economy and impair the high quality of life we all enjoy.

Thus, rather than continuing to cut state spending on essential state investments, CT should *be smart* –and consider *other* options for balancing the budget.¹⁰

What economists say should be considered. 2001 Nobel Laureate Joseph Stiglitz concluded, after analyzing the choices states face in balancing their budgets in these challenging times, that “reduction in government spending on goods and services is likely to be more harmful to the economy in the short run than an increase in taxes or a reduction in transfer program spending. Within the sphere of changes to taxes and transfer programs,

⁸ The biennial budget adopted by the General Assembly in the 2001 Session included a projected SFY 04 General Fund *deficit* of nearly \$90 million (even after excluding \$30 million needed to begin conversion to Generally Accepted Accounting Principles in FY 04). This “structural” deficit results from the phase-in of revenue reductions enacted in previous legislative sessions. Even before the economy faltered, this would have necessitated some structural changes in CT's revenues or expenditures. In addition, the need for additional investments in early care and education, state support for K-12 education (to reduce reliance on local property tax), transportation, mental health and other essential programs has become evident in the last several legislative sessions. These needs did not disappear when the economy declined; they too need to be addressed. Both require a long-term solution.

⁹ The danger of quick fixes is documented well in an OFA memo, Impact of Governor's Allotment Reductions to Alternative Incarceration Programs. OFA's analysis found that the \$2.3 million reduction to the Judicial Department's FY 01 Appropriation for the Alternative Incarceration Program (AIP) would result in an estimated \$8.1 million increase in correctional costs. The net cost to the state, therefore, of the “cut” in spending, was an increase in state spending of \$5.8 million. Other examples of penny-wise, pound-foolish budget decisions abound.

¹⁰ For more detail, see *Before You Cut, Think About the Alternatives* (CT Voices for Children, 2001) available on www.ctkidslink.org.

the impact on the economy depends primarily on the propensity to consume¹¹ – that is, on how much of an additional dollar of income is spent rather than saved – among those who receive the transfer payments or pay the taxes.... Since higher-income families tend to have lower propensities to consume than lower-income families, the least damaging approach in the short run involves tax increases concentrated on higher-income families.”¹²

In addition, on November 7, 2001, at a special hearing of the Human Services Committee, Professor Fred Carstensen of the University of CT Department of Economics and Director of the CT Center for Economic Analysis, testified that the consensus of economists is that the current economic contraction will be quite short, with “fairly vigorous growth” to begin again “by the second, or latest, the third quarter of 2002.” That is, the fiscal impacts of the recession “should be largely or entirely limited to this fiscal year.”¹³ Professor Carstensen also stressed the “really critical” point that the “economic recovery must be driven by consumption,” explaining:

Businesses in the late 90’s and in 2000-2001 spent historically unprecedented levels on buildings and facilities. They have a substantial excess capacity. There is no likelihood that businesses are going to begin again to invest until recovery has started and the economy is again on track. So what is critical is to maintain household consumption.

In light of that he stressed:

1. “Cutting social service budgets, and particularly any kind of income supplements and support services that impact the capacity of lowest income households to consume, deepens the economic contraction. And, in fact, broad budget cuts by the states exacerbate the problem of economic contraction because not only do you reduce the capacity of households themselves to consume, you send a powerful message that you have a negative outlook and are telling households to hunker down. So you create a feedback structure that is self-fulfilling. It’s very well established empirically in economic history.”
2. Cutting investments in people to make short-term savings will create long-term budget costs. “If you don’t make the investments, you increase future costs.”

¹¹ This is one of the reasons this plan proposes a refundable “working poor” tax credit that piggybacks on the federal Earned Income Tax Credit. Studies of the federal EITC demonstrate how quickly funds returned to low-income taxpayers are spent – representing re-investments in the communities in which these taxpayers reside. See, *The Earned Income Tax Credit in CT: State and Local Impact* (CT Voices for Children, 2002), available on www.ctkidslink.org.

¹² Peter Orszag and Joseph Stiglitz, *Spending Cuts Vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?* (October 31, 2001). <http://www.cbpp.org/10-30-01sfp.htm>

¹³ As discussed by Dr. Larry Mishel, of the Economic Policy Institute, at Voices’ January 8, 2002 Budget Forum, while the fiscal impacts of the recession on the state budget may be limited to this current state fiscal year, CT’s lowest income families will likely take some additional time to recover from this recession. Not until CT again reaches the low rates of unemployment enjoyed in the late 1990s, and the real wages of the state’s low-wage workers recover, will the recession be “over” for these families. Thus, CT may expect continuing need for financial supports for unemployed workers and the state’s lowest-wage workers.

3. By increasing the state income tax on highest income taxpayers (an increase that is partially subsidized by the federal government when taxpayers itemize) while eliminating exemptions from the state sales tax and cutting its rate from 6% to 5% or less, CT can generate more revenue while most CT households would pay less in total taxes. “You have a win/win situation. You can actually address the budget issue in a coherent way that actually cuts tax burdens even as you enhance state revenues.... I’ve got hard data, not only on the short term consequences, but on the long-term economic impacts that flow from making that kind of choice.”

II. Alternative Budget-Balancing Measures

The following measures can be taken to help balance the budget in SFY 02 and SFY 03 while allowing CT to preserve its important investments in education/job training, health and mental health services, and other programs and services essential to preserving CT’s economic competitiveness and quality of life. The options presented here are *illustrative* of changes that might be made. Not only are other changes in CT’s tax code possible, but also the size of the changes proposed here could be altered. Changes also could be time-limited until the economy recovers fully. The options table below assumes that none of the proposals to change the state tax code would become effective in SFY 02, except the cigarette tax increase (that the Governor has proposed be effective 4/1/02). If some of these proposed changes become effective in SFY 02, the need to tap the Rainy Day Fund to the extent indicated here would be reduced.

NOTE: Projections of the revenues gained as presented in this analysis are based on the most recent data available to CT Voices from publicly available sources.¹⁴ Voices has asked the CT Center for Economic Analysis for its assistance in producing a dynamic analysis of the primary options listed here; this will provide better projections of anticipated revenues and also short and long-term impacts on CT’s economy.

Criteria used in selecting the options in this alternative plan include that the options: a) will increase the progressivity and stability of CT’s tax code; b) can contribute to CT’s recovery from the recession by fueling consumer demand; and c) will allow CT to continue to make essential investments in its future, including both in economic and human development.

¹⁴ These include OFA, *Connecticut Tax Expenditure Report* (January 2002); OFA, *Connecticut Tax Expenditure Report* (March 2001); DRS, *1999 Personal Income Tax Statistics CT-1040/1040EZ, CT-1040 NR/PY* (March 2001); OFA, *Connecticut Revenue and Budget Data* (May 2001); OFA, *Connecticut State Budget 2001-2003* (October 2001); OFA, *Tax Changes Affecting General Fund Revenue Collections* (October 16, 2001); OFA, *Description of General Fund and Transportation Fund Revenue Sources* (December 2001).

Alternatives for Balancing the Budget¹⁵			
	SFY 02¹⁶	SFY 03	SFY 04
Comptroller's Projected Deficit <i>without</i> Gov's post-November Session Cuts Requiring Legislative Approval¹⁷	(\$277M)		
OPM's Projected SFY 03 Deficit¹⁸		(\$650M)	
1. Maximize Federal Funds			
<ul style="list-style-type: none"> - Reinstatement of sales tax on hospital patient care services (suspended from 7/1/01 to 6/30/03) and again claim federal reimbursement for funds to be re-distributed to hospitals for uncompensated care - Implement Medicaid Rehabilitation Option (adults/kids) - Seek Medicaid reimbursement for children in residential treatment under Private Non-Medical Institutions option - Seek Medicaid reimbursement for all school-based health clinic services for Medicaid-eligible children/youth 		\$114.8M (sales tax), recapture >\$50M in federal Medicaid reimbursements (lost federal matching funds) \$35-\$50M ~\$14M \$\$\$\$	\$114.8M (sales tax), recapture >\$50M in federal Medicaid reimbursements (lost federal matching funds) \$35-50M ~\$14M \$\$\$\$

¹⁵ Potential revenue gains shown are based on OFA's January 2002 Tax Expenditure Report's estimates of revenues *lost* on account of the particular preferential tax treatment, as well as projections from these data and that in prior Tax Expenditure Reports. Out-year projections use SFY 01 as a base year. Admittedly a crude method of estimating revenue impact, this helps illustrate the potential fiscal impact of various options available for increasing revenue.

¹⁶ NOTE: Depending on the effective date of any new change in tax law, there may be some possibility of securing additional state revenues in SFY 02. The Governor has proposed, for example, an April 1, 2002 effective date for the increase in the cigarette tax, providing some new revenues in SFY 02.

¹⁷ The Comptroller recently revised this number upward somewhat – to more than \$300M. Office of the State Comptroller, *Wyman Says Deficit Worsening, but Economy Showing Signs of Improvement* (February 1, 2002). OFA projects the SFY 02 deficit at about \$552 million after already adjusting for implemented savings (in the November Special Session and the Governor's allotment reductions of 9/28 and 12/20/01). If the Governor's December/January Proposals requiring legislative approval are all adopted (\$173M), OFA's projected shortfall is reduced to \$379M. OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

¹⁸ OFA projects the SFY 03 potential deficit at \$794.4 million *prior to savings measures* implemented in SFY 02, and \$710.1 if the savings measures agreed to during the November 2001 Session and the Governor's allotment rescissions are continued into the SFY 03 budget. OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

	SFY 02	SFY 03	SFY 04
2. Transfers of Funds/Liabilities Between General Fund and Transportation Fund			
- Move Town Aid Road Grant program back into Transportation Fund from General Fund (reversing change made in SFY 01)	\$33.5M	\$35M	\$35M
- Transfer revenues from sales of motor vehicles back into General Fund from Transportation Fund (reversing change made in SFY 1998)	\$30M	\$40M	\$40M
3. Changes to CT Tax Code			
A. Personal Income tax			
- Create 20% state EITC (based on state implementation rate that is 90% of federal EITC participation rate)		(\$42M)	
- Increase state income tax rate from 4.5% to 5% on taxpayers with AGI over \$1 million/year ¹⁹		\$122-\$191M	
B. Inheritance/Succession tax			
- Delay phase-out of inheritance tax (PA 01-1 November 15, 2001 Special Session)		\$11M	\$28.1M
Estate tax			
- De-couple state estate tax (CGS §12-391) from federal estate tax changes		\$36M	\$87M

¹⁹ Alternatively, CT could: a) increase the state income tax rate from 4.5% to 5% on taxpayers with AGI of \$500,000 or more/year and generate about \$156-\$244M million in additional revenue; b) increase the rate from 4.5% to 5.5% on taxpayers with AGI of \$1 million or more/year and generate from \$244-\$383M; or c) increase the state income tax rate from 4.5% to 5.0% or from 4.5% to 5.5% on taxpayers with AGI of \$2 million or more/year and generate about \$95-\$148M or \$189-\$296M million, respectively (The lower number is based on actual returns filed in 1999, while the higher number uses the revised income tax projections from the Comptroller's January 2002 report for projected total SFY 02 income tax revenues.) While the 1999-based number may be low (since it is not inflation-adjusted) the 2002 number may be high since the economy was stronger in 1999 than it is now, so the proportion of CT taxpayers in the highest income brackets, and their annual AGI, may be less.

	SFY 02	SFY 03	SFY 04
<p>C. Gift tax</p> <ul style="list-style-type: none"> - Rescind the six-year phase-out of the gift tax on gifts under \$1M that began 1/1/01 and restore gift tax to 2000 tax rates [CGS 12-642; PA 00-170] <p>OR</p> <ul style="list-style-type: none"> - Freeze the phase-out of the gift tax at current levels – no tax on gifts under \$50,000. 		<p>\$4.5M</p> <p>OR</p> <p>\$0.7M</p>	<p>\$5.3M</p> <p>OR</p> <p>\$1.5M</p>
<p>D. Sales tax – Alternative 1</p> <ul style="list-style-type: none"> - Sunset all exemptions from and rate reductions to sales/use tax, except those for sale of food for human consumption, clothing under \$75/item, home heating fuel, motor vehicle fuel, and health-related consumer goods <p>AND</p> <ul style="list-style-type: none"> - Possibly, reduce sales tax rate from 6% to some lower rate (reducing revenue gain from sunset of exemptions, but potentially increasing total state sales through capture of catalog/Internet sales, and increased in-state purchases) 		<p>~\$750M</p> <p>AND</p> <p>Awaiting CCEA analysis</p>	<p>~\$750M</p> <p>AND</p> <p>Awaiting CCEA analysis</p>
OR			

	SFY 02	SFY 03	SFY 04
Sales tax – Alternative #2			
- Sunset exemptions to sales tax and other tax expenditures OFA characterizes as “expedient”, such as:			
• Exemption for sales of equipment used to provide high speed data transmission or broadband internet service to a telecom company or CATV company [CGS § 12-412(112)]		\$8M	\$8M
• Exemption for child car seats [CGS §12-412(108)]		\$0.5M	\$0.5M
• Exemption for lease and rental of motion picture film for display by theatre owner/operator [CGS §12-407(2)(j); 412(50)].		\$2.5M	\$2.5M
• Exemption for shoe repair services, calibration services, call-before-you dig services		\$4M	\$4M
• Exemption for renovation & repair services for residential real property [CGS 12-408(F), 12-411(G)]		\$10M	\$10M
• Suspension of all sales tax on patient care services from 7/1/01 to 6/30/03 (PA 01-6, JSS) ²⁰		\$115M	\$120M
• Exemption for motor vehicle parking in lots, in valet parking at airports [CGS 12-407(2)(i)(N)]		\$2.5M	\$2.5M
• Exemption for car washes [PA 93-74]		\$1M	\$1M
• Exemption for amusement/recreation services; health and athletic club services [PA 93-74]		<\$250,000 for each	<\$250,000 for each
• Exemption for tax preparation services [PA 94-4]		\$4M	\$4M
• Exemption for Children’s Hospitals and Dempsey Hospital [CGS 12-407(28)]		\$5M	\$5M
• Coupons, discounts, battery deposits & trade-ins of like type excluded from definition of “sales price” [CGS 12-407(8) & (9)]		\$2.5M	\$2.5M

²⁰ NOTE: Prior to this temporary suspension, a reduced sales tax rate was applied to these services (5.75% rather than 6%), resulting in \$10 million in lost revenue.

	SFY 02	SFY 03	SFY 04
<ul style="list-style-type: none"> - Sunset or suspend further implementation of other sales/use tax exemptions and other tax expenditures that subsidize an activity/initiative that may now be a lower priority than investments in state-funded programs/services scheduled to be cut, such as: <ul style="list-style-type: none"> • Sales tax phase out on computer & data processing services and internet access charges [CGS 12-408(1)(C) and 12-411(1)(E)] • Exemption for certain advertising services (those for ad agency, direct mail and media advertising) [CGS 12-407(2)(u)(U)] • Exemption for over-the-counter sales of newspapers and puzzle magazines [CGS 12-412(6)] • Exemptions for sales of food and items costing 50 cents or less sold through coin-operated vending machines [CGS 17-412(27)] • Exemption for sales of machinery, equipment, tools, materials and supplies used in commercial printing [CGS 12-412(71)] • Exemption for sales of machinery, equipment, tools, materials and supplies used in biotechnology [CGS 12-412(89)] • Exemption for sales of services/property for operation of projects of CT Resource Recovery Authority [CGS 12-412(92)] • Exemption for non-commercial winter boat storage [CGS 12-407(2)(m)] • Exemption for sale of gold or silver bullion, rare coins [CGS 12-412(45)] 		<p>\$58M</p> <p>\$20M</p> <p>~\$15M</p> <p>\$1.2M</p> <p>\$12M</p> <p>\$3.5M</p> <p>\$3.0M</p> <p>\$300,000</p> <p>\$100,000</p>	<p>\$72M</p> <p>\$20M</p> <p>~\$15M</p> <p>\$1.2M</p> <p>\$12M</p> <p>\$3.5M</p> <p>\$3.0M</p> <p>\$300,000</p> <p>\$100,000</p>

	SFY 02	SFY 03	SFY 04
E. State Business Taxes			
<ul style="list-style-type: none"> - Sunset tax expenditures OFA characterizes as “expedient” such as: <ul style="list-style-type: none"> • Exempting subchapter S-Corporations from corporate business tax. [CGS 12-217 (c)]²¹ • Exempting capital gains realized from sale of land or open space to state, town, etc. where land to be preserved as open space or watershed from corporate business tax. [PA 99-173, 00-235, benefiting 10 taxpayers] • Fixed capital investment credit against corporate business tax [CGS 12-217w] • Credit against corporate business tax & insurance premiums tax for expenses related to rehabilitating historic homes [CGS 10-320] • Sale of “unused”²² R&E and R&D credits held by companies with less than \$70M in gross sales back to state for 65% of value. [CGS 12-217ee] • Credit against corporate business tax for donation of computers to schools [CGS 1a-228b](NOTE: credit is more valuable to a company than deduction for charitable donation) • Credit against the insurance premiums tax for 100% of property tax paid on data processing equipment [CGS 12-217t] (10 taxpayers benefit) - Sunset or suspend further implementation of other exemptions and other tax expenditures that subsidize an activity/initiative that may now be lesser priority than state-funded programs/services scheduled to be cut, such as: <ul style="list-style-type: none"> • Credit against corporate income tax for 100% of property tax paid on data processing equipment [CGS 12-217t] • Credit against insurance premiums tax for managed care organizations paid to provide medical coverage through HUSKY. (Organizations are already exempt from tax on HUSKY policies themselves.)[12-202b(b)] 	<p style="text-align: center;">\$26M</p> <p style="text-align: center;">\$1M</p> <p style="text-align: center;">\$40M</p> <p style="text-align: center;">\$1.5M</p> <p style="text-align: center;">\$30M</p> <p style="text-align: center;">\$0.5M</p> <p style="text-align: center;">\$20M</p>	<p style="text-align: center;">\$26M</p> <p style="text-align: center;">\$1M</p> <p style="text-align: center;">\$40M</p> <p style="text-align: center;">\$1.5M</p> <p style="text-align: center;">\$30M</p> <p style="text-align: center;">\$0.5M</p> <p style="text-align: center;">\$20M</p>	
	\$35M	\$35M	
	\$14.5M	\$14.5M	

²¹ If this exemption were repealed, corporate tax revenues would increase, but there would be some offsetting *decrease* in personal income tax revenues. There would be a net gain in revenue, however, since the corporate tax rate exceeds the personal income tax rate.

²² These credits would be “unused” because the company owes no corporate tax, or owes corporate tax less than the value of the credits that it returns to the state for a cash “refund” equal to 65% of the credit.

	SFY 02	SFY 03	SFY 04
F. Cigarette Tax - Increase tax on cigarettes from \$0.50 to \$1.11/pack, eff. 4/1/02	~\$30M	\$130M	<\$130M (expected to be less as smoking declines with increased tax)
G. Admissions Tax - Sunset all exemptions from Admissions Tax that OFA characterizes as “expedient”		\$9.7	\$9.7
4. Tap Budget Reserve (“Rainy Day”) Fund. - See below for explanation. A total of \$595 million is current in this Fund – the state’s “savings account.”	~\$185M (assumes that Gov’s January cuts are <i>not</i> made)		

Each of these options is described in a bit more detail, as follows:

1. Maximize Federal Revenues

Proposal: Increase federal revenues by maximizing all reimbursement possibilities under Medicaid, Title IV-E and other federal matching programs and by aggressively seeking federal grant funds. Re-convene the Task Force on Federal Fund Maximization (first convened in the early 1990s) and update its report on revenue-maximizing opportunities. Require agencies to report to the General Assembly regarding ways to increase federal revenues for programs/services within their jurisdiction, their efforts to maximize revenues, and barriers to maximization.

Revenue Gain: More than \$100M in potential Medicaid reimbursements alone.

Rationale: Equity and budget stability. Connecticut is second to last in the nation in the amount of federal funding coming into the state per dollar of federal taxes paid.²³ In 1998, Connecticut received \$0.69 back from the federal government for every \$1.00 in federal taxes that were paid. Only New Jersey fared worse (receiving \$0.68 per dollar of taxes paid).²⁴ This is due in part to CT’s significant wealth: CT pays more in federal income taxes per capita than other states (which is not surprising since CT also enjoys the nation’s highest per capita income), and CT’s federal reimbursement rate is lower than rates in poorer states (which is appropriate, given CT’s wealth). However, CT’s low rate of federal funding also is due in part to CT’s failure to claim all the federal funds to which it is entitled.

For much of the past decade, the rationale for not seeking unclaimed federal reimbursements and new federal grant funds was the spending cap. Now that the spending

²³ Federal spending is defined to include grants to state and local governments, payments to individuals (such as Social Security and the EITC), wages and salaries of federal employees, and purchases of goods and services. Congressional Quarterly, State Fact Finder 2000, Table E-12.

²⁴ 28 states get more than \$1.00 back from the federal government for every \$1.00 in federal taxes. Highest is New Mexico, receiving nearly two dollars back for every dollar paid.

cap is not the issue, but insufficient revenues are, state agencies should be directed to seek all available federal reimbursements, *before* they are told to cut programs. A legislative Task Force on Federal Fund Maximization produced a report in the early 1990s identifying potential new sources of federal funds. Reports since then, including DSS and DCF's report on financing CT Community KidCare, the Governor's Blue Ribbon Report on Mental Health and others, have identified a variety of untapped federal reimbursement options (a few of which are included in the table above). With CT facing a deficit, CT is foolish not to claim all federal funds to which it is entitled.

2. Fund Transfers

Proposal: Return the Town Aid Road Grant program to the Transportation Fund (reducing spending in the General Fund) and return the revenues from the sales tax on motor vehicle sales *from* the Transportation Fund to the General Fund.

Net Gain in Deficit Reduction: \$65 million in General Fund in SFY 03 and \$75 million in SFY 04 (from reduced spending and increased income).

Rationale. Equity and budget stability. The Transportation Fund projects a cumulative *surplus* of more than \$160 million in SFY 02.²⁵ This is *more* than the originally projected surplus in this Fund in SFY 02. Reversing two transfers made in the last three years could relieve some of the financial pressure on the General Fund by reducing spending by \$30M and increasing revenue by \$35M in SFY 03 – a net gain of \$65M in General Fund deficit reduction:

- *Motor Vehicle Sales Revenues.* PA 98-128 required the Commissioner of the Department of Motor Vehicles to deposit a portion of the sales tax collected on motor vehicle sales between individuals in the Transportation Fund instead of the General Fund. This has resulted in a \$30 million reduction in General Fund revenues in SFY 02, and \$40 million in revenues in SFY 03 and thereafter. Repeal of this provision would return these revenues to the General Fund.
- *Town Aid Road Grant.* In SFY 01, the \$35 million Town Aid Road Grant program was transferred *from* the Special Transportation Fund into the General Fund, resulting in \$35 million in additional spending in the General Fund that had previously come from Special Transportation Fund funds. The TAR Grant program provides funds to towns for construction, reconstruction, improvements, or maintenance of highways and bridges, for snow plowing, for sanding of icy pavements, for installation, replacement and maintenance of traffic control and vehicle safety programs, for traffic and parking planning, and administration, and for public transportation services and related services. It is consistent with the purposes of this program that it be funded from the Special Transportation Fund. Transfer of this Town Aid Road Grant program back to the Transportation Fund from the General Fund for SFY 02, and years thereafter, will reduce spending in the General Fund.

²⁵ OFA, *FY 02 and FY 03 General Fund and FY 02 and FY 03 Transportation Fund Budget Projections*, January 31, 2002.

3. Changes in CT Tax Code

Unlike budgeted expenditures, that are reviewed annually, the “spending” done through the CT tax code – through preferential tax exemptions, exclusions, deductions, credits and rate reductions that benefit a subset of taxpayers (sometimes just a *single* taxpayer) – is *not* routinely reviewed.²⁶ That is, there is no process that routinely assesses if the priorities represented in these tax expenditures continue to be important *or* whether the subsidies these tax breaks provide are more important to the entities receiving them than education, health-related, and other state-funded programs and services that threaten to be cut when revenues are short. According to OFA’s January 2002 *Tax Expenditure Report*, CT has chosen *not* to collect \$3.928 *billion* in revenue through these preferential tax breaks.

In its *Tax Expenditure Report*, OFA characterizes the rationale for each of these preferential tax breaks. Those that OFA says have a rationale of “incentive” are “intended to encourage the performance of certain desirable activities such as economic growth and development, charitable or non-profit work, or conservation of resources.” There is, however, no periodic review of these to assess if they are achieving their desired goal, or even if the specific goal is still one of high priority to the state. Other tax expenditures that have a rationale of “expediency.” According to OFA, this means that these tax breaks “violate one or more of the principles of a high-quality revenue system without any apparent counterbalancing or compensating precept.” (citing *Principles of a High-Quality State Revenue System* (2d ed.), National Conference of State Legislatures, 1992). Repeal of such preferential tax breaks would *enhance* the quality of the state’s revenue system without significant harm to other state interests.

The following options seek not only to increase state revenues, but also to increase reliance on the state’s most progressive taxes (state income tax, estate tax, inheritance tax, gift tax) and increase the stability of CT’s revenues in general. Many are listed; not all would need to be implemented to provide sufficient revenue to not only *continue* our investments in essential state services, but to *enhance* investments likely to pay a high-return in the long-term (such as investments in education, health and mental health care, public infrastructure).

A. Personal Income Tax

Proposal: Create a new top bracket rate for CT taxpayers with the highest incomes. Specifically, for CT resident and non-resident taxpayers with Adjusted Gross Income of \$1,000,000 per year *or more* increase tax rate from 4.5% to 5%, generating approximately \$122-191 million in additional revenue.²⁷ *In addition*, create a refundable state “working

²⁶ For background on CT’s tax expenditures, see *An Overlooked Form of Spending: Tax Expenditures and the Need for Review* (CT Voices for Children, 2002), available on www.ctkidslink.org.

²⁷ Two other options include: a) increasing the top bracket rate from 4.5% to 5% on CT taxpayers (resident and non-resident) with Adjusted Gross Income (AGI) of \$500,000 or more/year (about \$156M in additional revenue) OR b) increasing the top bracket rate from 4.5% to 5.5% on CT taxpayers (resident and non-resident) with AGI of \$2 million or more/year (about \$189M in additional revenue).

poor” tax credit that would benefit taxpayers with AGI from earnings that is under approximately \$32,000 (i.e., a credit set at 20% of the federal EITC).²⁸

Net Revenue Gain: Approximately \$80-149 million (\$122-191 million in revenue gain from the top bracket increase on the top 1% of CT taxpayers, reduced by \$42 million for the refundable “working poor” credit benefiting about 9% of CT taxpayers). NOTE: A 1% increase in the top bracket rate on taxpayers with AGI of \$1million or more would increase the net revenue gain to \$203-\$341million, while a 1% increase on taxpayers with AGI of \$2 million or more would produce a net revenue gain of \$147-\$254 million.

Rationale: Budget stability, economic stimulus, equity, increased tax code progressiveness. Nobel Laureate Stiglitz convincingly argues that in times of recession and state budget deficits, a state’s decision to balance its budget by increasing taxes on its highest income taxpayers is a smarter choice than a decision to reduce government spending on goods and services. As explained by Prof. Fred Carstensen, of the University of CT Department of Economics, at the hearing before the Human Services Committee on November 7, 2001, increasing CT’s top bracket rate on its wealthiest citizens, while continuing investments in government spending on education and health and mental health services, makes good economic sense. While cuts in government spending will exacerbate the recession and send a wrong message about confidence in the economy to consumers, a modest rate increase on the state’s highest income taxpayers will have little harmful effect on the economy.

A new top bracket rate on the incomes of the state’s wealthiest taxpayers can generate significant additional revenue while affecting a very small proportion of taxpayers. An increase in the top bracket rate from 4.5% to 5.0% for CT taxpayers with AGI of \$1,000,000 per year *or more* will affect about 10,700 taxpayers (0.7% of all CT resident and non-resident taxpayers), and generate \$122-\$191 million in additional revenue. A 1% increase on taxpayers with this wealth would generate \$245-\$383 million in additional revenue. CT resident taxpayers with an Adjusted Gross Income of \$1-\$2 million/year have an average AGI of \$1.36 million/year, each. CT resident taxpayers with an AGI of \$2,000,001/year or more have an *average* Adjusted Gross Income of more than \$7 million/year, each. [Data as of 1999 returns]

At 5.5%, CT’s top bracket rate would still be lower than the top bracket rate in New York (6.85%) and New Jersey (6.37%), and close to the top bracket rates in Massachusetts (5.3%, with a 12% rate on certain capital gains income).²⁹ Importantly, CT taxpayers subject to this higher tax rate can deduct the additional state tax due when they calculate their federal income tax liability. This results in a significant federal government subsidy of CT’s rate increase (i.e., about 30% of the “cost” of the state income tax increase for these taxpayers will be offset by a reduction in their federal taxes). Also, increased reliance on the CT

²⁸ Coupling this with changes in unemployment compensation law – to increase benefits for dependents, extend eligibility to part-time workers, adopt an alternative base period – would further enhance the economic stimulus effect in CT’s economy.

²⁹ It will also be lower than the rates CT imposed on interest income (7%) and dividends and capital gains income (1-14%) before CT adopted the current income tax.

income tax, which is a more stable tax than its sales/use and corporate taxes,³⁰ can enhance the state's bond rating, resulting in a decline in debt service payments.³¹

By comparison, the refundable "working poor" tax credit will cost approximately \$42 million in SFY 03 and benefit about 145,000 CT families (about 9% of CT taxpayers).³² OPM's *Self-Sufficiency Report* establishes that any CT family raising children who has earnings of \$32,000 or less is struggling hard to make ends meet. Most have received no financial benefit from the newly expanded credit against the state income tax for property taxes paid. Moreover, low-income residents pay a greater proportion of their incomes in sales and other consumption taxes than do higher income taxpayers, since they must *spend* all of their income to survive (while higher income taxpayers are able to save some of their income). The refundable "working poor" credit (state EITC) not only would help these lowest-income wage earners to make ends meet, it would help CT recover more rapidly from its recession, since the \$42 million in additional financial resources for these families will be spent quickly within CT's towns and cities, fueling consumer demand.³³

B. State Inheritance/Succession And Estate Taxes

Proposal: End phase-out of CT inheritance/succession tax (CGS §12-344). NOTE: PA 01-1 November 15, 2001 Special Session delayed this phase-out.

In addition, protect current CT estate tax revenues from being reduced as a result of changes in the federal estate tax by amending state law (CGS §12-391) to specify that for persons dying on or after January 1, 2002, the amount of the state estate tax shall equal the federal credit allowable for estate, inheritance, legacy and succession taxes paid to any state under the federal internal revenue code in force *on January 1, 2001* (rather than, as current law states, "in force at the date of such decedent's death.")³⁴

Additional Revenues & Averted Revenue Loss: Additional revenues of \$11M (SFY 03) and \$28.1M (SFY 04) from ending phase-out of CT inheritance/succession tax. \$36M in SFY 03, \$87M in SFY 04, increasing to \$200M in SFY 07 in averted revenue losses by decoupling CT estate tax from federal estate tax changes³⁵

³⁰ Total personal income in CT has continued to increase from SFY 01 to SFY 02, *despite* the economic downturn. The same was true in the very deep recession of the early 1990s in CT.

³¹ Professor Carstensen testified November 7, 2001 before the Human Services Committee that the income tax is a "vastly more stable revenue source than the sales tax. In the early 1990's, in spite of the recession and the loss of 157,000 jobs in Connecticut, household income, on average, never declined. It continued to go up and what created the fiscal crisis in the State of Connecticut was not really the economic recession. It was having one of the five worst tax structures in the country measured by stability of its structure.... We actually went from having one of the five worst to having one of the ten best when we restructured the tax system in the early 90's and we've done a lot of other improvements in terms of the stability of that structure." (p.36).

³² The data here are for the 1999 tax year. Changing economic times may change both the revenue that might be achieved by an increase in the top-bracket rate, and also the number of residents able to claim the EITC.

³³ See, *The Earned Income Tax Credit in CT: State and Local Impact* (CT Voices for Children, 2002), available on www.ctkidslink.org.

³⁴ See L. McNichol, I. Lav & D. Tenny, *States Can Retain Their Estate Taxes Even As The Federal Estate Tax Is Phased Out* (Center on Budget and Policy Priorities, 2002), available on www.cbpp.org.

³⁵ See OFA, *Tax Changes Affecting General Fund Revenue Collections* (October 16, 2001), p.2.

Rationale: Equity, budget stability, and increased tax code progressivity. CT's succession taxes (inheritance, estate, generation-skipping transfer taxes) are excise taxes levied on the transfer of wealth at the time of death. CT's inheritance tax is a tax on the separate shares of an estate passed on to beneficiaries, with the tax itself paid by the estate. CT's estate tax is considered a "sponge" tax as it is intended to preserve tax revenue for CT that would otherwise go to the federal government. It too is paid by the estate.

Inheritance tax. CT's inheritance tax was the very first tax applied universally in CT, and had not changed greatly since the 1930s -- until recently. PA 95-256 phases out the inheritance tax by increasing the exemption amount for each class of inheritors, until the tax no longer exists for any inheritor (on 1/1/05). Certain types of property are excluded from CT's gross taxable estate, such as proceeds of a life or accident insurance policy and jointly-owned property. In addition, the state law allows a variety of deductions from the gross taxable estate in computing the net taxable estate (e.g. unpaid mortgages, taxes, debts). In SFY 01, about \$240 million in revenue was collected from the inheritance tax. This is at least \$200 million *less* than would have been collected without the phase-out that has been implemented thus far. Freezing the phase-out of the inheritance tax would mean that (as of 1/1/02) there would continue to be *no* inheritance tax imposed on estates that are transferred to surviving spouses or to immediate family (parents or children). In addition, there would be *no* inheritance tax imposed on property under \$1,500,000 that is transferred to other relatives (siblings, nephews, and nieces) and on property under \$400,000 that is transferred to all others (including charitable organizations).

Estate tax. Revenues under CT's estate tax are threatened by the repeal of the federal estate tax over the next nine years and the phase-out of the credit against the federal estate tax for state death taxes paid.

The estate tax is "much more progressive than the individual income tax or any other major tax in the United States" --- nationally, 98 of every 100 people who die face no estate tax. The vast bulk of estate taxes are paid on very large estates. In 1999, the wealthiest 6.5% of those with taxable estates (i.e., 0.13% of all persons who died) --- those with estates larger than \$5 million -- paid 55% of all estate taxes.³⁶ A recent Treasury Department study shows that 91% of all federal estate taxes were paid by the estates of people with incomes in the top 5% --those whose annual income exceeded \$190,000 at the time of their death. *No* estate tax was paid by individuals with incomes in the bottom 60%, while less than 1% of federal estate taxes were paid by the lowest-income 80% of the population (those with incomes under \$100,000).³⁷

Importantly, it is sometimes claimed that repeal of the estate tax is necessary to save family farms and businesses -- that is, to assure they do not have to be liquidated to pay estate taxes. In reality, very few people leave a *taxable* estate that includes a family business or farm (only

³⁶ L. Burman & W. Gale, *The Estate Tax is Down, But Not Out* (The Urban Institute, Tax Policy Issues & Options, No. 2, December 2001).

³⁷ I. Lav & J. Friedman, *Estate Tax Repeal: A Costly Windfall for the Wealthiest Americans* (Center on Budget and Policy Priorities, February 6, 2001), available at www.cbpp.org. L. Burman & W. Gale, *The Estate Tax is Down, But Not Out* (The Urban Institute, Tax Policy Issues & Options, No. 2, December 2001), available www.urban.org.

6 of every 10,000 people who die – or 0.06% – leave a taxable estate in which a family business or farm forms the majority of the estate). Current tax law provides special tax breaks for such transfers.³⁸

C. State Gift Tax

Proposal: Rescind the 6-year phase out of the gift tax on taxable gifts under \$1 million, or – alternatively -- freeze the phase-out of the gift tax at current levels (no gift tax on taxable gifts under \$50,000). (CGS § 12-642; PA 00-170).

Revenue gain: \$4.5 million in FY 03, \$5.3M in FY 04 if rescind the phase-out and restore the gift tax to 2000 rates; \$0.7 million in FY 03 and \$1.5 M in FY 04 if freeze gift tax at current rates.

Rationale: Equity, budget stability, and enhanced tax code progressivity. Since 1991, CT has imposed a tax on gifts that are taxable under federal law. *Only those* gifts in a single year from one individual to another that are *over* \$10,000, or gifts in a single year from a couple to an individual that are *over* \$20,000, may be considered “taxable” gifts (CT defines which gifts are “taxable” gifts by incorporating in state law the federal definition of a taxable gift and incorporating by reference federal deductions). No gift tax is *ever* imposed on gifts made to a spouse or to charity.

In PA 00-170, CT began to phase out its gift tax over a six-year period, beginning with gifts given after 1/1/01. Prior to this date, a gift tax of 1% on taxable gifts was imposed on the donor when taxable gifts totaled up to \$25,000, a gift tax of \$250 plus 2% of the excess over \$25,000 when the total taxable gifts were over \$25,000 but not over \$50,000, and the tax increased thereafter up to a maximum gift tax when taxable gifts in a given year totaled more than \$200,000. In SFY 00, the gift tax produced \$32.8 million in revenues.

Starting January 1, 2002, no gift tax is due unless a donor’s *taxable* gifts in a single year total more than \$50,000 and, by January 1, 2006, there will be no gift tax due unless a donor’s taxable giving in a single year totals more than \$1 million. OFA characterizes the rationale for this phase-out as being, in part, “expedience.”

CT’s gift tax is borne primarily by CT’s wealthiest residents. In SFY 99, CT collected \$29.3 million from the gift tax. About 10,000 gift tax returns were filed, with more than half the returns reporting total taxable giving under \$25,000, and more than 60% reporting taxable giving under \$50,000. (All of these taxpayers would, under current law, no longer be required to pay gift tax.)

Although only about 500 of the gift tax returns reported taxable giving in 1999 of more than \$200,000 per taxpayer, the total tax from this group was about \$25 million of the total gift tax collected. That is, about 5% of the taxpayers paying CT’s gift tax reported taxable giving in 1999 of more than \$200,000 each – and these taxpayers paid 85% of the CT gift tax.

³⁸ In CT, for example, if the value of an interest in a closely-held business exceeds 35% of the value of the gross estate, the tax can be paid in 10 equal annual installments. CGS §12-376b

Phasing-out CT's gift tax disproportionately benefits CT's wealthier citizens. Freezing the phase-out, or rescinding the phase-out and returning to the rates that existed all through the 1990s, would enhance the progressivity of the state tax code.

D. State Sales/Use tax

Proposal: Alternative 1: Sunset all exemptions and rate reductions excepting those for food, clothing under \$75/item, home heating fuel, and health-related consumer goods. Possibly reduce sales tax rate on all sales of all goods/services from 6% to some lower rate (to try to increase total sales and capture increased revenues by cutting into mail order catalog and Internet sales)

Alternative 2: Sunset exemptions OFA characterizes as having an underlying rationale of "expediency" and others that may no longer further an important state purpose, or as important a state purpose as the programs/services threatened with budget cuts.

Revenue Gain: Alternative 1: More than \$500 million, unless coupled with a sales tax rate reduction.

Alternative 2: Revenue gain depends on which exemptions/rate reductions are repealed.

Rationale: Equity & budget stability. Sales taxes are considered *regressive* taxes. That is, people who are poorer pay a greater share of their income in sales tax than those who are wealthier. Also, Connecticut's sales tax "base" is relatively – and increasingly -- narrow. That is, rather than imposing the tax on *all* sales of goods and services (which provides a more stable revenue source, is easier administratively, and could generate the same amount of revenue, but with a tax rate less than 6%), CT has well more than 150 *exemptions* from the sales tax for all manner of things -- from sales of food and of clothing that costs less than \$75 per item, to sales of gold and silver bullion, vending machine sales, massage therapy services, sales of high-speed data transmission equipment, and the production of direct mail advertising services.

This year (SFY 02), CT expects to collect about \$3.25 billion in sales tax (24% of all revenues), but CT *will not* collect an additional \$1.58 billion in revenue because of these preferential exemptions from the sales tax for certain goods and services, or certain purchasers. The National Conference of State Legislatures and the National Governors' Association, in *Financing State Government in the 1990s*, conclude:

State sales taxes are in need of substantial overhaul if they are to continue to play their traditional role as a workhorse in the state-local revenue system. States must seriously consider expanding the sales tax base, or they are likely to be confronted with the need to continually adjust the tax rate if the sales tax is to continue providing its historical share of state revenues. *The taxation of certain service transactions and an examination of current exemptions offer the most likely avenues for revitalizing the state sales tax base.* (p.76)

As noted earlier, OFA has characterized certain of the exemptions from CT's sales/use tax as having an underlying rationale of "expediency." Repeal of such exemptions would both increase revenues, and also enhance the quality of CT's tax code. If coupled with a modest rate reduction, the change could also increase purchasing that is subject to the tax (i.e., substitute in-state sales for Internet sales).

E. State Business Taxes

Proposal: Repeal all tax expenditures OFA has characterized as having the rationale of "expediency" as well as selected others enacted in the last several years where the preferential tax treatment provided is less weighty than programs and services proposed to be cut.

Revenue Gain: Depends on options chosen. Substantial potential gain.

Rationale: Equity and budget stability. From the 1991 through 2000 legislative sessions, \$1.3 billion in tax reductions benefiting businesses were enacted, of which 39% (\$506 million) came from rate reductions³⁹ and 61% (\$783 million) came from other tax expenditures (exemptions, exclusions, deductions and credits against various business taxes).⁴⁰ Credits against various business taxes, which are particularly valuable since they offset tax liability dollar-for-dollar, soared over the 1990s. In 1991, companies claimed about \$2.26 million in credits against various CT business taxes. In 1998, they claimed nearly \$114 million in credits – a nearly 50-fold *increase*. The consequence of these changes over the 1990s were to markedly reduce revenues from business taxes. In SFY 02, CT will collect about \$990 million in various business taxes (corporate business tax, insurance premiums tax, public service and petroleum companies gross earnings tax), but will forego more than \$600 million in revenue because of tax exemptions, deductions and credits.

By reducing revenues, these tax expenditures also result in *other* CT taxpayers having to pay more in tax and/or in all citizens experiencing a decline in state services. In fact, in SFY 91, 19% of CT's revenues came from business taxes while in SFY 02, only 7% of CT's revenues will come from business taxes. (Over the same period of time, the proportion of state revenues from the personal income tax increased from 7% to 35%.) Thus, over the decade, the tax burden has shifted markedly *away* from CT businesses and onto individual CT taxpayers.

Importantly, these business tax expenditures are *not* reviewed annually in the way that direct subsidy payments to businesses through the appropriations process would be, although the effect of tax expenditures is to provide preferential financial advantage to certain CT businesses.

NCSL and NGA, in *Financing State Government in the 1990s*, write, "States should examine their business taxes to avoid applying different tax policies to industries and businesses that compete in the marketplace." (p.88). The General Assembly has acknowledged the need for

³⁹ CT's nominal corporate tax rate (7.5%) is less than the rates of neighboring states.

⁴⁰ OFA, *Synopsis of Tax Reductions for Business and Workers Compensation Reductions*, 2001.

some review, passing (in 1997) a law to establish a Corporate Business Tax Credit Review Committee. This Committee was charged to study and evaluate “all the existing credits against the corporate business tax” to assess whether the credit has provided a demonstrable benefit to the state, whether there is sufficient justification to continue the credit, and if the credit could be more efficiently administered. [CGS §12-217z] Though this Committee’s initial report was due “no later than January 30, 2002,” the Committee has never even been established.

As noted earlier, OFA has characterized a number of these business tax expenditures as having an underlying rationale of “expediency.” Repeal of such tax expenditures would not only increase revenues but also improve the quality of CT’s tax code. Others may no longer serve an important public purpose, or a purpose that remains more important than others now competing for state financial support. In addition, certain other tax expenditures could be better targeted to enhance other important state policies, such as reducing sprawl (e.g., restrict the current property tax exemption for new manufacturing equipment and machinery – & the corresponding PILOT payments -- to use in cities and towns with a priority school district.).

F. Cigarette Tax

Proposal: Increase tax on cigarettes from \$.50 pack to \$1.11/pack.

Revenue Gain: Estimated to be \$130 million in SFY 03. Likely to be less than this in SFY 04, as smoking should decline with an increase in tax. If enacted effective 4/1/02, as proposed by the Governor, this also will provide revenue in SFY 02.

Rationale: Budget stability and enhancing public health by reducing smoking. Repeated studies have demonstrated that smoking is harmful to health, and that the increase in the cost of cigarettes is an effective deterrent to teen smokers (since teens are very price sensitive). An increase in the cost of cigarettes has the dual benefit of generating additional revenue, and also reducing the number of youth who begin smoking.⁴¹

G. Admissions Tax

Proposal: Repeal all exemptions to the admissions tax that OFA characterizes as having an underlying rationale of “expediency.”

Revenue Gain: \$9.7 M.

Rationale: CT’s admissions tax has existed since 1971. The admissions charge to a place of amusement, entertainment or recreation is taxed at 6%. OFA has characterized virtually all of the exemptions to the admissions tax as having the rationale of “expediency.” Repeal of

⁴¹ This tax, however, would be a regressive tax. It also would not be a stable revenue source, since the price increase would decrease smoking, and with it revenues from the tax. In addition, the MATCH Coalition would object to the use of these revenues for budget-balancing purposes, advocating – instead – that the revenues be used to enhance CT’s investments in health and public health, including smoking cessation programs and services.

these exemptions, which give certain places of amusement or entertainment preferential tax treatment by exempting these admissions from this tax, would restore \$9.7 million in revenues.

4. Rainy Day Fund

Proposal: Use some of the Rainy Day Fund to balance the SFY 02 budget (and thereby avoid making further spending cuts while other changes are being implemented to increase revenues).

Rationale: The Budget Reserve (“Rainy Day”) Fund was established in 1978 and can have a balance of up to 5% of net General Fund appropriations. By statute, the Fund can be used to finance state operating deficits only at the *end* of a fiscal year. It is – in essence – the state’s savings account, a resource to be tapped when the state’s financial situation requires it. At the end of the fiscal year, any budget surplus first must go to replenishing the Fund, and then to paying off the state’s bonded debt or any other uses on which the General Assembly decides. The Fund currently has \$595 million in it.

The current times are precisely the times for which the Rainy Day Fund was intended. This proposed plan would use about 1/3 of the current Fund to balance the SFY 02 budget, and then assure that the SFY 03 is balanced by making some combination of the revenue changes proposed herein. This amount could be *reduced* if some of the tax code changes proposed here had an implementation date earlier than 7/1/02. Moreover, if the economy recovers in SFY 03, as it is expected to, any surplus in the SFY 03 budget could be directed to replenishing the Rainy Day Fund.

III. Conclusion

The recent economic downturn has created both the obligation and the opportunity to look more closely at CT’s tax and budget priorities, procedures, and structures. As we do so, it becomes evident that CT – the nation’s wealthiest state – can do better. For if CT makes *smart choices*, it has ample resources not only to continue – but to enhance – its investments in education, mental health, health, transportation, and housing that working families can afford. These high-return investments are not just good for CT families, but make good economic sense. They not only enhance the productivity of the state’s current and future workforce, but also avert costs, including those for special education, in-patient and residential care, and corrections.

To continue these investments in CT’s future and also keep CT’s budget in balance in this and future fiscal years, however, *all* budget-balancing alternatives must be on the discussion table, so their relative costs and merits can be compared. To look *only* at ways to cut appropriated spending, and not also at ways to increase state revenues through cuts to tax expenditures, is to consider only half the puzzle. It is to sell short CT’s future.