




“Never Waste a Crisis” State Fiscal Challenges and Revenue Options

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**CONNECTICUT
VOICES
FOR CHILDREN**




“The state is projected to experience deficits at the end of 2009-2010, 2010-11 and 2011-12 that are *unprecedented in our history* based on current services requests.”

Robert Genuario, OPM Secretary

Report to the Appropriations Committee &

The Finance, Revenue and Bonding Committee (November 12, 2008)



Overall Objectives of Overhauling Connecticut's Revenue System

- modernize tax structure
- make tax structure more fair
- ensure adequate revenues
- address **BOTH** the structural deficit and the portion of the deficit that is the result of the current economic downturn



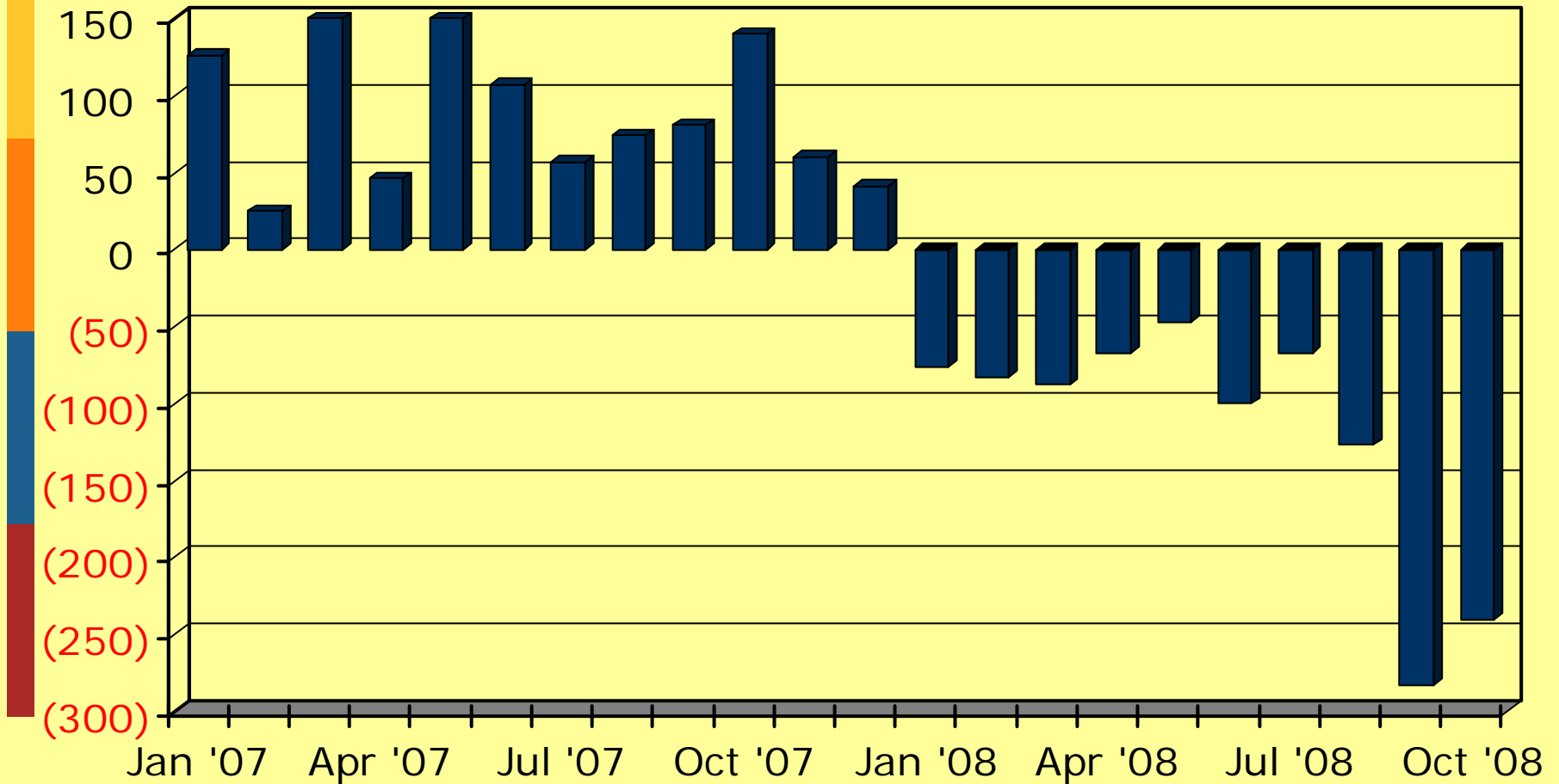
The economic and fiscal context

A Crisis, to be sure

- 31 States (including CT) face mid-year FY09 deficits
- 21 States (including CT) projecting FY10 deficits
- On track for **\$100 billion** in total state level deficits for 2010
- CT's **1.7% General Fund Deficit** among smallest of deficits in states (compares with national rate of 6.6%)

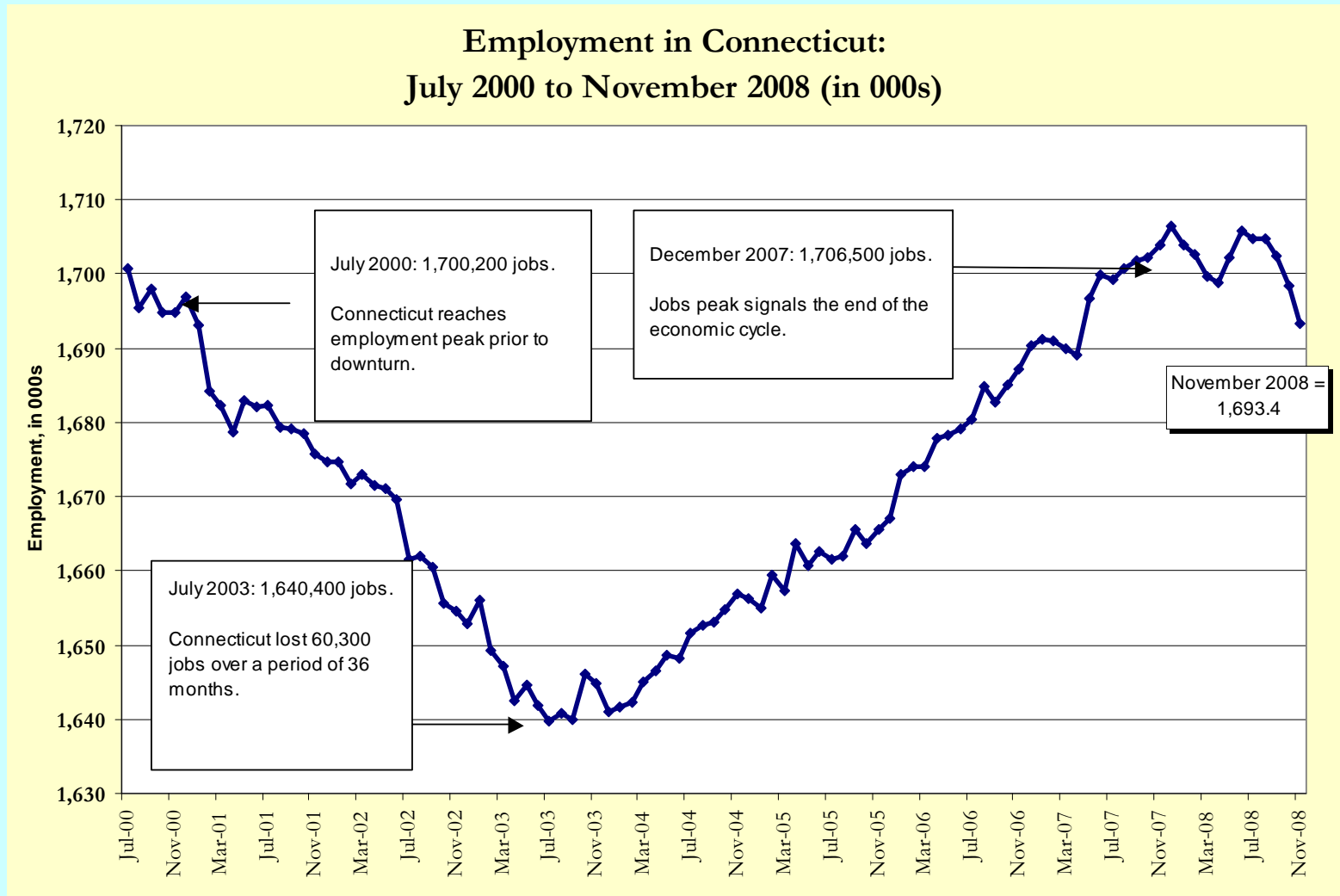
The Recession Intensifies...

Change in Payroll jobs, (000s), Source: BLS



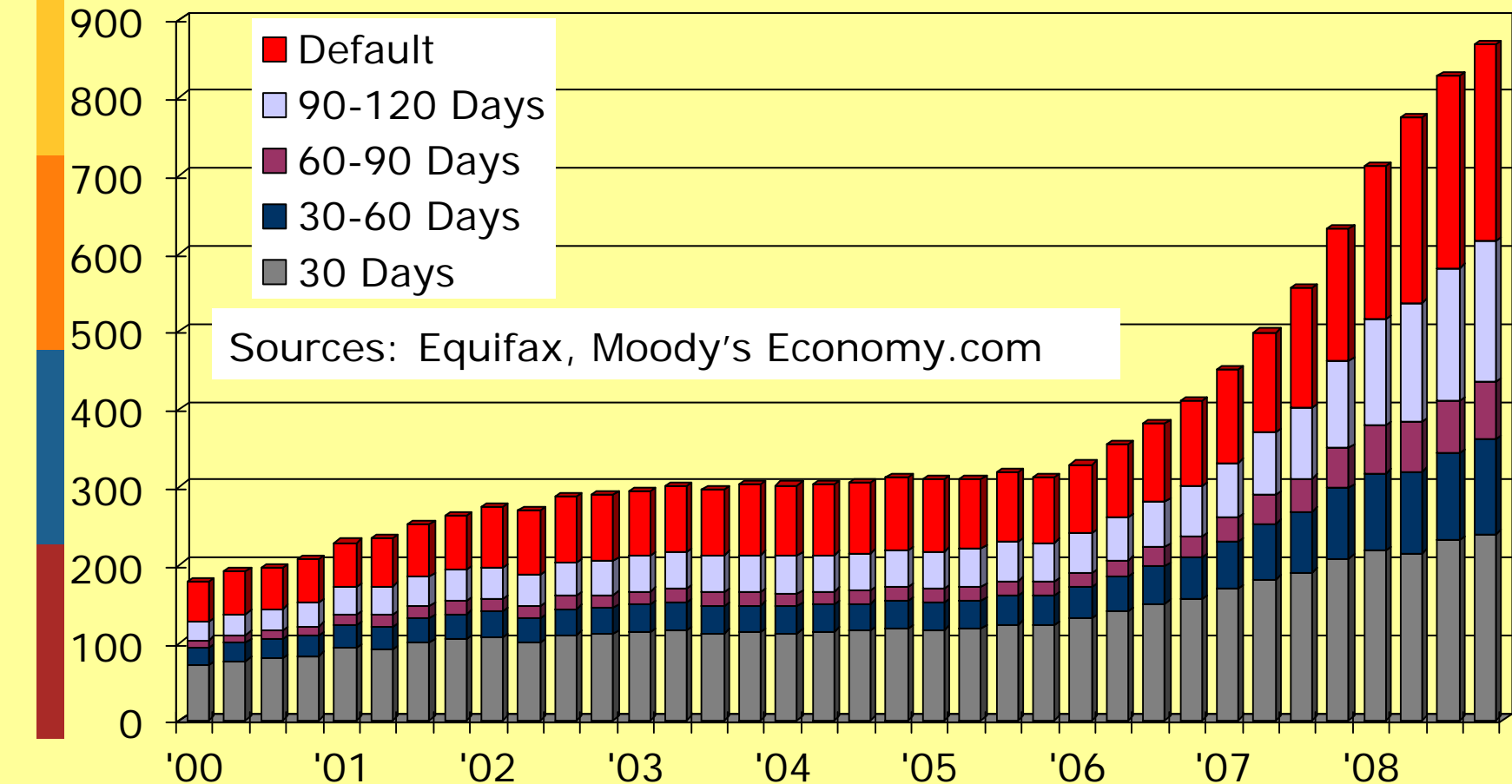
Source, Mark Zandi, Moody's/Economy.com, Nov. 08.

...including Connecticut



...As Households Buckle Under The Stress...

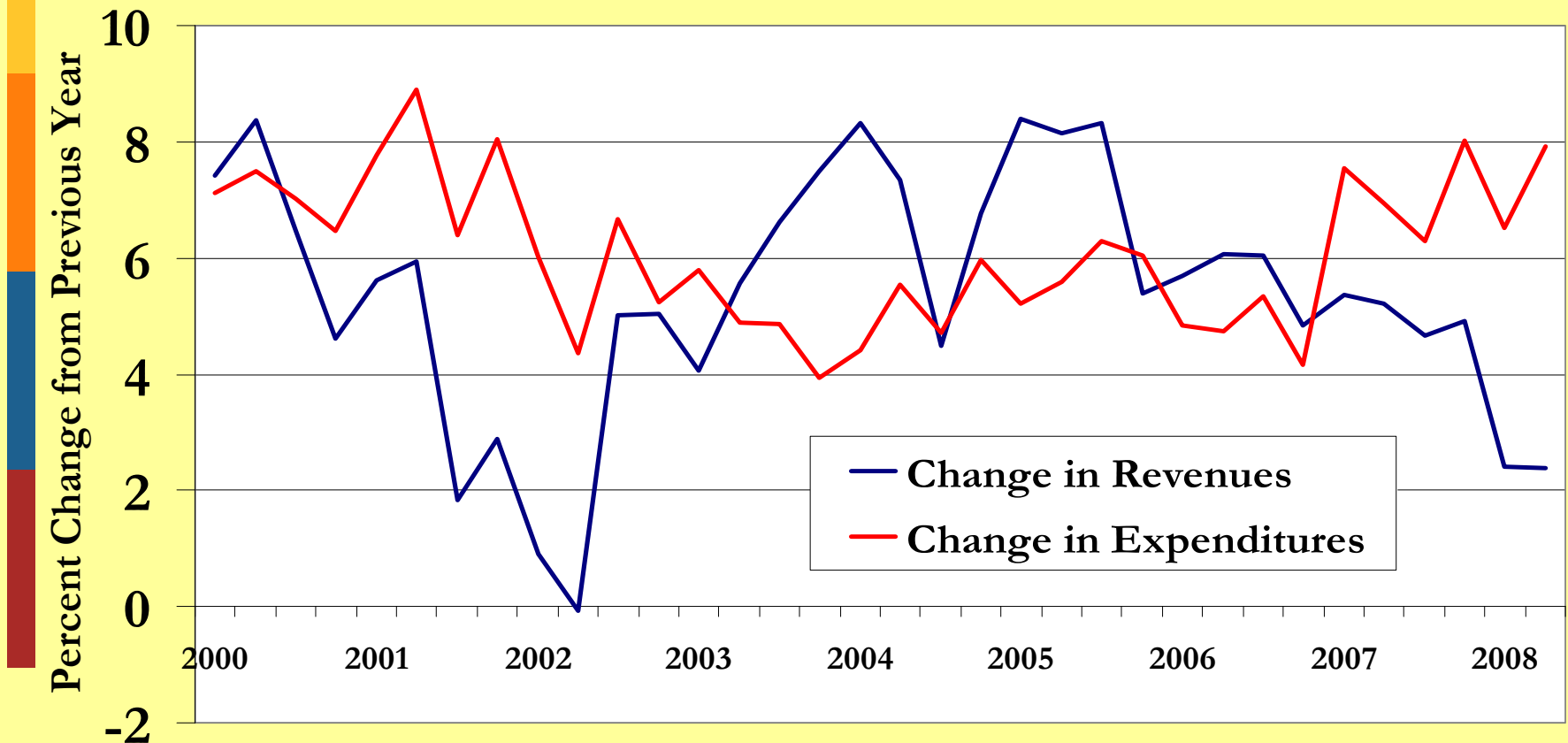
Household debt in delinquency or default, \$ bil, annualized



Source, Mark Zandi,
Moody's/Economy.com, Nov. 08.

...Hitting State & Local Gov't Hard

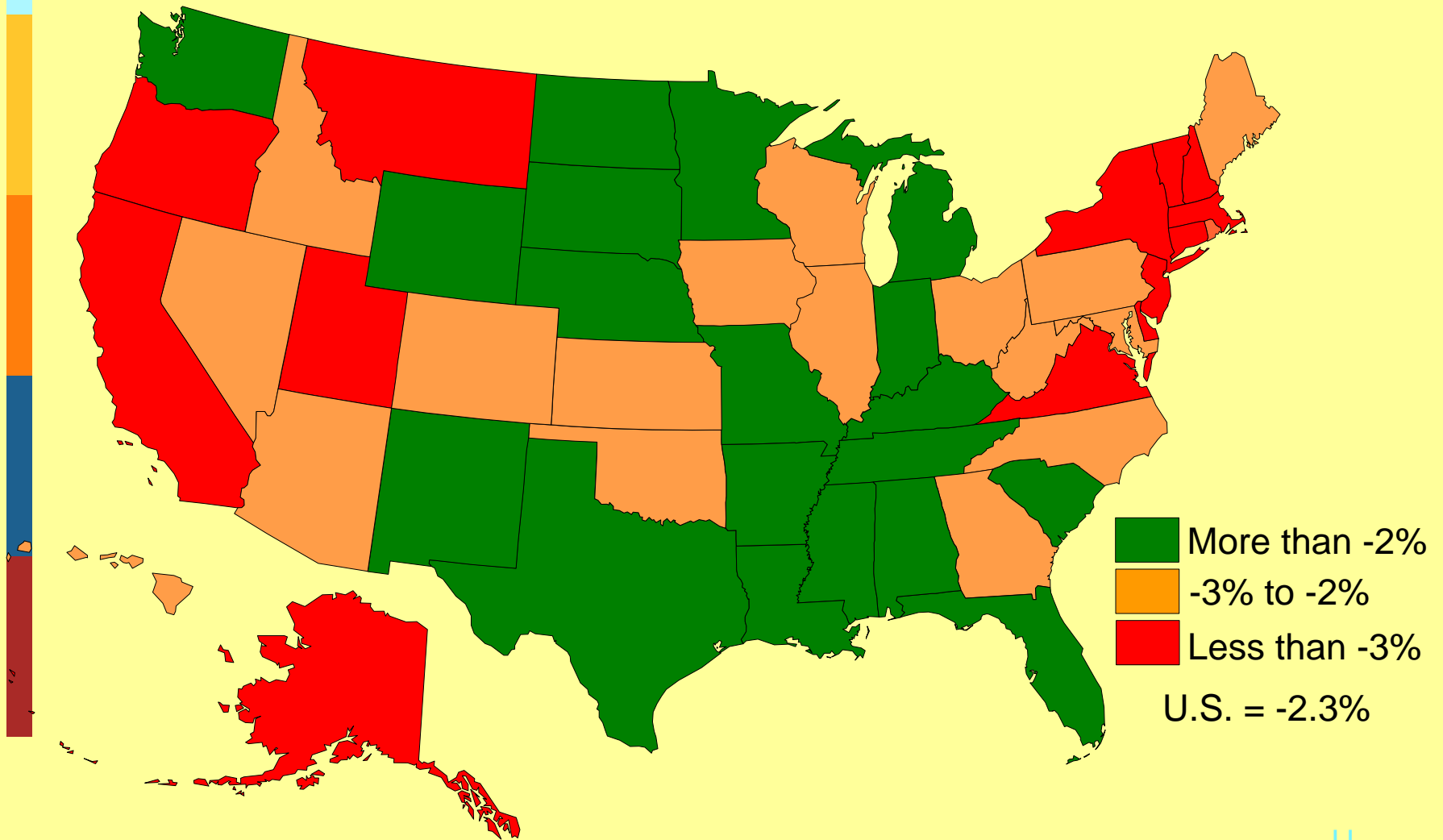
State & local revenues & expenditures,
% change year ago, (2000-2008)



Source: Mark Zandi, Moody's/Economy.com, from BEA data

State Tax Revenues Will Decline...

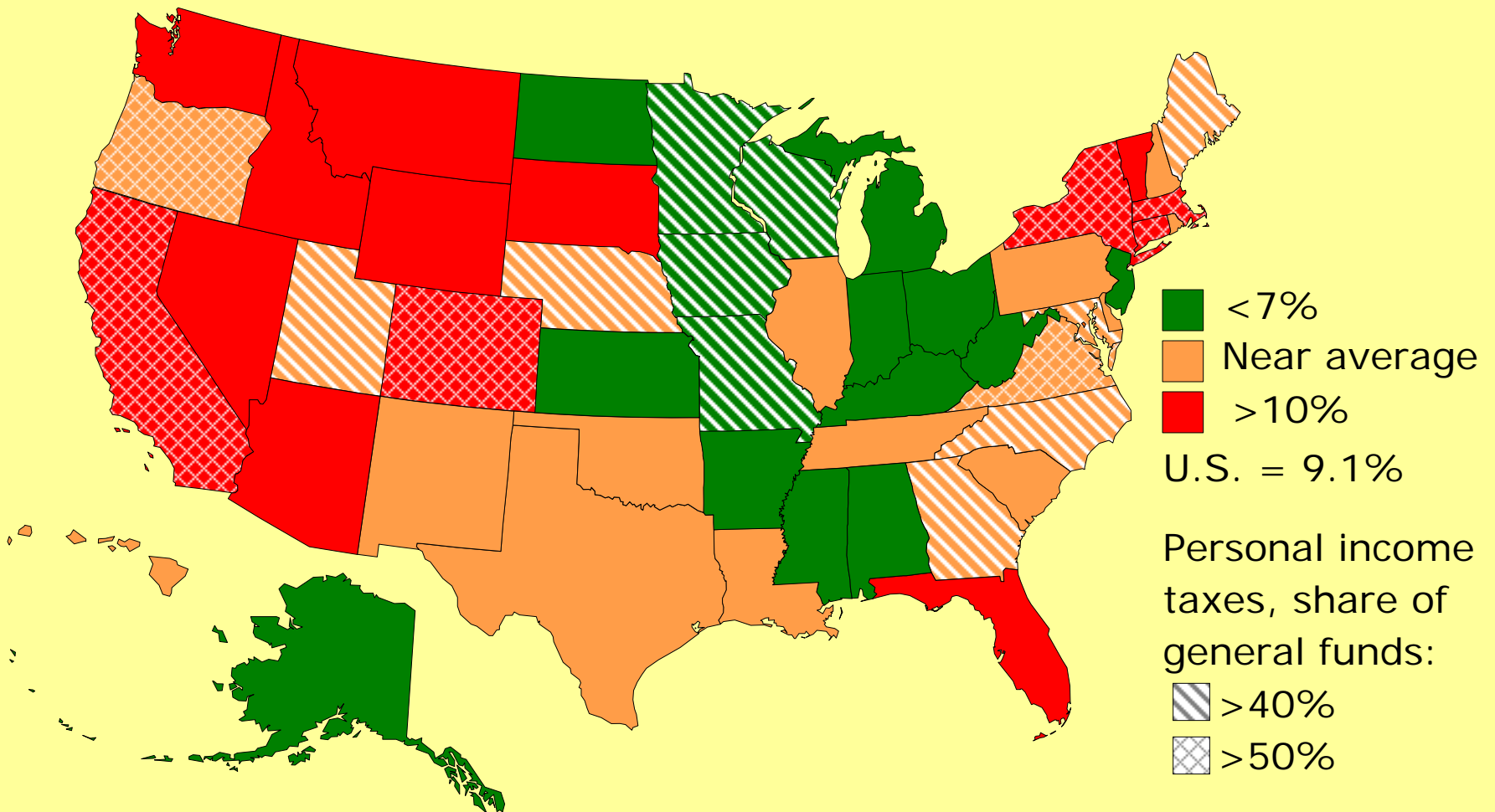
General fund taxes, annual % change, FY '09-'10



Source: IRS, Census , and Mark Zandi, Moody's/Economy.com

...As Capital Gains Weaken...

Capital gains as a % of AGI, 2006



Connecticut's Deficit Projections Getting Worse by the Minute

	August Projection	September Projection	November Projection
FY09	\$23.9 m	\$292.6 m	\$391.8 m
FY10	\$726.6 m	\$955.5 m	\$2,495 m
FY11	\$1,040.4 m	\$1,184 m	\$3,215 m
FY12	\$830.9 m	\$1,294 m	\$3,321 m

About the Deficit

- Importantly, Connecticut's current deficit has **two distinct components**:
 - **Structural deficit**, which we've seen coming for years
 - Deficit resulting from **economic downturn**
- **Both** of these components need to be addressed in **revenue solutions**

Where Do We Start? Step back from Crisis Mode

- Connecticut's budget – both the expenditure side and the revenue side – should reflect our values and our aspirations
- It should answer the question “What kind of state do we want: for ourselves, for our children, for each other, (and how can we fairly and adequately pay for it)?”

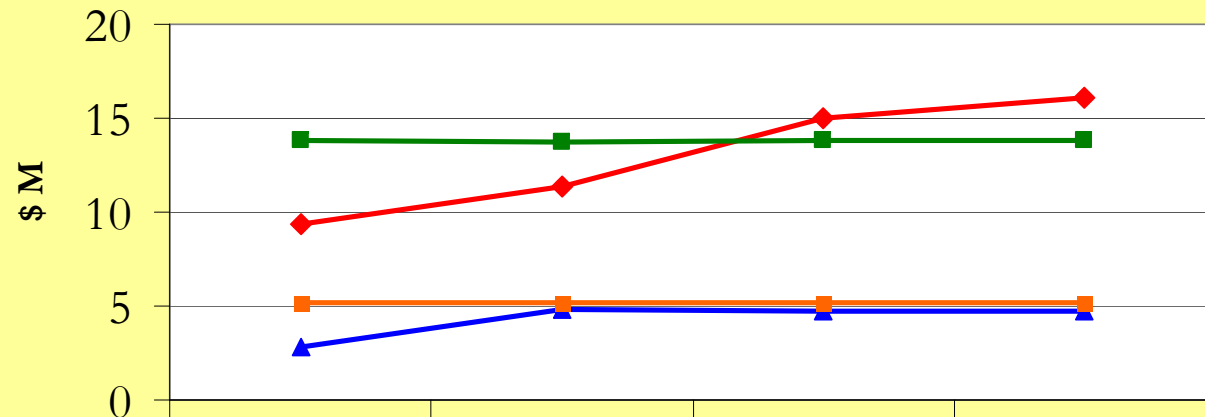
Where Do We Start?

**“Just Say NO! to crippling budget cuts”
(but don’t shy away from ‘spending smarter’)**



What Does “Smart Spending” Look Like?

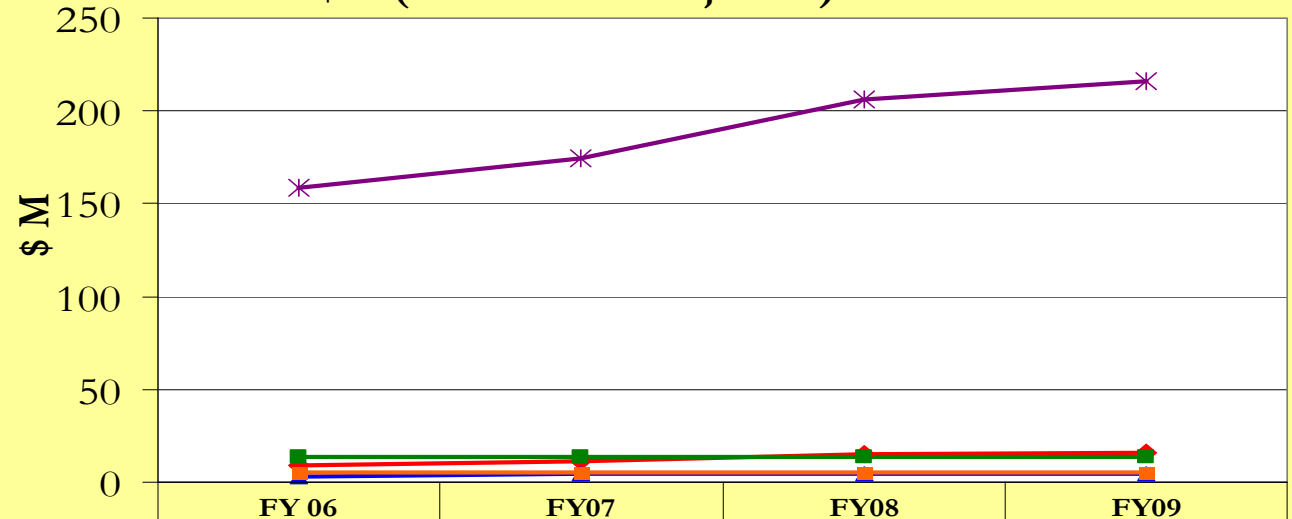
Select DCF Investments in Prevention, FY06-FY09, \$M
(not inflation adjusted)



	FY 06	FY07	FY08	FY09
◆ Family Support Services	9.4	11.4	15	16.1
■ Grants for Psychiatric Clinics for Children	13.8	13.7	13.8	13.8
▲ Community Based Prevention Programs	2.8	4.8	4.7	4.7
■ Family Preservation Services	5.2	5.2	5.2	5.2

Smart Spending...vs. not-so-smart spending

DCF Investments in Prevention, FY06-FY09,
Vs. Amount for Board and Care -- Residential
\$M (not inflation adjusted)



	FY 06	FY07	FY08	FY09
◆ Family Support Services	9.4	11.4	15	16.1
■ Grants for Psychiatric Clinics for Children	13.8	13.7	13.8	13.8
▲ Community Based Prevention Programs	2.8	4.8	4.7	4.7
■ Family Preservation Services	5.2	5.2	5.2	5.2
* Board and Care for Children -- Residential	158.3	174.8	206.4	216



Some Revenue Options: The Sales Tax

About Raising Sales Taxes

- \$3,582 million in FY08
- OFA estimate for FY09, \$3,748 million
- **7% tax rate** applied to same FY09 sales would generate **additional \$625 million**
- FY 09 year-to-date revenues down \$1.3 million by Oct. 08
- Vulnerable economy could be further crippled by raised rate
- Sales taxes are regressive (see following ITEP table).

State	Sales Tax Rate
NJ	7%
RI	7%
CT	6%
MA	5%
NY*	4%/8%

Sources: <http://www.osc.state.ct.us/reports/monthly/fye08/scheduleb2.htm>, <http://www.taxadmin.org/fta/rate/sales.html>, http://www.ct.gov/drs/lib/drs/research/08comparstate/mon_stmt_oct_2008.pdf, Note that New York City levies an additional 4% sales tax.

About Raising Sales Taxes:

Tax Incidence of Sales Taxes

"Who Pays?" Incidence of Connecticut's State and Local Taxes, 2006



Source: Douglas Hall and Shelley Geballe, "Who Pays?" *How Our State and Local Tax System Burdens Connecticut's Poor and Middle Class*, (CT Voices for Children, 2008)

About Broadening the Base to Apply Sales Tax to Services (I)

- State economies evolving, but state tax structures not as nimble.
- Several States have broadened the base to which sales taxes apply, including more services
- A broad base is an important element of sound tax policy
- CT currently taxes 79 services
- In 2006, NJ broadened base to include more services
- Leading states include Hawaii (160), New Mexico (158), Washington (158)

About Broadening the Base to Apply Sales Tax to Services (2)

- OFA estimates **CT will lose \$152.4 million** through tax expenditures for services in FY 09
- **BUT** this estimate is based only on those services that have been exempted from services that we already tax. Does **NOT** include services that we completely do **NOT** tax (eg. Physicians, accountants, attorneys).



“But Sales Taxes Are Regressive”

Because Sales Taxes are regressive, increases in sales tax should be paired with low income tax relief:

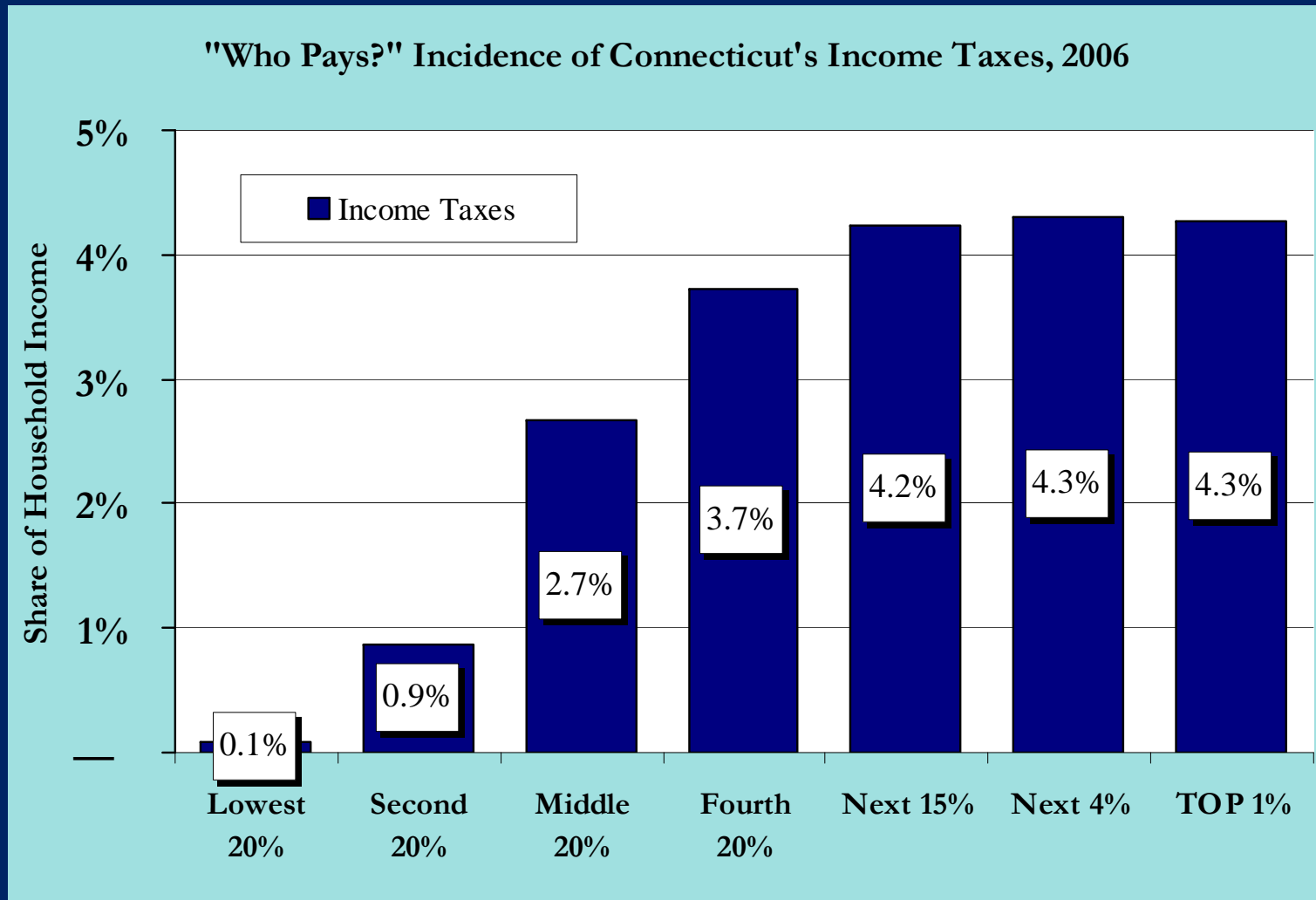
- **State earned income tax credit**
- **Child tax credit**
- **Low income tax credit**



Some Revenue Options: The Income Tax

About Raising Income Taxes:

Tax Incidence of Income Taxes



Source: Douglas Hall and Shelley Geballe, "Who Pays?" *How Our State and Local Tax System Burdens Connecticut's Poor and Middle Class*, (CT Voices for Children, 2008)



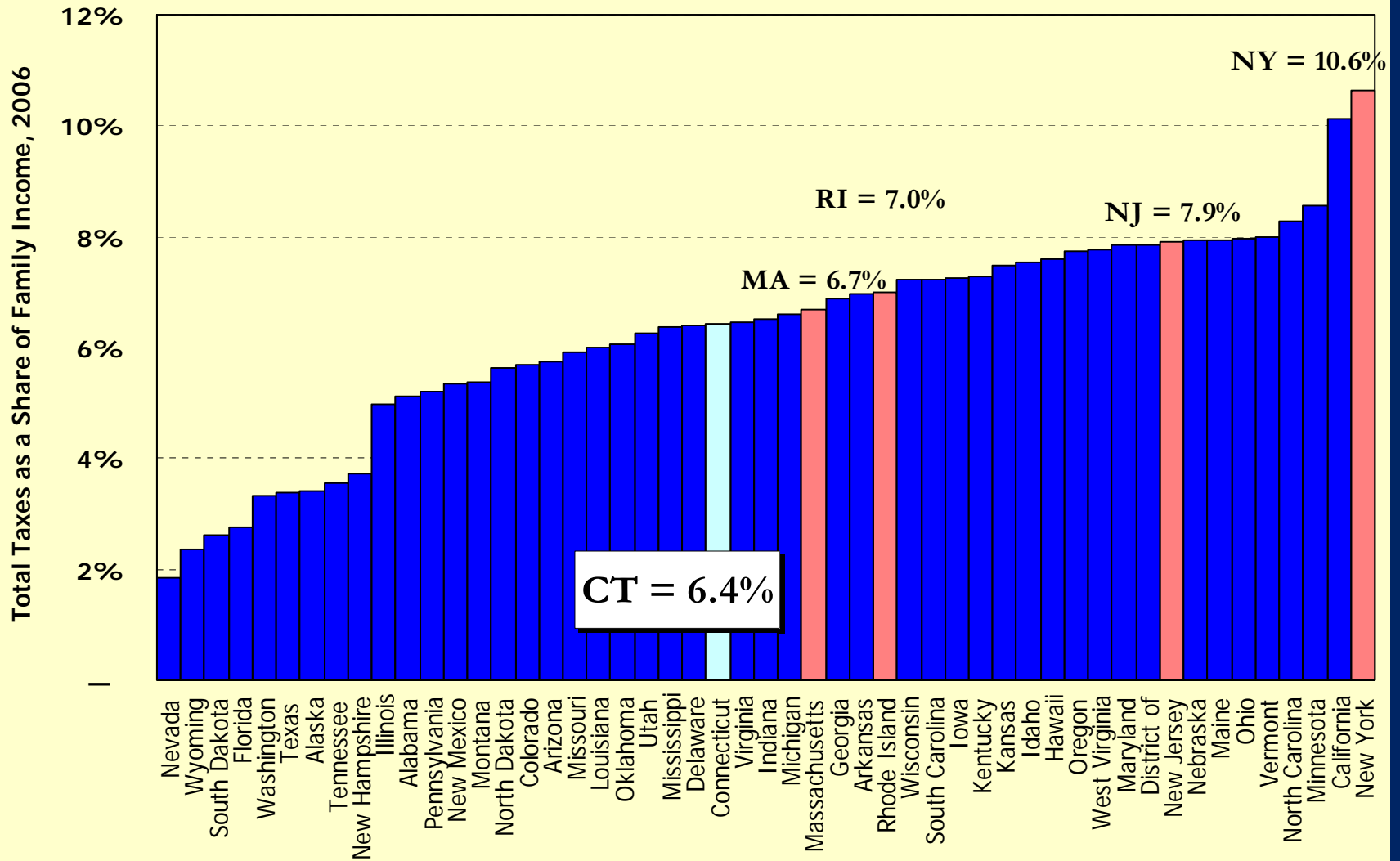
Two Approaches to Overhauling the CT Income Tax Structure:

- 1. New Bracket(s) with Higher Rates for Top Incomes**
- 2. Use Federal Income Tax as base for calculating CT Income Tax (as in RI)**

I. New Bracket: Higher Rate on top earners

- CBPP estimates that a **1% surtax** on income exceeding **\$500,000** would yield **\$345.3 million** (based on TY06 data)(1)
- ITEP estimates that creating a **6% bracket** for families with incomes exceeding **\$200,000** would yield roughly **\$470 million** (TY2006 data).
- These estimates are likely higher than we can expect given declines in income due to economic downturn

Connecticut's Highest Income Taxpayers (Top 1%) Pay a Smaller Share of Family Income in State and Local Taxes Than Neighboring States'



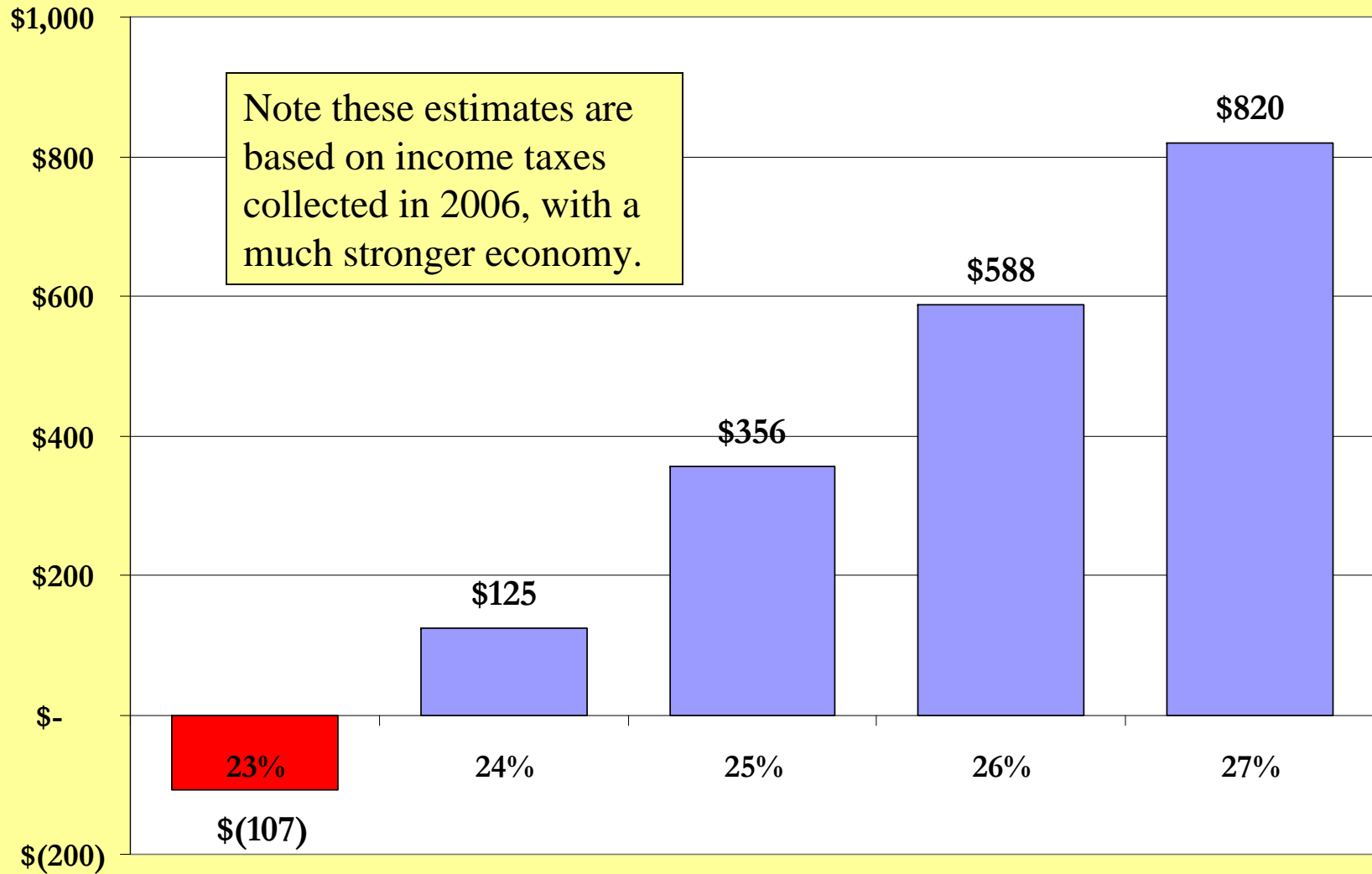
Source: ITEP, *Who Pays?*, forthcoming, 2008.



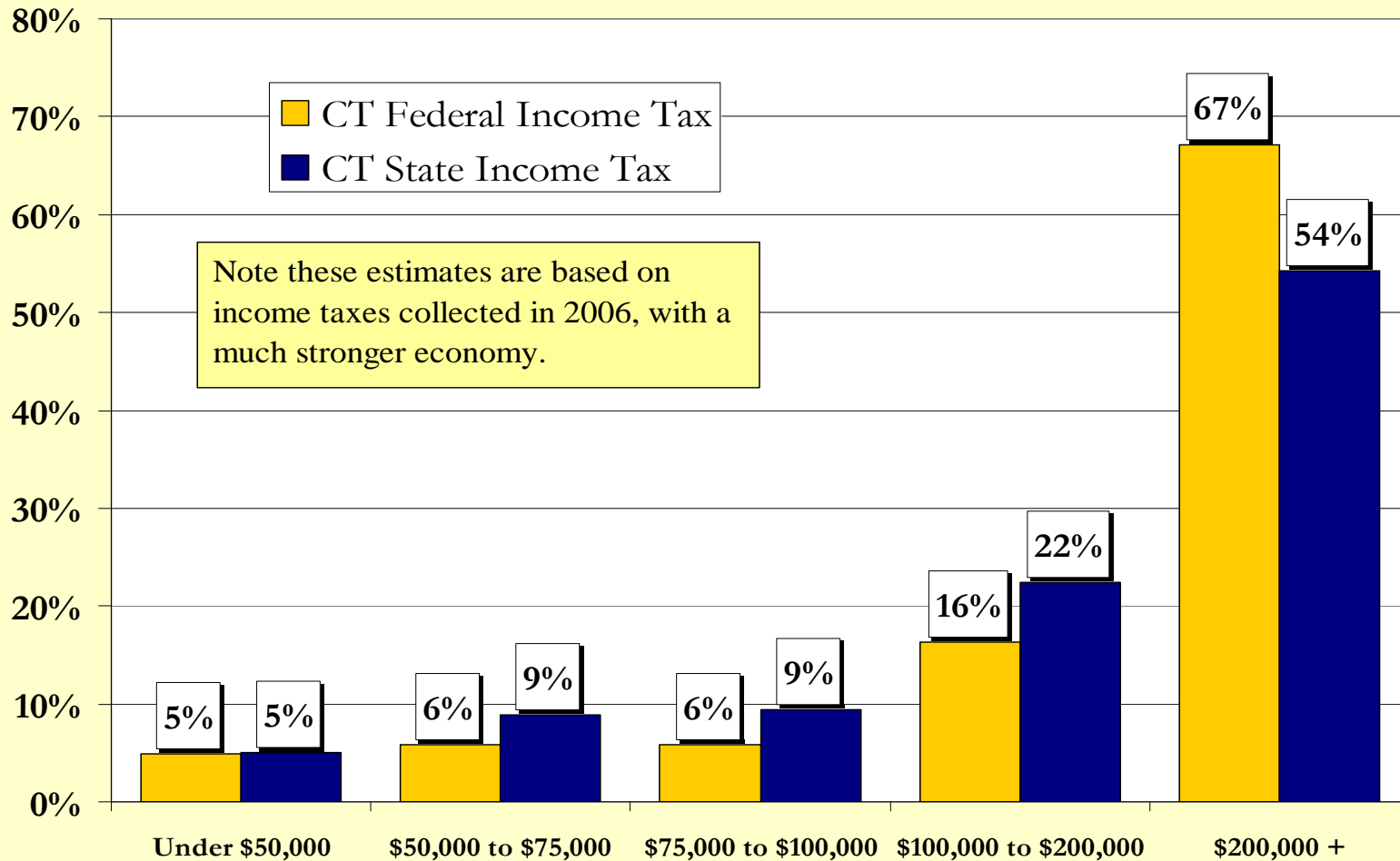
2. Use Federal Income Tax as base for calculating CT Income Tax

- State income tax calculated as % of federal income tax owed.
- Very simple to administer
- State loses some of its flexibility
- RI previously used 25% of federal. Some percentage options yield significant revenue:

Differences Between Various Revenue Options Based on Federal Income Tax,
and CT Income Tax Collected, TY2006 (\$M)



**Distribution of Income Taxes Paid by CT Taxpayers: Federal and State
Income Taxes: Percent of All Income Taxes, By Income Range, TY 2006**





Some Revenue Options: Cigarette/Tobacco Taxes

About Tobacco Excise Taxes

- **\$335.2 million in FY08**
- **\$348.1 forecast for FY09**
- **July 1, 2007, CT raises tobacco excise to \$2.00 pack (4th highest in country)**
- **08/09 revenues down 11% from 07/08 levels**



Three Reasons To Raise Tobacco Excise Taxes

1. **Source of significant revenue: \$335.2 million in FY 08**
2. **Appropriate “close the gap” revenue option during economic downturn (because the revenue generated diminishes over time)**
3. **Sound health policy (higher price discourages use, particularly among children and youth)**

Three reasons **NOT** to Raise Tobacco Excise Taxes:

1. Incidence of tax (ie, “Who Pays”) falls disproportionately on lower income families
2. Small states make it harder to capture revenue when lower cost cigarettes are within easy driving distance
3. Not sound *long-term* fiscal policy due to diminishing returns

Excise Tax Rates on Cigarettes

State	Excise Tax per Pack	Rank among 50 States
NJ	\$2.58	1
RI	\$2.46	2
CT	\$2.00	4
MA	\$1.51	15
NY	\$1.50 (+ \$1.50 in NYC)	16
US Median	\$1.00	N/a



Some Revenue Options: Mandatory Combined Reporting

About Mandatory Combined Reporting

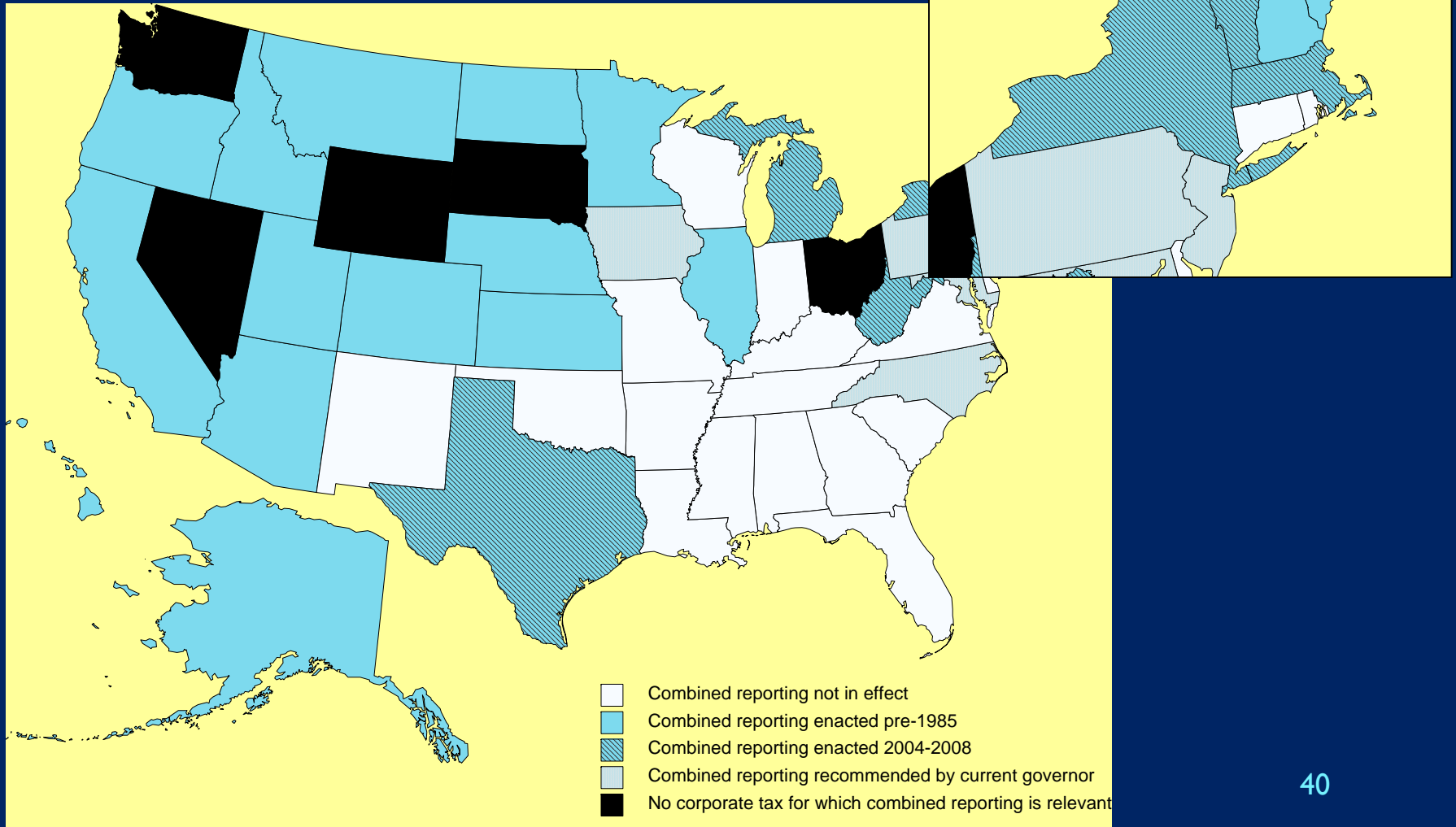
“in the absence of combined reporting, multi-state corporations will always be able to develop new methods of transferring profits from high-tax to low-tax states.” ⁽¹⁾

What is Combined Reporting?

- Combined reporting “treats a business composed of a parent corporation and one or more subsidiaries as a single corporation for tax purposes.”
- Counteracts aggressive corporate “tax planning”


(1) Inst. on Taxation & Econ. Pol’y, Combined Reporting of State Corporate Income Taxes: a Primer (2008), <http://www.itepnet.org/pb24comb.pdf>.

About Mandatory Combined Reporting: time to get with the program



About Mandatory Combined Reporting

- 21 states currently require mandatory combined reporting
- States that have recently adopted combined reporting include: MA, NY, VT, WV, and Texas
- Legislation can apply to either domestic or international dimensions of corporation [domestic far simpler, international prevents wider range of tax avoidance]
- Revenue estimate for mandatory combined reporting: **\$117 million**, projected from NY, MA, WI, IA, and MD estimates



**Some Revenue Options:
Look at Both Sides of the Budget:
Tax Expenditures Take \$5B bite
out of budget**

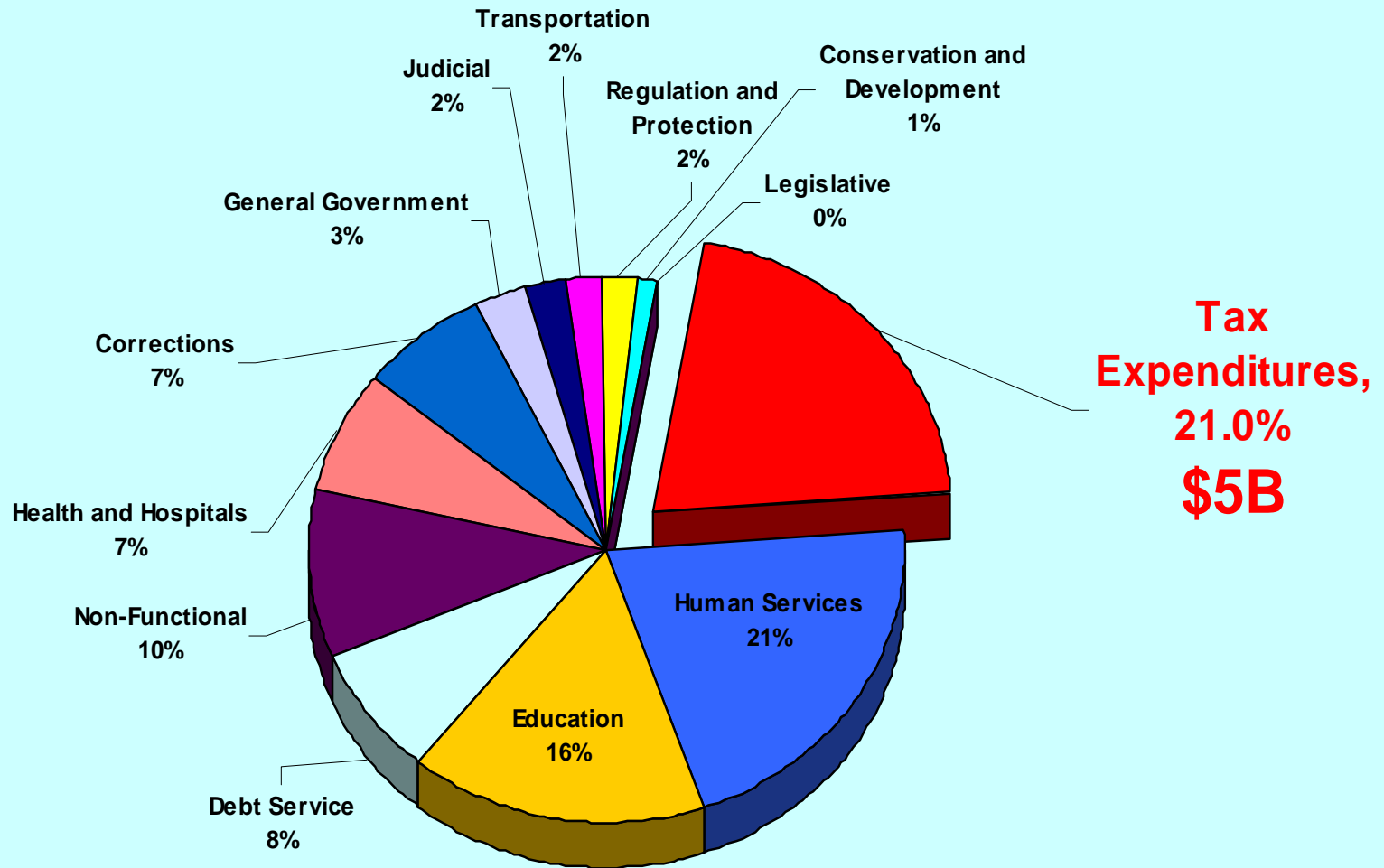


Tax Expenditures: A Form of “Hidden Spending”

Tax expenditures (tax credits, exemptions, exclusions, deductions) provide preferential financial benefit to one or more taxpayers through the tax code.

Unlike appropriated expenditures, tax expenditures are rarely revisited & become permanent revenue losses, regardless of changed economic conditions or evolving public policy, and without an assessment of their continued value to the state.

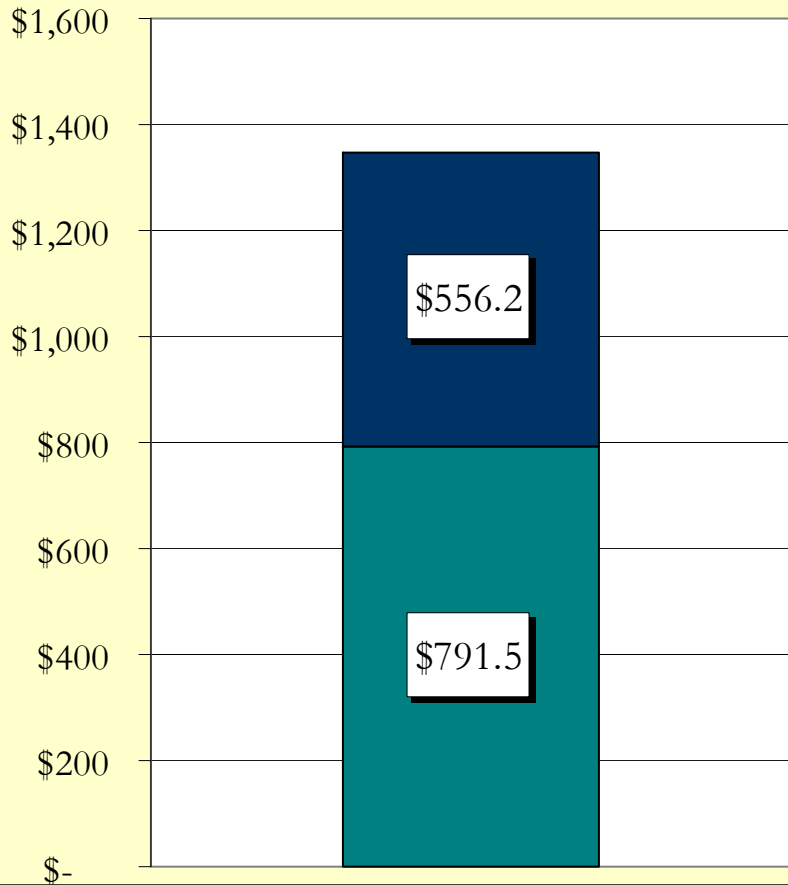
Consider both Appropriations Budget and Tax Expenditure Budget



Total “spending” through appropriations and through tax expenditures totals \$23.6 billion in FY09. The financial benefits provided through the tax code roughly equal all funding for DSS, and are more than all spending on education.

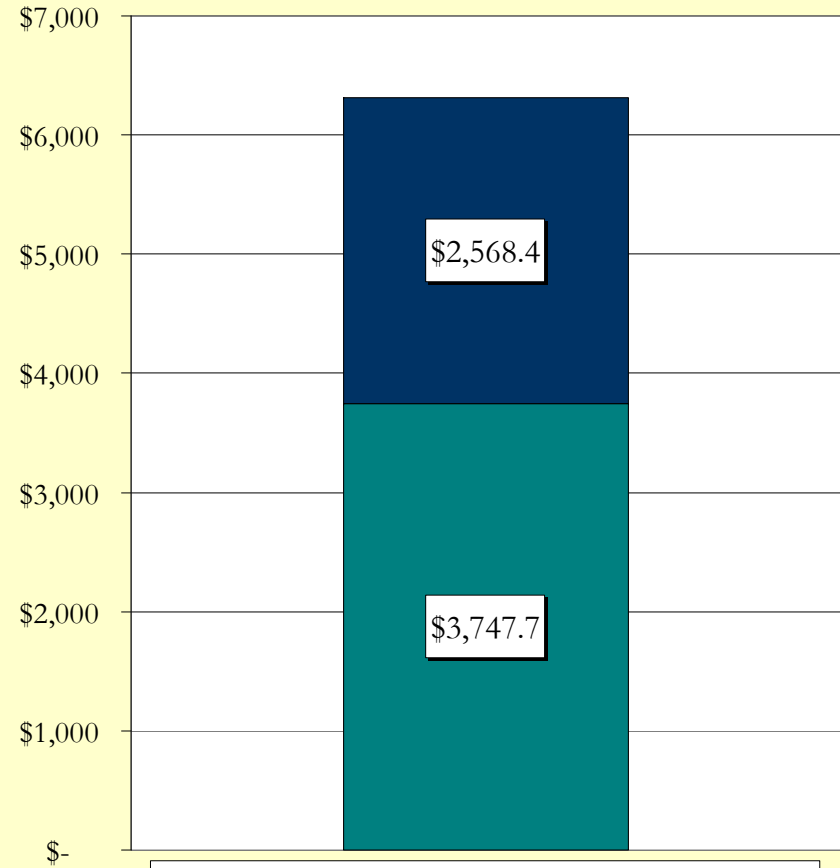
TAX EXPENDITURES ERODE REVENUES, IS CT GETTING ADEQUATE RETURN?

FY09 Corporation Business Taxes (\$M)



■ FY09 corporation business tax exemptions, deductions, credits
■ FY 09 budgeted corporation business tax revenues

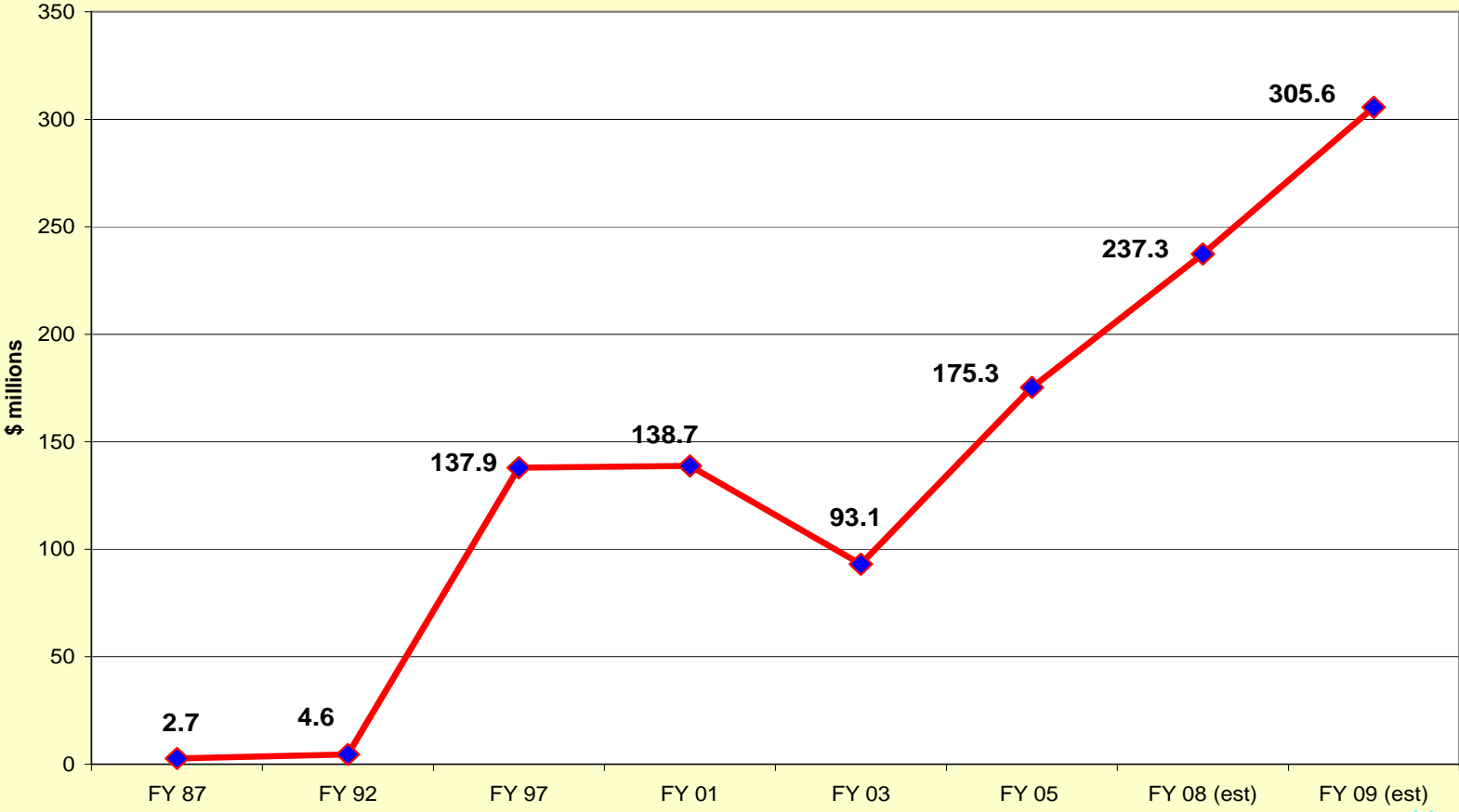
FY09 Sales and Use Taxes (\$M)



■ FY09 sales and use tax exemptions
■ FY 09 budgeted sales and use tax revenues

TAX CREDITS ERODE REVENUES, IS CT GETTING ADEQUATE RETURN?

REVENUES LOST FROM CORPORATE TAX CREDITS, FY 87-FY 09 (est.)
(in millions)





Addressing Corporate Tax Expenditures

- **Business Tax Commission** (to review all business taxes and propose changes to modernize the corporate income tax)
- Review/sunset all tax credits
- Cap tax credits (including movie tax credits)
- Review apportionment formula

Other Tax “morsels”

Clearly not the solution to a long term fiscal imbalance, but could play a role in helping to ‘bridge the gap’:

- Escheat unclaimed bottle deposits. MA collects **\$37 million** on unclaimed bottle deposits (strongly opposed by beer and soda distributors)
- Collect all taxes owed: close the “tax gap”

A vertical bar on the left side of the slide, divided into four colored segments: light blue at the top, orange in the middle, medium blue below that, and red at the bottom.

What Other States Have Done

WHAT OTHER STATES HAVE DONE: MARYLAND

Faced with \$1.7 billion deficit for FY 09, and having made \$200 million in spending cuts already, MD adopted a comprehensive package that increased revenues by \$1.35 billion, and included:

1. Increased sales tax from 5% to 6% and applied the sales tax for the first time to computer services.
2. Increased corporation income tax rate from 7% to 8.25% and closed some loopholes.
3. Increased progressivity of personal income tax (tax had been essentially flat at 4.75% for taxable income over \$3,000). Created new marginal rates. For single filers: 5% on income from \$150-\$300K, 5.25% on income from \$300K-\$500K, and 5.5% for income over \$500K. For joint/HH: 5% for income \$200K-\$350K, 5.25% for income \$350K-\$500K, and 5.5% for income over \$500K. Also increased personal exemption and expanded state Earned Income Tax Credit.
4. Made \$550 million in spending reductions (e.g., education aid to towns, grants to counties, eliminating 500 vacant state positions, fund transfers including from employee health insurance fund and open space fund)

WHAT OTHER STATES HAVE DONE: MASSACHUSETTS

1. Convened MA Study Commission on Corporate Taxation, then adopted corporate tax reforms based on its recommendations that strike compromise between making MA less vulnerable to manipulation via aggressive tax avoidance planning and making it more competitive & less burdensome. Provisions include:

- *Requires* unitary combined reporting by C- & S-corporations (and eliminates combined return election). Corporations must list *all* profits, *including from any subsidiaries*, and apportion the profits for tax purposes to more accurately reflect the amount of their business activity in MA.

- Adopts “check-the box” provision that bars corporations from claiming different corporate structures on its federal and state tax returns (e.g., can’t file as corporation on federal tax return & as partnership/trust on MA return)

WHAT OTHER STATES HAVE DONE: MASSACHUSETTS

-Replaces entity-level tax for larger S corporations with a rate determined by formula based on the size of the corporation's gross receipts (S corporation with \$9M or more in gross receipts is taxed at a rate equal to the difference between the corporate & personal income tax rates; a company with \$6-9M in gross receipts is taxed at 2/3rd this rate.

-Reduces corporation tax rate from 9.5% to 8% by 2012 and financial institution tax rate from 10.5% to 9% in 2012.

2. Created new Commission, made up entirely of state legislators/their designees, to review appropriateness of use of single-sales-factor formula for apportioning income of manufacturing companies and others.
3. Required MA Department of Revenue to investigate bringing state into full compliance with the Streamline Sales and Use Tax Agreement.
4. Increased cigarette tax

Estimated Revenue Gain from corporate tax loophole closings:

\$285M in FY 09, \$390 in FY 10, \$269M in FY 11

WHAT OTHER STATES HAVE DONE: RHODE ISLAND

1. Required detailed public accounting of the tax credits and other incentives RI provides as part of state's economic development efforts:
 - Before finalizing any incentive agreement, a report must be prepared & publicly released showing the state's financial exposure in the proposed project, # of jobs to be created and the approximate wage rates/ fringe benefits for each job category involved, an analysis of the personal income tax the project would generate, the duration of construction jobs involved, and details about hiring and job-training efforts. Subsequently, an annual report giving status of each project must be distributed to committees of cognizance and posted on the Internet. A claw-back provision for entities that don't perform.
 - Requires that RI DRS prepare annually a report listing all state incentives and tax credits (by name of individual business, how much each received) and detailing the performance of the entities receiving them, and make presentation to General Assembly re the costs of all.
2. Capped, at \$15M/year, RI film tax credits, repealed RI foreign tax credit (savings of \$3.6M/year for foreign tax credit repeal), put moratorium on new projects qualifying for historic structure tax credit. Increased fines for traffic violations.
3. Cut spending by reducing state employees through attrition, cut some health/welfare programs.

WHAT OTHER STATES HAVE DONE: NEW YORK

Changes to date include:

1. Adopted combined reporting (parent corporation and most subsidiaries treated as single entity for income tax purposes; NY tax share of entities' *combined* nationwide income).
2. Changed filing fees for LLCs and LLPs. Various LLCs and LLPs with *any* NY source income to pay filing fee based on that income (rather than the # of partners or members, as was prior law). LLC/LLP's with no NY source income pay \$25 minimum filing fee. For others, filing fee depends on NY source income share; fees range from \$25 to \$4,500 (if NY gross source income is over \$25M). Also allow NYC to impose filing fee, based on NYC gross income.
3. Voluntary Disclosure and Compliance program (tax amnesty) and reopen Voluntary Compliance initiative (let taxpayers report/pay underreported tax liabilities resulting from abusive tax avoidance transactions with some penalty waivers).
4. Financial institution data-match system for state tax collection purposes. Require each financial institution doing business in NY to develop, with NY authorities, a data-match system to facilitate identification and seizure of non-exempt financial assets of NY tax debtors (can be same system used for child support enforcement).
5. Expanded film production credit from 10% to 30% of production costs. Credit not transferable, but if exceeds taxpayer's tax, excess treated as overpayment to be refunded/credited. Capped aggregate amount of credits at \$75M for FY 09, ~~\$75M~~ \$85M for FY 10.



**WHEN CONSIDERING BUDGET-BALANCING OPTIONS,
THE FEDERAL GOVERNMENT SHOULD BE
PART OF THE SOLUTION
SINCE IT'S BEEN PART OF THE PROBLEM**

In the last recession, increased federal aid (e.g., increased Medicaid reimbursements) reduced some of the need to increase state revenues/cut state spending.

Our Congressional delegation should be urged to pass another economic stimulus package that includes *substantial* financial assistance to states, including funding for infrastructure projects and increased Medicaid matching rates.



“...although CT is now in slightly better shape than many other states, there is much to be done to anticipate and withstand future economic volatility and keep the state fiscally sound. This current downturn is both a warning and an opportunity to make significant and positive changes.”

Peter Goia, VP and economist, CBIA

Hartford Courant, 8/24/08

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available state budget documents):**

http://www.ctkidslink.org/announcement_83.html