

Connecticut Tax Study Panel Briefing Note The Connecticut Individual Income Tax (Personal Income Tax, CPIT)

Initial Comments

In 1991 Connecticut became last of the 41 states (plus DC) to enact a broad based income tax that includes in its base wages and salaries. Prior to that (1969-1991) the state taxed only capital gains, interest and dividends.¹ Since its enactment in 1991m the Connecticut PIT has steadily grown in importance as a source of state revenue to point where Connecticut ranks 2nd among the states in its reliance on the PIT as a source of state revenue.

In its study for the Panel, the individual income tax, the CPIT PIT was evaluated *vis-à-vis* four of the Tax Panel's criteria that are appropriate to a personal income tax analysis

- 1) The certainty and predictability of the CPIT as a source of state tax revenue, where adequacy is defined not only in terms of the size of the personal income tax base relative to Connecticut's financing needs, but also in terms of the buoyancy, or ability of the CPIT to meet changing financing needs over time.
- 2) The Vertical Equity (fairness) of the CPIT, where fairness is defined in terms of the distribution of the CPIT tax burden among Connecticut citizens of varying abilities to pay tax.
- 3) The simplicity (collectability) of the CPIT defined in terms of the degree of complexity that confronts both the government and taxpayers in imposing, collecting, and payment of taxes.
- 4) The economic efficiency and competitiveness of the CPIT defined in terms of the relationship the reliance on the CPIT and state economic growth.

Summary Assessment

Overall, the Connecticut PIT receives reasonably good marks along each of the above dimensions.

Certainty and Predictability.

The Connecticut PIT is imposed on a broad base of Connecticut Adjusted Gross Income, which has the potential to grow apace with Connecticut personal income over time (Cordes, 2015; Wallace, 2015); and estimates of the PIT's buoyancy suggest that it has been among the most buoyant of the state income taxes. There are, however, some potential limitations on the ability to rely on a growing Connecticut PIT base: (1) aging of the Connecticut population combined with exclusion of Social Security and military retirement benefits from Connecticut AGI; (2) the fact that the states increasing reliance on the CPIT has reduced the "competitive space" between Connecticut tax rates and the Connecticut income tax as compared to its neighboring states.

In addition, the fact that income from capital gains is a relatively larger share of Connecticut AGI than is the case both nationally, and among its neighbor states, Connecticut PIT revenue is prone to be more volatile.

¹ The seven non-income tax states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and Tennessee tax interest and dividends only. ACIR, *Significant Features*, 1994 (Vol. 1) and *CCH State Tax Handbook*, 2015.

Equity/ Fairness in State Taxation

Because the Connecticut PIT is levied on a broad base, the payment of the Connecticut PIT is distributed in a manner that is generally consistent with the principle of *horizontal equity*. Aside from the exclusion of Social Security and military retirement benefits from Connecticut AGI, and the provision of three fairly minor tax credits, the Connecticut PIT taxes most sources of income at the same rate.

The Connecticut PIT also has a progressive distribution of the tax burden (*vertical equity*), and the progressivity of the Connecticut PIT has grown over time. Those who favor using the tax system as a means of reducing inequality in the distribution of income would regard this as a positive feature of the Connecticut PIT. The data show that progressivity is achieved by a consistent relationship between share of Connecticut AGI and Share of the CPIT paid by income class (Figure 2, below).

The Connecticut Earned Income Tax Credit (EITC), which is administered through the Connecticut PIT, is generally viewed as an effective means of provided added income support to working poor individuals and families.² With regard to work incentives/disincentives, the EITC provides positive incentives to work for those who are not in the labor force, and negative incentives (resulting from means testing) for those who are presently working. Recent empirical research also suggests that a well-designed state EITC may have some effect mitigating poverty (Cooper, Lutz, Palumbo, 2015)

Collectability

Conforming the definition of the Connecticut income tax base to the Federal income tax does much to reduce the cost of administration of and compliance with the Connecticut PIT. Two alternatives to the existing Connecticut PIT, conforming to Federal taxable income, and replacing the current tax rate structure with a single tax rate (as is the case in Massachusetts) would modify the progressive structure of the Connecticut PIT, but would likely yield only small to modest benefits in reductions in the burden of complying with the Connecticut PIT.

The current set of exemption phase-outs and low tax rate recapture in the Connecticut PIT has the advantage of ensuring that the taxpayer's average effective tax rate, moves closer the taxpayer's actual tax bracket rate as income increases. A disadvantage of this structure is that it creates rather high "shadow marginal tax rates" as income increases. Whether these shadow tax rate affect behavior will depend on their salience to the taxpayer, but they do introduce at least some element of non-transparency into the Connecticut PIT.

Economic Effects and Competitiveness

The accompanying Panels work on Connecticut competitiveness found a negative relationship between the level of the CPIT and Connecticut GSP growth. The effect was found to be small, but the findings nevertheless send a signal that in considering how to best structure the Connecticut state/local revenue system as the state looks to the 2020s, that caution should be taken to not rely more intensively (Wasylenko, September 30). However, the study also concluded that with respect to the Connecticut revenue system as a whole, the system should be progressive in effect, and that the CPIT was the only effective tool in the revenue system for offsetting the inherent regressivity of the other Connecticut state and local revenues (Wasylenko, Sept 30; Mirrlees, 2011).

² There is, however, evidence that perhaps as much as 25% of the benefits paid out through the Federal EITC are based on questionable claims; and barring any additional effort by Connecticut authorities to verify eligibility for the Federal EITC, this error rate is likely to carry over to the Connecticut EITC.

Connecticut Individual Income Tax Options. Revenue Neutrality. All base broadening (narrowing) is understood to be made with the hard budget constraint of revenue neutrality. There are two ways to accomplish this: (1) personal income tax broadening (narrowing) that captures new revenue triggers a reduction (increase) in the general statutory rate. And/or (2) a revenue gain (loss) can be offset by a change in the rate and/or base of another type of revenue that is part of the Connecticut State/Local tax system.

Policy Option	Description and Impact	Evaluative Criteria and Comments
Dealing with Income Tax Volatility: Maintain and periodically review the Budget Reserve (Stabilization Fund)	Like other states in which income from capital gains is an important component of the personal income tax base, the Connecticut PIT is exposed to significant volatility especially during periods of significant economic downturn. There is no “easy fix” for this problem within the PIT itself. However, the presence of such volatility points to the need for maintaining and strengthening the existing Connecticut budget stabilization fund (Office of the Comptroller, 2015).	
Fiscal Architecture: Tax retirement income as a mean-tested component of the regular income tax.	An aging population in and of itself imposes a constraint on future growth in the tax base. The revenue impact of this constraint can be further exacerbated if states grant preferential tax treatment to income received by senior citizens. Unlike some states, Connecticut does not contain provisions that, for example, exempt entire portions of income from individual income taxation. However, Connecticut does make adjustments in computing Connecticut AGI that exempt Social Security and military retirement benefits from taxation. At presently the revenue effects of these exemptions are relative small.	As, as the Connecticut population ages, these provisions, especially the Social Security exemption, could become more significant; and consideration should be given to treating these forms of income in the same way as they are treated under the federal income Merit of treating all retirement income as part of the regular CPIT is that it reinforces a policy focus on the entire CPIT, spending signal that all incomes
Substitute Federal Taxable Income for Federal AGI as the Starting Point for Computing Connecticut AGI	While “full conformity” by using Federal Taxable Income as the starting point for determining Connecticut taxable income might seem like a means for further simplifying compliance with the Connecticut PIT, the disadvantages of doing so would seem to outweigh the advantages. Most notably, using Federal taxable income would narrow the base of the Connecticut PIT, requiring the enactment of higher statutory tax bracket rates in order to raise the same amount of revenue as from taxing a broader base linked to Federal AGI. Any benefits from less time required to compute Connecticut tax liability would be small to nonexistent, since it is likely that additions to and subtractions from Federal taxable income would still be necessary in order to arrive at Connecticut AGI.	
Reaffirm the role of the EITC/ retain the Connecticut EITC and Restore the Percentage of Federal EITC to 30%	To the extent that Connecticut citizens wish to supplement the efforts of the federal government by providing income support to working poor Connecticut residents, the state EITC, despite an error rate, is still the most proven effective means of delivering the benefit	These considerations would support retaining the EITC in its present form --- state budgetary circumstances permitting – and returning the percentage supplement to the Federal EITC to 30%.

Policy Option	Description and Impact	Evaluative Criteria and Comments
<p>Replace the Current Connecticut Income Tax With a single “Flat Tax” rate</p>	<p>While a single-rate income tax would have a simpler structure than an income tax with multiple rates, the practical saving in compliance burdens from having a single rate would be quite small. Any complexity introduced by multiple tax rates can be dramatically reduced by providing clear and easy to use tax “look-up” tables and tax calculators, both of which are provided by the DRS. The main effect of moving to a flat tax (assuming equal revenue yield) would be lower the marginal tax rate faced by higher income taxpayers, while raising it for lower income taxpayers.</p>	<p>Estimates presented in the Panel’s research suggest that the effect of such changes would be to reduce the current progressivity of the Connecticut PIT by roughly on-half.</p>
<p>Capital Gains Income: Maintain the Current Treatment of (net) capital gains income Or Conform to Federal Preferential Treatment</p>	<p>By using Federal AGI as its starting point, the Connecticut income tax includes capital gains in its tax base. Although long-term capital gains are taxed at preferential rates under the Federal income tax, they are taxed at the same rate as all other income in the Connecticut income tax.</p> <p><i>Inter alia</i>, Supporters of the current CPIT treatment argue that (i) investment effect is driven by federal, not much lower, state income tax rates; and (ii) that even when taxes at ordinary state rates, gains see favorable treatment since they are taxed only at realization (thus there is a deferral effect that accrues to the investor). <i>Inter alia</i>, critics note that other capital gains (e.g., housing) appreciation is favored thereby creating a horizontal inequity</p>	<p>In light of the uncertain evidence about the effects of preferentially taxing capital gains on risk-taking and entrepreneurship, the case for taxing capital gains at a lower rate under the Connecticut PIT is not a strong one. This conclusion is further buttressed by the fact that none of Connecticut’s neighboring states tax capital gains preferentially. Moreover a capital gains cut would need to be made up by increasing tax rates applied to other sources of income.</p>

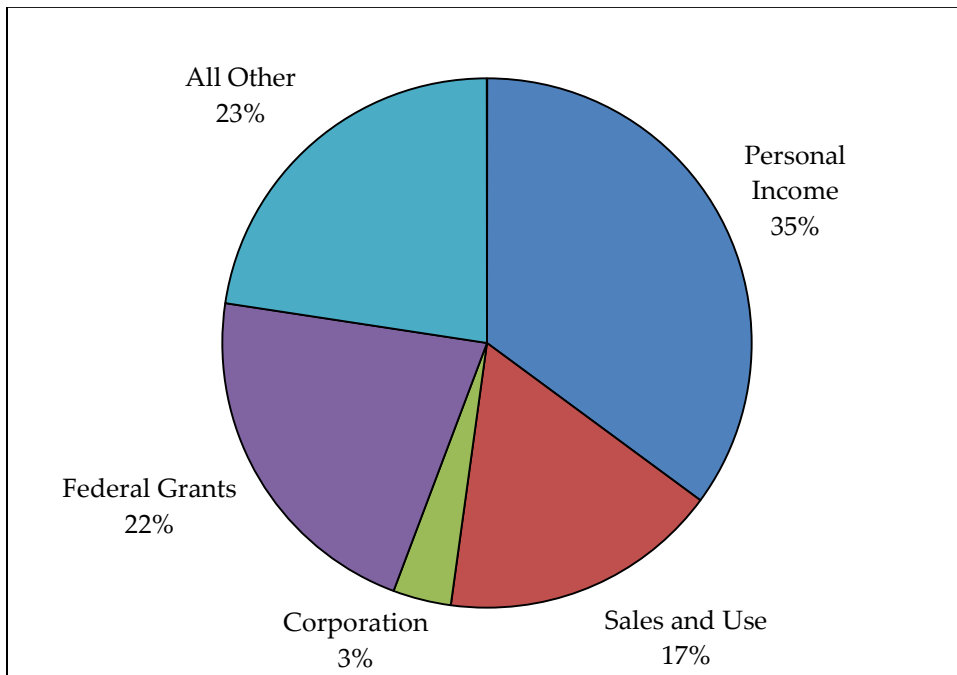
Figure 1. Composition of State General Fund Revenue, 2010-1024

The following charts show the percent of State General Fund revenue derived from the following sources (Pellowski , OPM, September 2015):

- Personal Income Tax;
- Sales and Use Tax;
- Corporation Tax;
- Federal Grants; and,
- All Other Sources

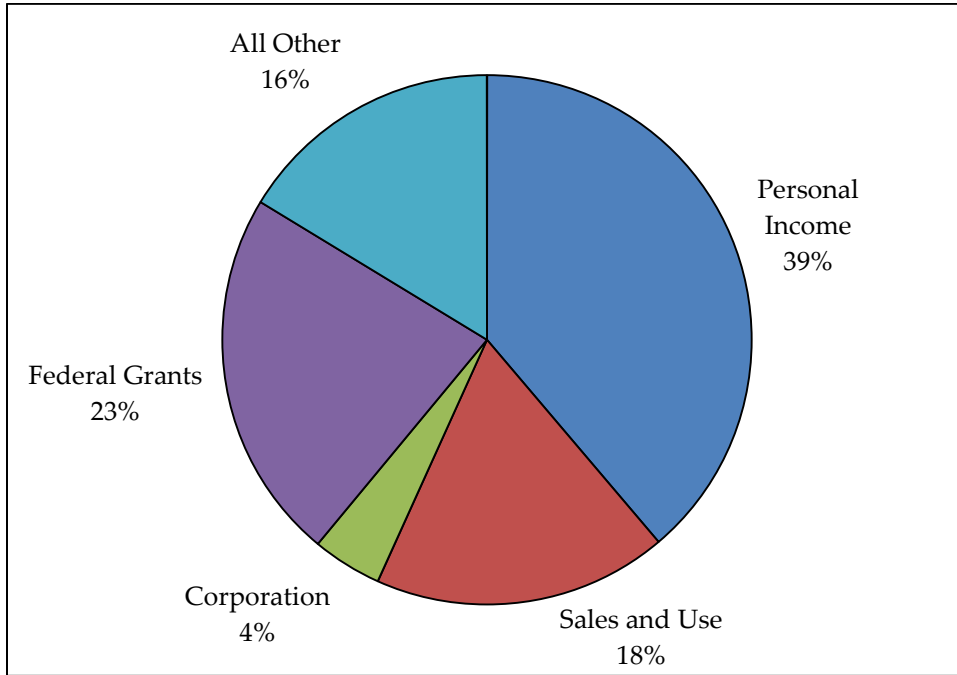
For fiscal years FY 2010 – FY 2014 as presented in Appendix A, revenues are shown as a percentage of collections prior to refunds and net transfers to other funds. For an comparative purposes, FY 2014 has been adjusted for net budgeting of Medicaid. Beginning in that year, direct federal grants for Medicaid were applied directly to Medicaid expenditures, rather than being counted as a resource of the General Fund as in prior years.

FY 2010



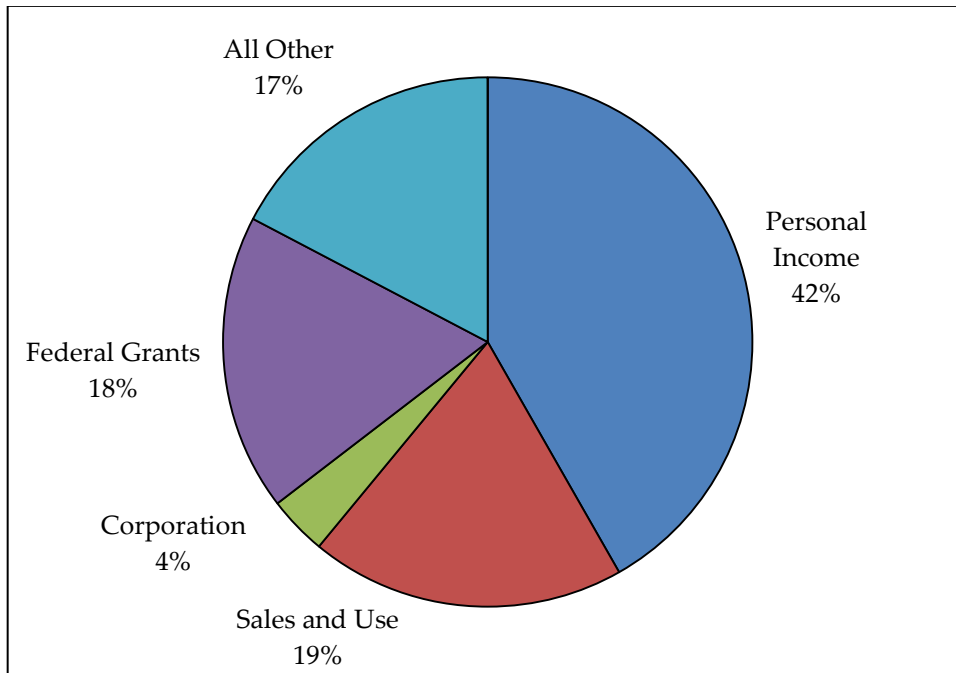
Refunds reduced collections by \$1,072 million.

FY 2011



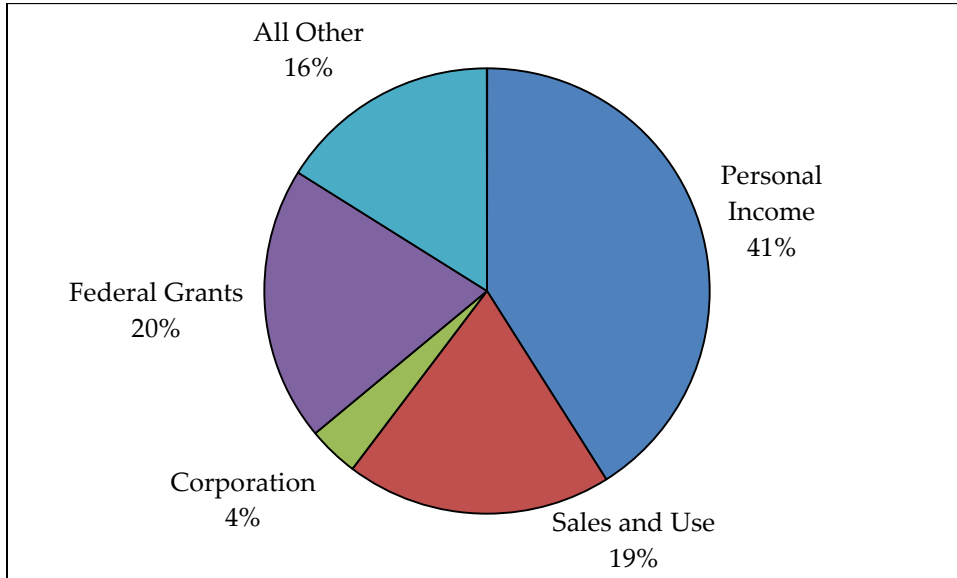
Refunds reduced collections by \$967 million.

FY 2012



Refunds and transfers reduced collections by \$1,348 million.

FY 2014 – Adjusted for Net Budgeting of Medicaid*



Refunds reduced collections by \$1,254 million.

**For purposes of this chart, \$2,993 million was added to Federal Grants in order to estimate what General Fund revenues would have been had the State of Connecticut not switched to net budgeting Medicaid in FY 2014.*

Figure 2: Progressivity of the Connecticut Personal Income Tax

