CONNECTICUT VOICES FOR CHILDREN

Connecticut Taxes in Context: An Analysis of the Governor's Proposed FY 07 Budget

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"Those who cannot remember the past are condemned to repeat it."
-George Santayana

In the early 1990s, Connecticut reduced its tax base by $2 billion based on temporarily high revenues. When the recession began in 2002 and revenues fell by $1 billion, the budget reserve was inadequate and painful cuts were required from which the state still has not recovered.

Both OFA and OPM currently project a deficit in the General Fund in FY 08 even without an unexpected downturn in the economy. These projections were also made *prior* to the passage of the most recent federal budget, which is likely to reduce federal revenues coming into Connecticut.

Cutting taxes without restoring revenues in some other way will condemn us to repeat the history of the late 1990s. The Governor's budget sets us on that path by making permanent reductions in the tax base of at least $294.5 million without offsetting increased revenues from other sources.

Furthermore, **the proposed revenue reductions do not further many of the key principles of a sound tax system** as outlined by the recent Program Review and Investigations Committee's report, *Connecticut State Taxes*. For example:

Estate Tax. Phasing out the estate tax makes our state tax code less equitable as it is the most progressive of all Connecticut's taxes (although removing the cliff that families with incomes at the threshold face should be addressed). It is paid by only the wealthiest families. Here in Connecticut, a state recognized for the wealth of our citizens, the number of taxable estates was only 2.2% of the number of deaths in 2003. For years Connecticut has had inheritance/estate and gift taxes; these taxes have not only generated needed revenues but also contributed to the progressivity of our state tax system. Connecticut's estate tax is forecast to be an important source of revenue for the state and there is no evidence that it has caused out-migration. Anecdotes about wealthy Connecticut residents fleeing to warmer climes should not drive public fiscal policy.

Tax credits. One of the principles of a fair tax system, as outlined out by Program Review (and the National Conference of State Legislatures)—the principle of neutrality—is that the tax system should not be used to influence economic decisions on spending or investment. The tax credits proposed by the Governor (particularly the film industry tax credit) explicitly seek to use the tax code to promote economic development, and so violate the principle of neutrality. In addition, to the extent the state seeks to promote economic development in this way, direct grants are a more transparent and accountable tool than tax credits. Just as the Governor proposes for other legislation, these proposals also require scrutiny for their economic impact (for example, would the economic activity have occurred anyway?). This scrutiny *must* assess not only the economic impact of the specific credits proposed, but also the opportunity cost of the credit. That is, if the revenues that will be lost by enactment of the credit were to be used in other ways, would there be greater economic return? In general, before enacting new tax credits, the cautions in the recent report by the Program Review and Investigations Committee must be heeded:

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"[E]fforts at spurring economic growth through tax credits and incentives appear to have little positive effect on job growth or in enhancing the state's competitive position." In fact, Connecticut ranks 40^{th} (i.e. in the lowest tax group) when calculating business taxes as a percentage of business profits, **AND** in the share of state and local taxes that are paid by business!

Budget Gimmicks and Fund Transfers. The Governor's budget also relies on some budget gimmicks and fund transfers that will exacerbate the projected General Fund deficit in FY 08. They include:

- Carrying forward $91 million of FY 06 unexpended funds for FY 07 expenditures to balance the FY 07 budget. Because these funds are to be used for on-going expenses ($35 million for fringe benefits and the balance for Medicaid), use of one-time funds creates a "hole" in the FY 08 budget.
- Carrying forward $8 million of FY 05 surplus appropriated in the FY 06 budget for "contingency needs" to help pay for the 2% cost of living increases beginning October 2006 for certain private providers.
- Transferring $40 million per year of petroleum receipts tax revenues from the General Fund to the Special Transportation Fund starting in FY07 to finance transportation related initiatives (rather than, for example, increasing the gas tax to pay for such needed improvements).
- Diverting casino revenues and some General Fund revenues in FY 07 to a new Casino Assistance Revenue Fund that will compensate towns for the property taxes they will lose with the repeal of the tax on certain motor vehicles. Although this reduction in General Fund revenues is offset in part by repeal of the property tax credit on the personal income tax, there remains a net reduction in General Fund revenues in FY 07 and thereafter. This proposal change also ducks real spending cap reform by funding this Fund through a revenue intercept, moving about $500 million of state spending outside the spending cap.

The Governor's decision to use much of the remaining surplus to pre-fund payments on our Economic Recovery Notes (reduce debt) and to increase the Budget Reserve Fund are *prudent* uses of surplus given the state's fiscal situation. However, although the increase to the Budget Reserve Fund will increase total funding to $940.9 million -- "higher than it's ever been" -- the Fund would remain just short of 2/3 of the statutory level (10% of net General Fund appropriations), keeping us at risk if an economic downturn occurs in the next year.

Elimination of the Property Tax on Motor Vehicles

The proposal to eliminate the property tax on motor vehicles and create a fund (with intercepted casino revenues and transfers from the General Fund) to reimburse cities and towns for lost revenues begins to address what has long been considered an inequity in taxation across municipalities on automobiles. It also addresses a concern of the Program Review and Investigations Committee that the current property tax credit against the income tax is not "well-targeted" as a form of property tax relief, because it "does not provide any relief to individuals who are not required to file an income tax but pay other taxes," and also provides the full credit for "fairly high earners," e.g., a married couple filing jointly gets the full credit if their CT AGI is $100,500 (or less).

While the proposed change addresses the first of these concerns, it actually exacerbates the second. For example, while it will provide monetary benefit to renters and low-income families who did not benefit from the $350 property tax credit against the income tax (because they didn't own their home and/or had no income tax liability to offset with the credit), it will also provide significant benefit to our highest income families with expensive cars. These families also were not eligible for the property tax credit against the income tax (because it phases out at high incomes), but were required to pay property taxes on their expensive cars. **In fact, the net benefit may well be greatest for our most wealthy families, making our tax code more regressive.**

Further, to characterize this new grant as a significant increase in state aid to municipalities is a bit curious, as the proposal really is a substitution of one source of revenue for towns (property tax on cars) for another (the state funds). **The towns' financial position is not significantly** changed (although towns lose control over this one source of revenues and become dependent on another state grant). **Rather, benefits accrue to individuals, and disproportionately to those at the top and bottom of the income spectrum.**