

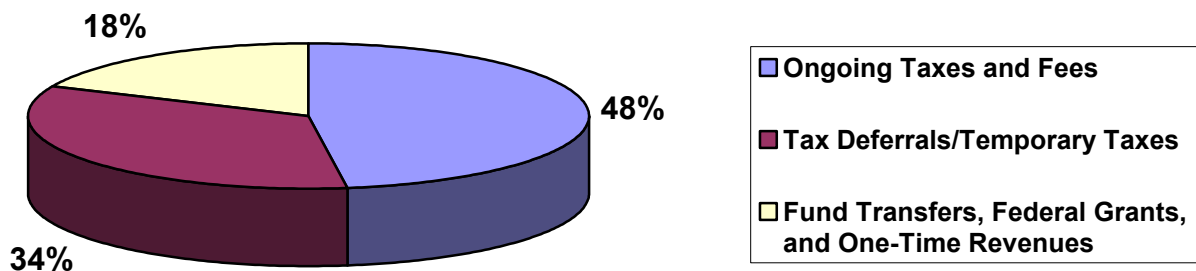
Summary of Governor's Proposed FY 06 Revenue Changes

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February 11, 2005 (revised)

In Sum. Governor Rell proposes to address 53.8% of the \$1.16 billion structural deficit in SFY 06 through \$623.5 million in cuts in current services spending, and the balance through \$585.2 million in net revenue increases. These new revenues result from permanent tax and fee increases (generating revenues on an on-going basis), temporary tax changes (generating temporary revenues) and a variety of other revenue measures including fund transfers, escheats, transfers of revenues and expenditures from one fiscal year to another, and revenues from enhanced enforcement of the tax code. *Less than half* the proposed new revenues (48%) result from permanent changes in taxes and fees that can be expected to generate revenues beyond this biennium, and 43% of these permanent revenues come from "sin" taxes. Another third (34%) of the proposed new revenues come from temporary tax increases, delays in the scheduled phase-out of tax reductions, and other temporary tax changes. The balance (18%) comes from a variety of fund transfers, one-time revenues, and federal funds.

Proposed New FY 06 Revenues, by Type



A Bit More Detail. The following table shows the various revenue changes proposed by the Governor. While many of these are noted in the “Tax Changes and Revenue Enhancements” section of her Budget Summary (pp. 9-11), several are reported in other parts of the budget.

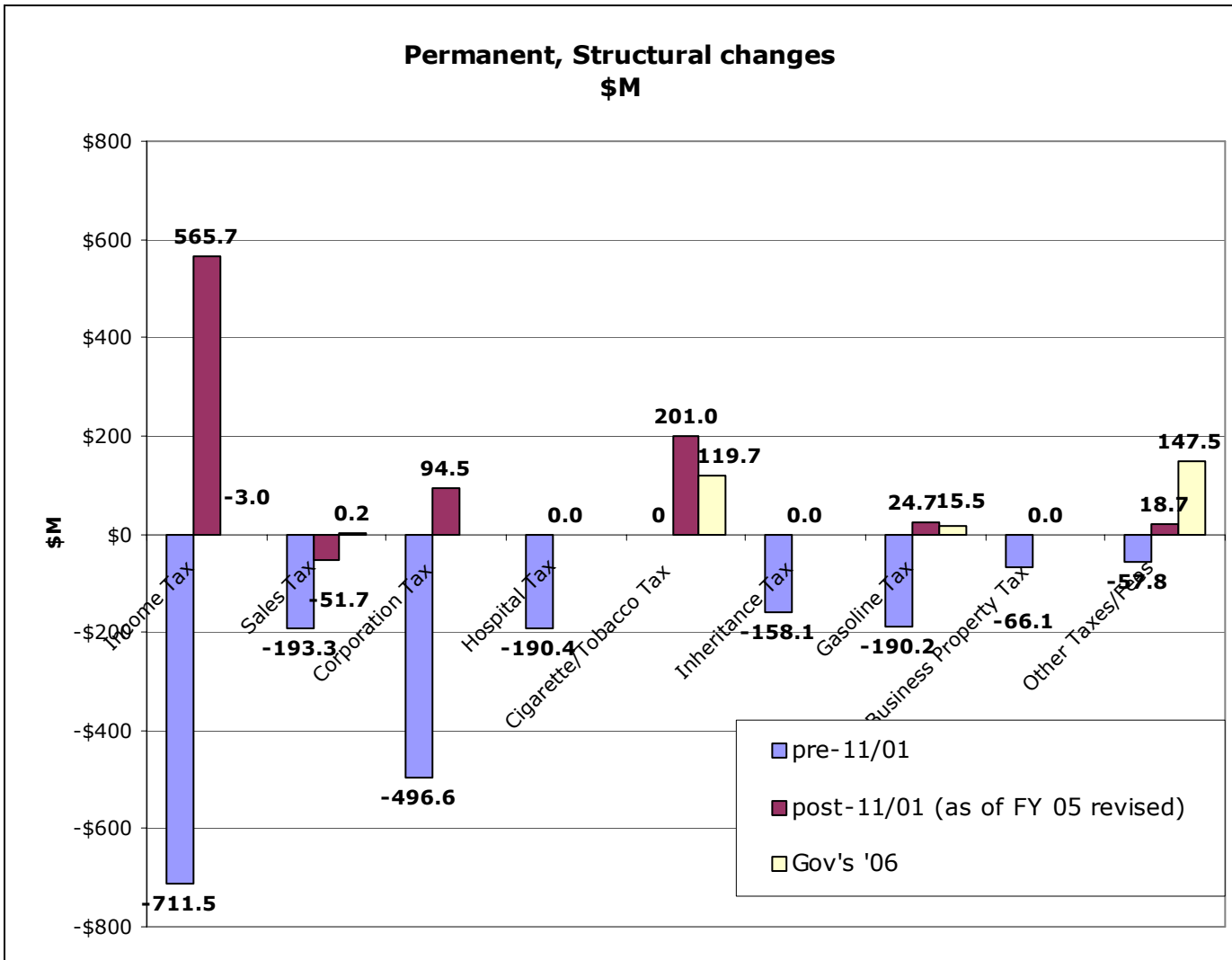
| Governor’s Proposed Revenue Changes FY 06 & FY 07 | | |
|--|--------------|--------------|
| | FY 06 | FY 07 |
| PERMANENT TAX AND FEE CHANGES | \$M | \$M |
| <i>Personal income tax</i> | | |
| Exempt 50% of military pensions from personal income tax | (2.5) | (2.5) |
| Allow \$100 deduction for contributions to political campaigns that agree to voluntary spending limits | (0.5) | (0.5) |
| <i>Sales and use tax</i> | | |
| Re-impose sales tax on certain aviation services | 0.2 | 0.2 |
| <i>Business taxes</i> | | |
| Eliminate research and development credit exchange program (effective for 2005 income year) | 0.0 | 20.0 |
| Disallow Insurance Reinvestment Tax credits for investments made after 12/31/05 | 0.0 | 0.0 |
| <i>Other Taxes & Fees</i> | | |
| Adopt nursing home provider tax equal to 6% of gross patient care services effective July 1, 2005 | 139.2 | 139.2 |
| Increase cigarette tax from \$1.51 to \$2.25/pack effective 7/1/05 (FY 06 revenue includes floor tax on existing inventory & increased sales tax) | 104.0 | 87.6 |
| Increase tax on other tobacco products from 20% to 90% of wholesale price; increase tax on snuff from \$0.40 to \$1.80/ounce (revenues include increased sales tax) | 15.7 | 15.4 |
| Increase alcoholic beverages tax by 15% | 7.9 | 7.1 |
| Impose \$1 per trip surcharge on all tickets on New Haven MetroNorth Line beginning January 1, 2008 (\$20M/year revenue gain) | 0.0 | 0.0 |
| Increase gas tax by 1 cent/gallon on 7/1/05, 1 cent on 7/1/06, 2 cents on 7/1/07, one cent on 7/1/08 and one cent on 7/1/13 [Each 1 cent increase to generate \$15.4M in new revenues] | 15.4 | 30.8 |
| Increase billboard license fees | 0.4 | 0.4 |
| TOTAL PERMANENT TAX & FEE CHANGES | 279.9 | 297.7 |
| TAX DEFERRALS/ELIMINATIONS & TEMPORARY TAXES | | |
| <i>Personal income tax</i> | | |
| Delay for 2 years the scheduled increase in the property tax credit from \$350 to \$500. Maintain credit at \$350 for income years 2005 and 2006. Starting in income year 2007, increase credit by \$50/year until reach \$500 in 2009 | 105.0 | 105.0 |
| Delay for 2 more years the phase-in of a higher singles’ exemption; keep exemption at \$12,625 until 2007 | 7.0 | 20.0 |
| <i>Business taxes</i> | | |
| Impose 15% surcharge for business income year 2005 and 10% surtax in 2006. Eliminate surcharge for income year 2007 [NB: There had been a 20% surcharge in income year 2003 and a 25% surcharge in income year 2004] | 67.1 | 10.9 |
| Reduce net operating loss carry-forward from 20 years to 5 years (reducing number of years operating losses can offset future income) | 7.4 | 17.9 |
| <i>Other taxes</i> | | |
| Delay for an additional 2 years the scheduled phase-out of the state succession tax (rates will not be reduced again until 1/1/07) | 11.0 | 26.0 |
| Delay for an additional 2 years the scheduled phase-out of the gift tax (rates will not | 0.0 | 6.0 |

| | | |
|--|--------------|--------------|
| change until 1/1/08) | | |
| TOTAL TAX DEFERRALS/ELIMINATIONS & TEMPORARY TAXES | 197.5 | 185.8 |
| OTHER REVENUES | | |
| <i>Income</i> | | |
| Increase compensation to family members of deceased veterans (\$100,000 to family + \$50/month/child until child reaches 18; \$50,000 for spouses without children and dependent parents; \$100,000 to guardian + \$50/month/child if is child left with no parent | (0.3) | (0.3) |
| <i>Improved enforcement of existing tax laws</i> | | |
| Require non-resident withholding for personal income tax due from gaming | 6.0 | 6.0 |
| Add two appellate officers to staff of Department of Revenue Services to reduce the nearly 900 tax appeals in DRS inventory | 6.0 | 7.4 |
| Add 20 revenue examiners & 2 systems developers to increase audits in the withholding, small business and self-employed tax areas | 16.0 | 20.0 |
| <i>Escheats</i> | | |
| Escheat unclaimed bottle deposits | 20.0 | 20.0 |
| Securitize unclaimed property | 0.0 | 40.0 |
| <i>Fund transfers</i> | | |
| Intercept revenue for the Emergency Spill Response Account | (12.0) | (12.0) |
| Transfer from Energy Conservation and Load Management Fund to GF | 12.0 | 12.0 |
| Transfer from Banking Fund to GF | 0.0 | 20.0 |
| Transfer from Insurance Fund to GF | 0.0 | 5.0 |
| Eliminate transfer from GF to Tobacco and Health Trust Fund | 12.0 | 12.0 |
| Reduce funding for Mashantucket Pequot grant | 48.7 | 48.7 |
| Transfer funds from Safety Inspection Account to Special Transportation Fund | 1.0 | 0.0 |
| Reduce transfer from GF to Conservation Fund | 1.0 | 1.0 |
| Reduce transfer from Special Transportation Fund Emission Fund (2 years) | 4.9 | 2.5 |
| Reduce transfer to Transportation Strategy Board | 9.0 | 9.0 |
| Increase boating license fee | 2.0 | 0.0 |
| <i>Federal funds</i> | | |
| New federal Medicaid reimbursements resulting from nursing home provider tax | 118.6 | 119.1 |
| Loss in federal funds resulting from proposed expenditure changes | (76.6) | (69.5) |
| <i>Other changes</i> | | |
| Defer GAAP Accounting | (17.0) | (17.0) |
| Transfer FY 06 revenue to FY 07 | (41.0) | 41.0 |
| TOTAL OTHER REVENUES | 107.8 | 262.1 |
| SOME ADDITIONAL PROPOSED "REVENUE" CHANGES¹ | | |
| Pay only 11 months of monthly payments to managed care organizations on behalf of HUSKYA and B clients in FY 06, and pay 12 months and the deferred month (i.e., 18 months) in FY 07 | 54.8 | -54.8 |
| Fund FY 06 state energy expenses with FY 05 surplus | 10.0 | 0 |
| Pre-pay principal and interest payments for FY 06 and FY 07 with FY 05 surplus | 70.1 | 67.6 |
| Source: Connecticut FY 2006-FY 2007 Biennium, <i>Governor's Budget Summary</i> (February 9, 2005) | | |

¹ The use of FY 05 surplus to pre-pay expenses in subsequent budget years creates a structural deficit in these subsequent years. The proposed changes listed in this table are illustrative. The Governor proposes that a total of \$57.1 million in FY 05 surplus be carried forward to fund FY 06 expenditures. Office of Fiscal Analysis, *Synopsis of the Governor's 2005-2007 Biennium Budget* (February 10, 2005).

A Bit of Contextual Analysis. Putting the Governor's proposed FY 06-07 budget in context, three points about revenues merit mention:

1. *The trend of shifting tax burden from corporations to individuals and families continues.* The majority of the new *permanent* tax and fee increases proposed by the Governor would be paid by individuals and families, rather than by businesses. This continues a trend started when deficit-mitigation efforts began in 2002. The following chart compares the *permanent* tax and fee changes enacted in three time periods: a) from 1995 until November 2001 (when Governor Rowland was in office, but prior to the deficit emerging); b) from November 2001 through the revised FY 05 budget enacted last Session; and c) what has been proposed by Governor Rell.²



As illustrated in this chart, a significant proportion of the personal income tax cuts enacted between 1995 and November 2001 have been rolled back -- \$565.7 million in personal income tax increases since November 2001 compared to a \$711.5 million cut in personal income taxes between 1995 and November 2001. The only *permanent* changes to the personal income proposed by the Governor would *reduce* revenues by an additional \$3.0 million. Cigarette taxes also have increased -- by a total

² For a listing of the various taxes and fees that have been *increased* since November 2001, as well as those that have been *cut*, see Appendix A. See also S. Geballe, *How Can Connecticut Still Be Facing a General Fund Deficit in SFY 06?* (Connecticut Voices for Children, 2005), available at www.ctkidslink.org.

of more than \$320 million if the Governor's proposed change is adopted. By comparison, a comparatively small proportion of the corporation business taxes cut in the pre-2001 period have been added back and only the repeal of the refundable research and development credit is expected to result in an on-going revenue gain (beginning in FY 07).

In short, the majority of the Governor's proposed *permanent* tax and fee increases will be borne by individuals and families, not by corporations: the cigarette and alcohol tax increases, the surcharge on Metro-North tickets, the gas tax increase, and the nursing home provider tax (to the extent individuals pay for this care).

Independent analyses also speak to this shifting of responsibility for funding state and local government from corporations to individuals and families.

A January 2004 report prepared by Ernst & Young for the Council on State Taxation (a non-profit trade organization with a membership of 550 major businesses engaged in interstate and international trade) found that Connecticut was one of only three states to reduce overall state and local business taxes³ between FY 2000 and FY 2003. It reported that, nationally, total state and local business taxes *increased* by 8.3% over this period, while Connecticut's state and local business taxes *declined* by 1%. The COST report also found that Connecticut ranked in the bottom 10 of all states on three of four measures of business tax burden: 43rd (8th lowest) in the share of all taxes paid by business; 40th in business taxes per dollar of private sector economic activity; and 40th in business taxes per dollar of capital income. While it also found that Connecticut ranked 12th highest in business taxes per private sector employee, this reflected – in part – the continuing decline in private sector employment in Connecticut in what had become the state's longest recession since 1939.⁴

Also, Robert Tannenwald of the Federal Reserve Bank of Boston recently released a report that sought to “clarify recent debate about the fairness, adequacy, and competitiveness” of business taxes. He found that in FY 2000 Connecticut ranked 40th (11th lowest) in business share of state and local taxes (including property taxes), 28th in business taxes as a percent of business profits, and 28th in business taxes as a percent of statewide personal income (business tax burden).⁵

2. *Even if the Governor's permanent tax and fee increases are adopted, Connecticut taxpayers will still be paying less in total state taxes than they did in 1995.* Between 1995 and November 2001, about \$2.064 billion in state taxes were cut – when a strong stock market was resulting in significant General Fund surpluses. If Governor Rell's proposed tax and fee increases are *all adopted*, the *total* in net new permanent state taxes and fees enacted since November 2001 will be about \$1.13 billion in FY 06. Although the tax burden has shifted over this period of time (as noted above), *total state taxes* that will be paid in FY 06 if the Governor's proposed changes are adopted are still just over *half* the total taxes cut in the late 1990s.

3. *Reliance on “sin” taxes adds to the regressivity of Connecticut's taxes.* On average, all but the wealthiest 20% of Connecticut families pay between 9-10% of their personal income in state and local taxes. The wealthiest 1%, by comparison, pays about 4.4% of their income in state and local

³ COST included within its 50-state comparison of “total state and local business taxes:” property tax (on real, personal, and utility property), sales and use taxes, excise taxes, gross receipts taxes, corporate income taxes, employer payroll contributions (including unemployment insurance, workers' compensation insurance, and disability insurance taxes) and license and other business taxes. The other states with a decline in these total taxes were Oregon (less than 1% decline) and Alaska (10% decline).

⁴ Connecticut Department of Labor, “Employment Declines for Third Year,” *The Connecticut Economic Digest*, 9(3) (March 2004, p. 1).

⁵ R. Tannenwald, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?* (Federal Reserve Bank of Boston, *Public Policy Discussion Papers*, No. 04-4, August 20, 2004).

tax (after the federal deduction). Sales taxes of any kind are inherently regressive because low income families spend a much greater proportion of their income than do high income families; about $\frac{3}{4}$ of the income of low-income families is spent on items subject to sales tax, compared to about $\frac{1}{6}$ th of the income of the wealthiest families.⁶ Thus, the Governor's proposal to raise sales taxes adds to the regressivity of our tax code. By comparison, an increase in the personal income tax paid by our highest income families (by increasing the tax rate on income over a certain level) would make our tax code fairer.

While sin taxes are thought by many to be a "good" type of sales tax – since they can discourage a particular type of behavior (smoking and drinking, especially among youth who are more price sensitive), sin taxes are a naturally *decreasing* source of funding. As the tax increases, consumption – and revenues – will decline. Unlike the personal income tax, which grows with inflation and an increasing population, sin taxes do not keep pace with economic growth. These taxes *cannot* be counted on to provide adequate revenues over time.

Summary. With the impending retirement of the baby-boomers and threatened cuts in federal funding, Connecticut must act quickly to get its fiscal house in order. This budget's reliance on fund transfers, one-time revenues, sin taxes and budget gimmicks means that Connecticut will *continue* to face budget challenges in the years ahead. The modest proposed increases in on-going revenues from tax and fee increases also mean that Connecticut will continue to lack the resources to make the investments in education, health care, transportation, and housing that are necessary if Connecticut is to retain its high quality of life, and its competitive economic position. Many important programs and services – need-based scholarship aid, child care subsidies, energy assistance, youth development programs – are funded below *FY 01 levels* in this budget.

Now, as the economy is improving, is the time to adopt a *bold* budget – a budget that takes advantage of Connecticut's prosperity by adopting a more progressive state income tax, restoring its estate tax, and asking more of its large multi-national corporations and then invests these new funds in the programs and services necessary to narrow the state's divides that so threaten the long-term prosperity and health of Connecticut residents and the state itself.

⁶ Institute on Taxation and Economic Policy, *The ITEP Guide to Fair State and Local Taxes* (February 2005), p. 11.

**General Fund FY 05 Revenue Gains from
Permanent Tax Increases Enacted Since 2002 (\$M)**

| | Projected FY 05 Revenue (\$M) |
|--|----------------------------------|
| Personal Income Tax | |
| -Increase 4.5% rate to 5% ⁷ | \$445.5 |
| -Reduce maximum property tax credit from \$500 to \$350 | \$112.2 |
| -Capture tax due from out-of-state owners of LLPs, LLCs, S corps | \$ 8.0 |
| Corporation Business Tax | |
| -Surcharge of \$250 on LLCs, LLPs, and S corporations | \$ 28.0 |
| -Limit use of tax credits to offset no more than 70% of pre-credit tax liability | \$ 30.0 |
| -Prohibit use of tax credits to eliminate \$250 Alternative Minimum Tax | \$ 0.5 |
| -Set a maximum per company for refundable research & development tax credit | \$ 8.5 |
| -Require company to add back to income certain interest expenses w/ related company | \$ 10.0 |
| -Increase from \$25,000 to \$250,000 the "preference" tax for a corporation that <i>elects</i> to file using unified reporting | \$ 30.0 |
| Sales & Use Tax | |
| -Reduce exemption from \$75/item of clothing to \$50/item ⁸ | \$ 35.2 |
| -Repeal exemption for health & athletic clubs ⁹ | \$ 7.9 |
| -Impose 3% rental surtax on rental trucks | \$ 0.1 |
| -Impose tax on self-storage units | \$ 1.5 |
| -Repeal final step of phase-out of 1% tax on computer/data processing services | \$ 10.8 |
| -Require vendors with state contracts to collect sales/use tax from customers | \$ 5.0 |
| Cigarette Tax | |
| -Increase tax from \$0.50 per pack to \$1.51 per pack | \$201.0 |
| Insurance Companies Tax | |
| -Eliminate tax credit for Managed Care Organizations providing HUSKY coverage ¹⁰ | \$ 15.6 |
| -Limit use of tax credits to offset no more than 70% of pre-credit tax liability | \$ 2.5 |
| Public Service Companies Tax | |
| -Extend 5% tax on cable TV to satellite TV | \$ 3.0 |
| Other | |
| -Apply controlling interest transfer tax to additional real property transfers | \$ 5.0 |
| -Allow alcohol sales until 9 p.m. on weekdays and Saturday | \$ 2.1 |
| TOTAL | \$962.4 |

**General Fund Annual Revenue Losses
from Permanent Tax Reductions Enacted Since 2002 (\$M)**

| | Annual Revenue Loss (\$M) |
|---|---------------------------------|
| Personal Income Tax | |
| -Increase maximum property tax credit back to \$500 from \$350 (eff. 1/1/05) | (\$105.0) |
| Corporation Business Tax | |
| -Extend refundable research & development tax credit to capital base taxpayers with no net income | (\$ 12.5) |

⁷ Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was less (\$393.0 million).

⁸ Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was less (\$32 million).

⁹ Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was more (\$8.5 million).

¹⁰ The managed care organizations concurrently received a fee increase, so there was no net savings to the General Fund.

| | |
|--|------------------|
| Sales & Use Tax | |
| -Exempt certain services provided by specified aircraft companies, retroactive to 1994 | (\$ 0.2) |
| -Exempt non-cable communications services bought by cable company | (\$ 0.1) |
| -Repeal 5.75% tax on patient care services | (\$116.4) |
| Public Service Companies Tax | |
| -Exempt portion of co. revenues used for debt service on energy securitization bonds | (\$ 1.7) |
| -Exempt sales of natural gas to existing, specified plant | (\$ 5.0) |
| -Exempt sales of natural gas for fuel in co-generation plant co-sited with manufacturing plant though not co-owned | (\$ 0.8) |
| TOTAL | (\$241.7) |