Staff Briefing

Connecticut's Tax System

October 14, 2005

Legislative Program Review
& Investigations Committee

CONNECTICUT GENERAL ASSEMBLY

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Introduction

Connecticut's State and Local Tax System

In March 2005, the Legislative Program Review and Investigations Committee voted to undertake a study of Connecticut's state and local tax structure, examining all major state taxes and the local property tax as a system. The study's main purpose is to assess the system's overall performance relative to other states and in relation to nationally recognized criteria. After an extensive literature review, the principles of a high-quality state revenue system developed through a National Conference of State Legislatures (NCSL) project were identified as the primary framework for evaluating Connecticut's system.

There are nine guiding principles: complementary; reliable; balanced; equitable; promotes compliance; fair and efficient administration; competitiveness; neutral; and accountable. To date, much of the committee staff work has focused on identifying measures and analytical techniques for applying all nine to Connecticut's state and local tax system as a whole, and to each major component tax. None of the principles are easily defined, as each involves qualitative as well as quantitative concepts. In addition, there is considerable overlap among the principles and, in some cases, conflicting purposes. For example, a tax system that is simple to administer and understand may not also be balanced and equitable.

This briefing report contains the interim results of committee staff research and analysis and represents a preliminary assessment of the state's tax structure based on currently available information. Two areas particularly hampered by data limitations are evaluations of tax burden on individual taxpayers and revenue adequacy in terms of state expenditure trends. Additional data are being gathered and more extensive analysis of the system and its components will be completed during the next phase of the study.

However, the preliminary findings about the tax system, along with the explanation of other states' experiences with tax and expenditures limits and their impacts, should provide the committee with a basis for discussion for the next phase of the study as well as for the upcoming panel of tax experts and public hearings around the state. Altogether, the information gathered in this report and the input from experts and the testimony that will be heard at those hearings should help the committee decide on an approach for the next phase of the study. It is important to note, however, that final assessment of the system will involve value judgments and policy choices by the committee as well as interpretation of economic indicators and other social science measures.

Methods

The program review committe staff has relied on many sources and a variety of methods to carry out this study. Dozens of reports on other state tax systems, in terms of reforms and key principles, tax incidence, and tax compliance and administration were reviewed. Policy reports authored by a wide range of organizations -- business, taxpayer, professional groups as well as "think tanks" representing a variety of viewpoints – were also reviewed. Local and national experts were interviewed and provided considerable assistance in identifying well-accepted tax system measures and research methods.

The study presents a number of data challenges. The best comparative information on state and local finances is compiled by the U.S. Census. The most recent data on tax revenues and expenditures for both the state and local levels of government, however, are from 2002. Detailed data on Connecticut local government budgets is not centrally collected and information on local property tax collections, due to the nature of the tax, lags state level data (i.e., the most recent local totals are for FY 03).

Problems with state information systems have also complicated data collection efforts throughout the committee study. Finalized state fiscal information for FY 04 will not be available from the Comptroller before the end of October 2005 and FY 05 data will not be ready for another few months due to technical troubles with the recently implemented new statewide automated accounting system, CORE-CT. Conversion to a new automated information system within the Department of Revenue Services has significantly impeded compilation of data on state tax programs and department administrative activities by the committee staff. Confidentiality issues related to tax information has also complicated research efforts and delayed several key areas of analysis. Efforts to resolve each of these data-related matters are continuing.

Report Organization

The briefing report contains four main sections. Section 1 summarizes the results of committee staff's preliminary assessment of Connecticut's overall tax structure using the NCSL principles. A profile and preliminary assessment of each major component tax is presented in Section 2. National tax policy trends, with an emphasis on current state tax and spending limitations, are highlighted in Section 3. That section also contains case studies of the experiences of several states, including California and Massachusetts, that have enacted major reforms of their tax systems. An initial review of the general organization and key resources of the state's primary tax administration agency, the Department of Revenue Services, is provided in Section 4.

Section 1

Assessing Connecticut's Tax System

The ideal tax system is reliable, fair, and efficient. In theory, state tax policies should be designed to achieve these goals, resulting in a structure that produces a revenue stream adequate for providing services the public expects, without disruption, frequent rate or base changes or undue burden on any taxpayer group. In practice, decisions on tax policy are usually made incrementally, often in response to a fiscal crisis or constituent demands, or to promote any number of other policy goals from job creation to environmental protection.

In general, legislators do not have the time or the information to assess current tax policies and determine whether fundamental restructuring, selected fine-tuning, or no action is needed to improve system performance. The main purpose of this program review committee study is to provide an assessment of Connecticut's existing state and local tax system based on well-established evaluation criteria. The primary evaluation criteria used in the study are nine principles of a high quality revenue system developed under the auspices of the NCSL. This section of the report contains a brief overview of Connecticut's state and local tax system, highlighting its composition, trends in collection, and broad comparisons with other states.

Preliminary results from committee staff analysis of the NCSL principles for a high quality state revenue system as applied to Connecticut's overall tax structure are discussed below. A table summarizing these results is presented at the end of this section. Detailed profiles and preliminary assessments of each major component tax are contained in Section 2.

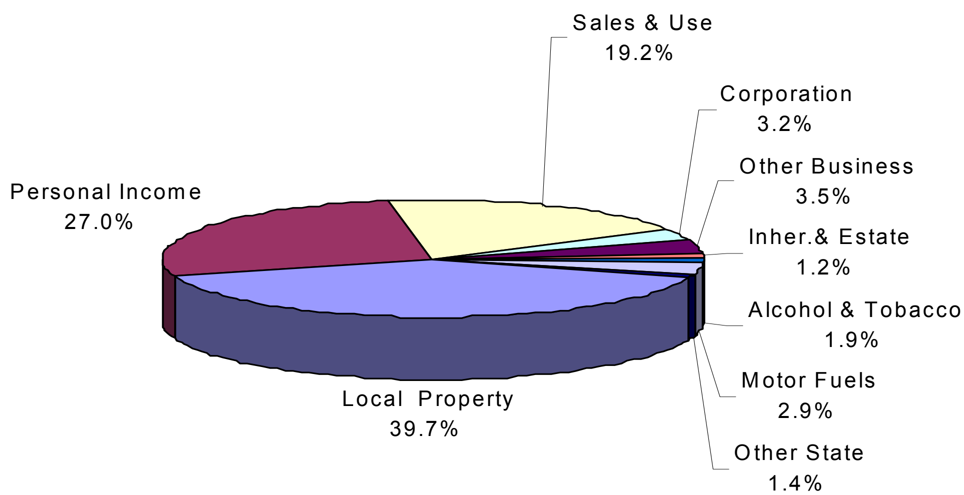
Tax System Overview

The Connecticut state and local tax system, for the purposes of the program review committee study, is comprised of the local property tax, the only significant municipal level tax, and all state taxes. Altogether there are more than 40 different types of state taxes. The five major state tax components that fall under the committee's scope of study are: personal income tax; corporate taxes; a general sales and use tax; several selected sales or excise taxes; and inheritance and estate taxes.

The main components of the system and their relative contribution to total revenues as of FY 03 are illustrated in Figure I-1. (FY 03 is the most recent year for which both state and local tax collections data are available.)

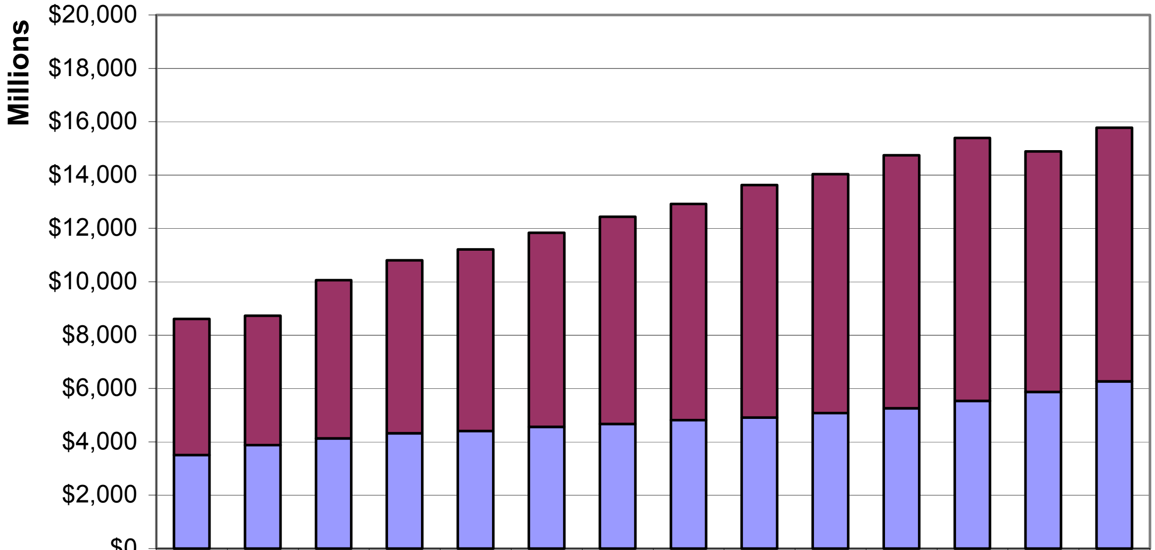
Taxes are the primary revenue source for both state and local governments in Connecticut. As of FY 04, receipts from all state taxes represented 74 percent of all state revenues. At the local level, towns rely very heavily on the property tax to fund services. The most recent available data (FY 03) show that the property tax accounts for 98 percent of all municipal tax collections. Those property tax revenues make up two-thirds (68 percent) of all revenues the towns receive, with less than one-third (32 percent) coming from state aid and intergovernmental transfers like federal grants.

Figure I-1. Connecticut State and Local Tax Structure Composition: FY 03



Total state tax and local property tax collections in Connecticut since FY 90 are shown in Figure I-2. It is important to note this time period includes one fiscal year before the state's personal income tax was enacted in 1991 and the two years it was phased in before being fully implemented in FY 93. Between FY 90 and FY 03, actual state and local tax revenues together rose from \$8.6 billion to nearly \$15.8 billion, increasing on average 4.8 percent per year. Local property tax collections grew steadily over this time period, while state and total revenues dipped one year during the most recent economic recession (FY 02).

Figure I-2. State and Local Tax Collections Since FY 90



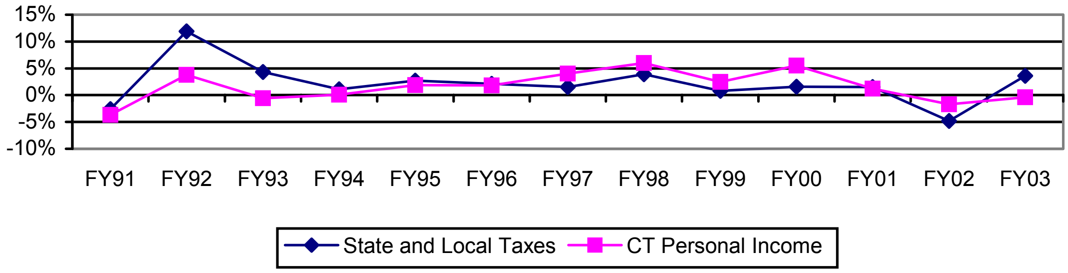
	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
State Taxes	5,104,	4,858,	5,928,	6,483,	6,806,	7,271,	7,765,	8,101,	8,721,	8,962,	9,492,	9,860,	9,012,	9,507,
Local Prop.Tax	3,503,	3,874,	4,134,	4,322,	4,400,	4,560,	4,667,	4,810,	4,906,	5,075,	5,253,	5,532,	5,868,	6,264,

Source of Data: Comptroller Annual Reports (state), OPM (local)

Growth in state and local tax revenues over this period adjusted for inflation is shown in Figure I-3. Also shown is inflation-adjusted growth in the state economy, as measured by annual change in Connecticut personal income[1]. Between FY 91 and FY 03, real growth in tax revenues averaged 2.1 percent per year, exceeding the average annual growth in inflation-adjusted personal income, which was 1.6 percent.

[1] Personal income is defined as all current income received by persons from all sources including wages, rental income, and public and private transfer payments, and is an often-used measure of the economy.

Figure I-3. State and Local Tax Revenues and Connecticut Personal Income: Annual Inflation-Adjusted Growth:



Source: PRI analysis

Connecticut's tax system, in terms of state share of total state and local tax revenues and two commonly used measures of relative tax burden, is compared with other Northeastern states and the U.S. average in Table I-1. Data are for 2002, the most recent available for state and local revenues for all states. The per capita tax burden measure, which controls for differences in population, and the per $100 of personal income measure, which controls for differences in state income, are both based on total collections from all state and local taxes. The rankings are for all 50 states and the District of Columbia.

Table I-1. State and Local Taxes 2002: Connecticut and Other Northeastern States

	State Share	Per Capita		Per $100 Personal Income	
	Percent	**$**	**Rank**	**$**	**Rank**
Connecticut	59.7	$4,440.7	3	$10.2	21
Maine	57.8	$3,561.7	9	$12.5	2
Massachusetts	62.0	$3,763.7	5	$9.6	39
New Hampshire	52.7	$2,911.7	28	$8.3	50
New Jersey	52.9	$4,115.6	4	$10.2	20
New York	48.7	$4,683.7	2	$13.1	1
Rhode Island	58.7	$3,456.3	13	$10.9	8
Vermont	77.3	$3,226.8	19	$10.8	10
U.S. Total	59.1	$3,215.7	-	$10.2	-

Sources of Data: Governing Sourcebook 2005 and NCSL (Feb. 2005), both based on U.S. Census 2002

Connecticut is nearly the same as the U.S. average for state share of total state and local revenues, and for state and local tax burden when measured against personal income. On a per capita basis, Connecticut's tax burden is higher than average and ranks third highest in the country. On both measures, New York has the highest burden of all states in the region and ranks one and two nationwide. New Hampshire has the lowest state and local tax burden in the region using either measure and is 50th in the country in terms of taxes per $100 of personal income.

Preliminary Assessment: NCSL Principles

In the early 1990s, the National Conference of State Legislatures convened a group of policymakers, legislators, legislative and executive staff, and academicians to identify elements of sound state fiscal policy. Out of that effort, a document called "Principles of a High-Quality State Revenue System" was created and subsequently updated. The report identifies nine principles on which to evaluate a tax system: 1) complementary; 2) reliability, including stability and sufficiency; 3) balanced; 4) equity; 5) facilitates compliance; 6) fairly administered; 7) economically competitive; 8) neutral; and 9) accountable. Each of the principles is discussed below in the context of assessing Connecticut's tax system.[2]

Complementary

The elements of a tax system that rely on state and local government to raise revenues should be complementary, meaning tax bases are not in competition, tax policies are not contradictory, and revenue-raising authority matches with financial responsibilities. In Connecticut, there is little overlap in taxing authority between the state and municipalities. Local government in this state is limited to raising revenue through a property tax, unlike many other states where counties and sometimes municipalities can also levy local sales, or more rarely, income taxes.

Limiting the local revenue base to the property tax avoids taxpayer confusion and concerns over "double" taxation. At the same time, it restricts municipal capability and flexibility for funding what has become a wide array of expected local services. In recognition of this constraint, state policymakers need to be cautious about introducing new unfunded mandates on towns and must honor previous municipal funding commitments, particularly in the area of education, the largest mandated expense for most Connecticut communities.

Complementary tax systems can be especially difficult to achieve when state or local governments adopt constitutional or statutory tax and expenditure limitations (TELs). Measures put in place to provide tax relief and control public budgets can have intended and unintended consequences in terms of the breadth and quality of services provided, as well as raise taxpayer fairness issues. Connecticut has a constitutional cap on state spending and a balanced budget requirement, which were put in place as part of a fiscal reform package adopted at the same time as the state personal income tax; however, no formal constraints have been placed on state taxing authority. To date, Connecticut has not instituted any statutory limits on local taxing authority (e.g., caps on local property assessments), although various proposals to do so have been introduced in recent legislative sessions. The potential benefits and risks of TELs, along with a description of the actual experiences of several states that adopted caps on state and local taxes and/or spending are discussed in more detail in Section 3.

[2] *"Principles of a High-Quality State Revenue System"* NCSL (updated December 2002)

Reliable

High quality tax systems produce revenues in a reliable manner, which involves three factors: stability, certainty, and sufficiency. Each factor is discussed separately below.

Stability. A stable tax system produces revenues that are predictable and relatively constant over time. Revenue stability is important to budgetary planning, helping governments avoid fiscal crises and erratic funding of public programs. Some revenue variability is inevitable. Tax collections will change with demographic shifts and changes in the structure of the economy, as well as from the impact of natural disasters, wars, and other events that no one can forecast.

Tax system volatility can be reduced, however, by incorporating a mix of tax types that respond to the economy in different ways. This allows the system to weather economic downturns by relying on revenues from one source during boom periods, and another during slumps. For example, in good times income tax revenues usually outpace growth in the economy, measured either by personal income or gross state product[3], but they also fall off more deeply during recessions. While sales tax revenues also fluctuate with business cycles, their volatility is less dramatic, and local property taxes, which do not grow as quickly as other revenue sources, are the most reliable.

Program review committee staff examined the revenue volatility of state and local taxes by analyzing long-term growth trends and the amount and frequency of year-to-year fluctuations in revenues for total state taxes, for each of the three major state taxes (personal income, general sales and use, and corporate income), and for the local property tax. The results of this analysis are summarized in Table 1-2.

In each case, the state tax revenues included in Table I-2 were adjusted to remove the effects of year-to-year legislative changes on collections,[4] (e.g., revisions in the rate, base, and exemptions) so tax system volatility due to economic conditions could be isolated. Since volatility can vary with business cycles, a 30-year period that encompasses several recessionary and expansionary cycles was examined. Longer-term trend analysis in Connecticut is complicated by the fact the state's personal income tax, now the major source of state revenues, was not established until 1991 and did not go into effect fully until FY 93. For that reason, the table includes information for the full period and for a sub period following implementation of the personal income tax (FY 93-FY 04).

The table includes two calculations: long-term average annual growth, a gross measure of revenue volatility; and standard deviation, a statistic that indicates the range in variation around the long-term trend rate. The greater the standard deviation, the more volatility there is in tax revenue performance. For example, Table 1-2 shows total tax revenues grew, on average, almost

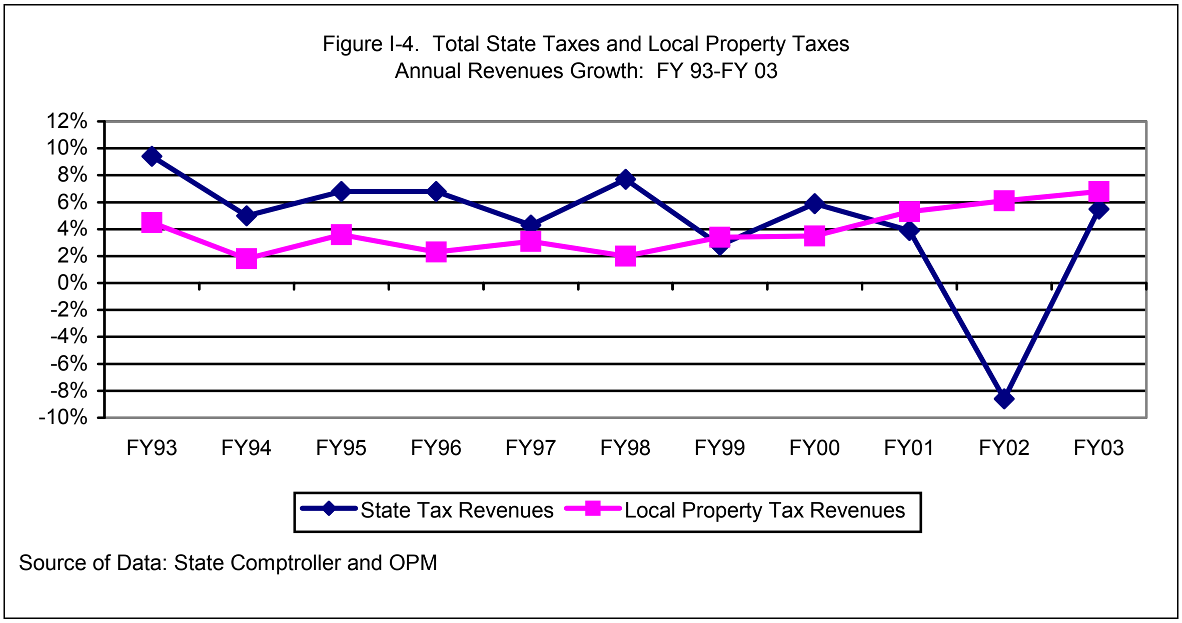
[3] Gross state product is another measure of the state's economy, and is defined as the current market value of all final goods and services produced by labor and property in the state.
[4] Each year the Office of Fiscal Analysis adjusts percent changes in revenues up or down to accommodate for the estimated amounts caused by legislative action. These adjusted changes are what program review used in this calculation.

6 percent a year between FY 75 and FY 04. The standard deviation of 6.2 means most of the time, annual growth rates will be between roughly 12 percent and 0 percent, or fairly volatile. The corporate tax is by far the most volatile component tax with annual growth rates that could range from a decline of 9 percent to an increase of 18 percent, while the general sales tax is the most stable state tax source, with annual average growth rates between 2 and 12 percent over the full period. The volatility of the tax system has been less in the sub period, with a standard deviation for the entire system of 4.1 in the FY 93 –FY 04 period. This could be partially due to the income tax absorbing some of the previous volatility in the other component taxes, thus making for a less volatile tax system overall.

Table 1-2. Average Annual Growth and Standard Deviation of Connecticut State Tax Revenues: FY 75 – FY 04 and Local Property Tax Revenues FY 93-FY 03		
	Full Period: FY 75 – FY 04	**Sub-Period: FY 93 – FY 04**
Total State Tax Revenues		
Average Annual Growth	5.8%	5.2%
Standard Deviation	6.2	4.1
Sales and Use Tax		
Average Annual Growth	7.0%	5.5%
Standard Deviation	5.1	2.3
Corporate Income Tax		
Average Annual Growth	4.4%	3.0%
Standard Deviation	13.7	10.3
Personal Income Tax		
Average Annual Growth	n/a	7.7%
Standard Deviation	n/a	7.5
Local Property Tax		**Sub-Period: FY93 – FY03**
Average Annual Growth		3.9%
Standard Deviation		1.6
Source: PRI		

Measures of volatility of the local property tax are also presented in the table, but for a different time period (FY 93 through FY 03), due in part to data availability. During the period, local property tax revenues grew 3.9 percent each year on average, with a relatively low standard deviation of 1.6, as shown at the bottom of the table.

Looking at volatility of all state taxes and the local property tax together between FY 93 and FY 03 shows the long-term average annual growth is 4.2 percent, slightly less than the rate just for state taxes; stability for the overall system, however is greater, with a standard deviation value of 2.8. Thus, by these measures, the property tax is certainly less volatile, and in fact shows the local property tax has an important stabilizing effect on the state and local tax system as a whole.



Year-to-year volatility differences in the two taxes are more apparent in Figure I-4. Annual percent changes in local property taxes are far less dramatic than annual changes in state tax collections, as Figure1-4 illustrates.

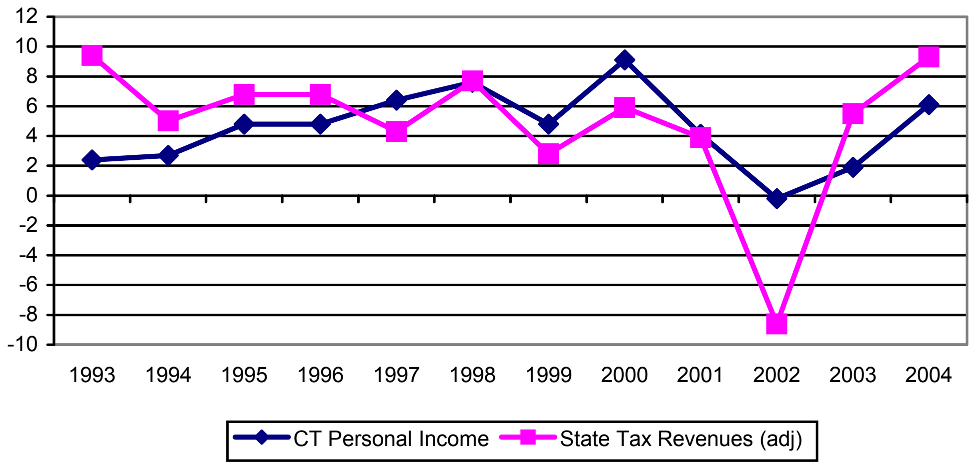
On the whole, the volatility of Connecticut's state tax revenues exceeds that of the state's economy and is greater than the national average for state tax revenues. Figure I-5 shows, since FY 93, the first year the state's personal income tax was fully implemented, total state tax revenues (adjusted to remove the impact of year-to-year legislative changes in tax rates or base) have fluctuated more than Connecticut's total personal income.

Figure I-6 compares annual growth in Connecticut state taxes revenues with the year-to-year change for all states since FY 93.[5] Throughout this time, the volatility -- or degree of change from year to year -- of Connecticut's state tax revenues was greater than the national average.

In general, Connecticut's economy, as measured by personal income growth, is less stable than the U.S. economy on average (see Figure I-6). (Data are not easily available to allow any nationwide comparisons of volatility in revenues for combined state and local tax systems. Based on earlier analysis, however, it is likely the volatility of Connecticut's tax system would be less if local taxes were included and might compare more favorably to a national average.)

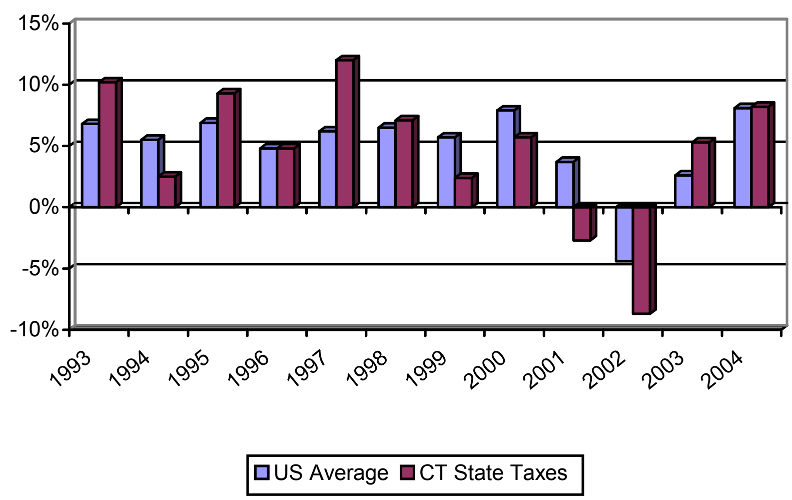
[5]Since adjustments for legislative changes cannot be made to for all other states, Connecticut revenues shown in this chart are unadjusted.

Figure I-5. Connecticut State Tax Revenues and Connecticut Economy: Annual Growth Rates

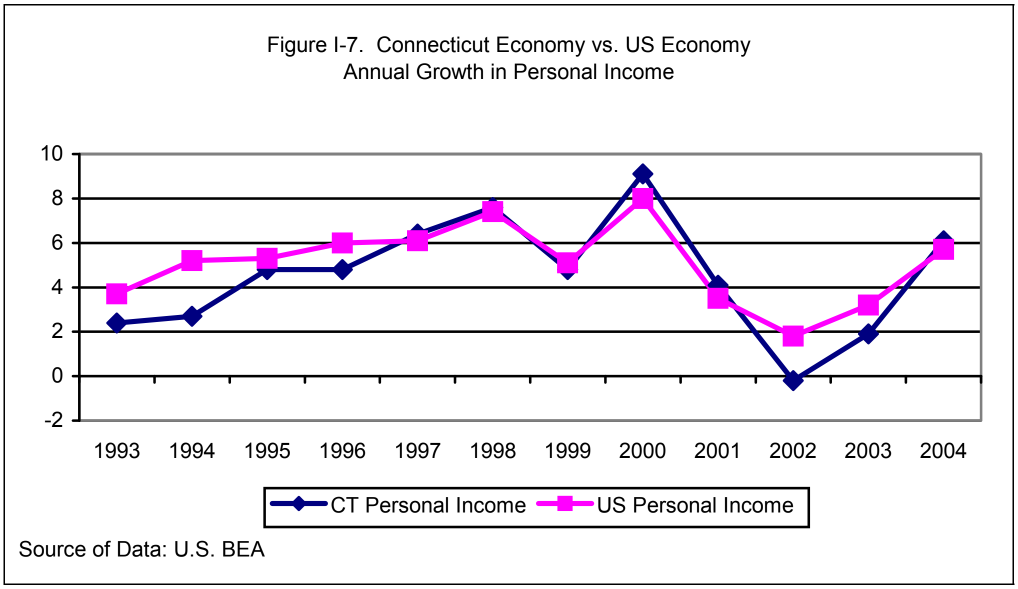


Sources: U.S. BEA and OFA

Figure I-6. Annual Growth: CT State Tax Revenues And U.S. Average



Source of Data: US Census



Section 2 provides more detailed analysis on the volatility of each component tax of Connecticut's system. Based on that analysis, it appears much of the volatility of the overall system is related to the state's personal income tax (PIT). While the corporate tax is the most volatile of all the system's component taxes, its contribution to total revenues has been decreasing sharply both in actual dollars and as a percentage, which lessens its impact on the stability of the state's tax system. The high variability in Connecticut PIT revenues is due largely to the high incomes of taxpayers at the top bracket, the percentages of total taxes they pay; and the variability in both (rather than due to tax's rate structure). As the state becomes more reliant on the personal income tax, its volatility makes the whole tax system more susceptible to dramatic upswings and downturns.

Certainty. A reliable tax system achieves certainty by keeping the number and types of tax changes to a minimum. Frequent revisions impede long-term planning by taxpayers and government agencies as well as add administrative and compliance costs.

The component tax profiles contained in Section 2 include a discussion of major legislative changes to each tax since the early 1990s. All the state taxes have undergone modifications, with corporate taxes being the most prone to rate and base changes, including several rate reductions and the addition of various business tax credits. On the whole, the personal income tax has been immune from broad revisions; the top rate changed once while the value of the property tax credit on the income tax has fluctuated a few times. The current sales tax rate of 6 percent has not changed since it went into effect in 1992, but the number of exemptions has steadily increased each year. The state has also opted to offer sales tax "holidays," and rebates from time to time, a policy that reduces revenue certainty.

It is difficult to assess at what point the number and scope of changes in a tax system result in more harm, in terms of uncertainty, than good, which can include improved efficiency, fairness, or just increased revenues. In most states including Connecticut, recessions have tended to bring about increases in tax rates, new additions to tax bases, or elimination of some exemptions or credits; when the economy improves, the reverse occurs. However, based on the most recent economic cycle, states appear to be making more use of temporary revenue adjustments, such as one-time surcharges to increase collections and rebates or refunds, rather than rate or base reductions to provide tax relief. Such practices help preserve tax system reliability.

In 2003, for example, Connecticut made some modifications to the tax system -- increasing the top rate of the income tax to five percent, raising the cigarette tax, and expanding the base for the sales tax. However, the state has also increasingly used one-time surcharges, especially in the corporate income tax, to raise revenues. This provides more certainty to the tax structure itself, although the financial impact on the taxpayers affected may be as great, especially if the surcharge is imposed year after year.

Sufficiency or adequacy. A reliable tax system raises funds adequate to pay for the level of services the public, directly or through elected representatives, chooses to provide. Sufficiency, therefore, requires the system to produce enough revenue to balance the budget each year and adapt to desired spending changes. This element of a tax system is especially difficult to assess since the debate over appropriate funding and spending levels is the crux of the legislative process each year. Adequacy is essentially a value judgment; one legislator's view of adequate funding for needed public services could be another's idea of profligate government spending.

One broad indicator of tax system adequacy is whether revenue growth keeps pace with spending and growth in the economy over the long term. Program review committee staff compared increases in state and local tax collections between FY 91 and FY 03 with several measures of economic growth as well at trends in state and local expenditures. Results are summarized in Table I-3.

Table I-3. Connecticut Fiscal Growth Over Time

	Total Percent Change FY 91-FY 03
Revenue Growth	
State and local taxes	62.9
State taxes	66.6
Local property taxes	59.8
Expenditure Growth	
State and local expenditures	59.9
State expenditures	64.7
Local expenditures	53.7
Economic Growth	
Total percent growth Connecticut Personal Income	55.7
Total percent growth Connecticut Gross State Product	52.8*
Total percent growth inflation (Consumer Price Index-urban)	32.5

*FY 93-03 period
Source: PRI analysis

Based on Table I-3, it appears Connecticut's tax system produced sufficient revenues over this 13-year period. Total growth in state and local tax revenues, individually and combined, have more than kept up with personal income growth and is well above the cumulative inflation rate for this period. The overall increases in tax collections, combined and at the state and local levels, have also exceeded the growth in their respective expenditures.

To assess adequacy another way, committee staff examined General Fund budget balances over the past 20 years. In Connecticut and all other states except Vermont, a balanced budget is required by law. Unlike the federal government, states are precluded from deficit spending; their tax systems must produce revenue sufficient to meet approved expenses. In most cases, states including Connecticut, balance their budgets every year; however, deficits sometimes occur or are avoided through fiscally questionable means (such as issuing short-term bonds to pay off the revenue shortfall).

Figure I-8 shows Connecticut has experienced budget deficits several times over the last 20 years. Four consecutive years of deficits, including the nearly $1 billion shortfall at the end of FY91, precipitated adoption of Connecticut's currently configured revenue system that relies heavily on a personal income tax, as well as a number of fiscal reforms intended to improve the system's reliability (i.e., the balanced budget requirement, state spending cap, and more realistic "rainy day fund.").

An unprecedented 10-year cycle of surpluses, some of which reached more than $500 million, followed, due in large part to a similarly unprecedented period of robust economic growth. However, a recessionary period compounded by the impact of the September 11th terrorist attacks and war in Iraq contributed to another massive deficit in FY 02 and a smaller shortfall in FY 03. The already significant volatility of Connecticut's state revenue system was exacerbated by this unusually severe economic downturn.

An analysis carried out recently by the Federal Reserve Bank of Boston (FRBB) offers another way to assess state tax system adequacy using a measure called fiscal comfort. The FRBB used a method called the representative tax system to measure the ability of states to generate revenues (*fiscal capacity*) and the extent to which states use their tax base (*tax effort*) for FY 1999.[6] Another methodology computes *fiscal need* through the development of a representative expenditure system, which is a common bundle of state and local functions. The final measure calculated in the analysis is *fiscal comfort*, a state's fiscal capacity relative to its fiscal need.

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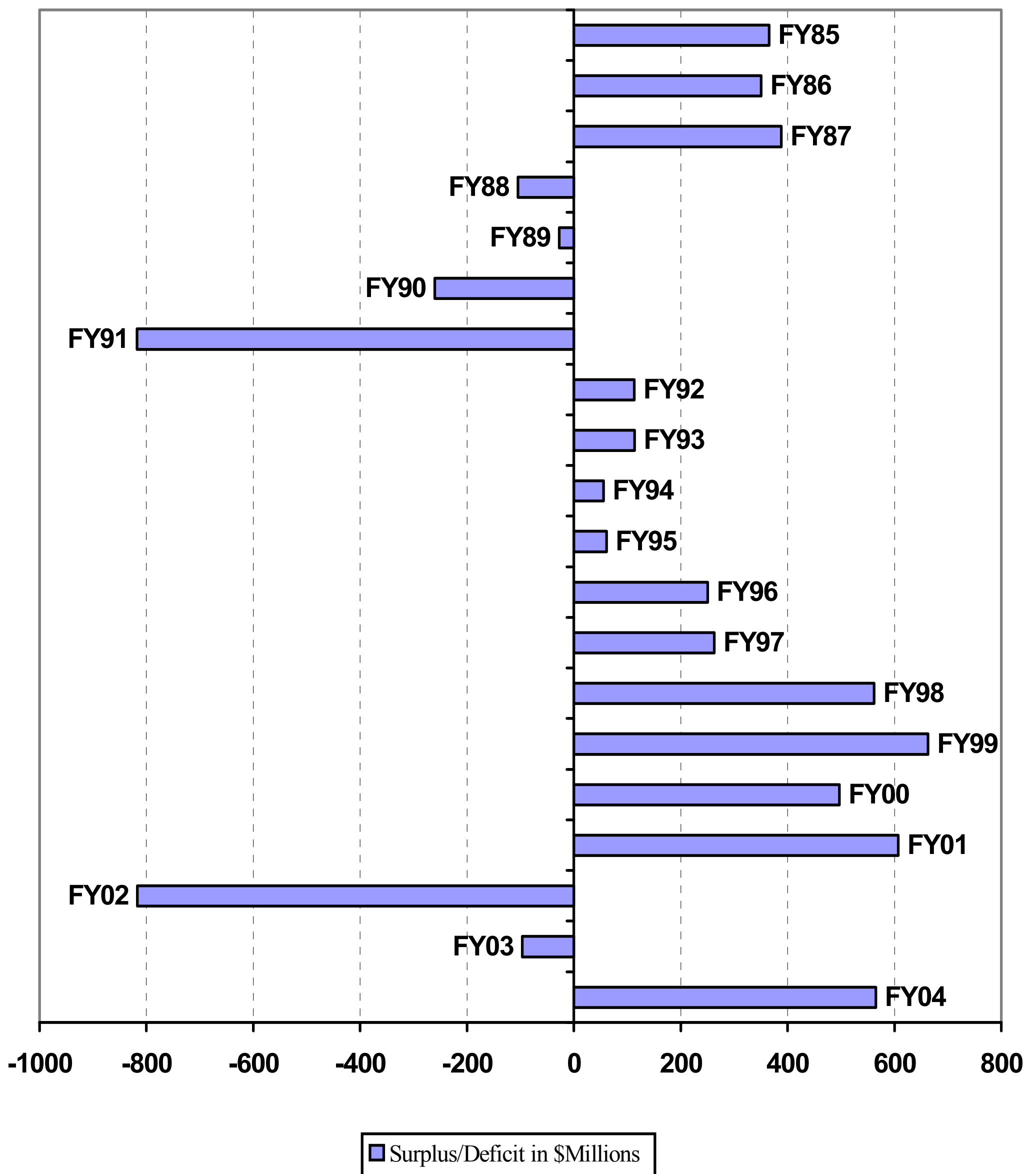
[6] See Robert Tannenwald and Nicholas Turner, *Interstate Fiscal Disparity in State Fiscal Year 1999*, Federal Reserve Bank of Boston, December 2004. The representative tax system (RTS) develops an average tax rate among states for 27 different tax bases. Each state's fiscal capacity was measured by how much would be raised if national average tax rates were applied to each state's tax base. Therefore, because the RTS rates are the same for each state, potential revenue yields vary directly with the size of the underlying base. The state's tax effort was measured by comparing its actual revenue to its potential under the RTS. Thus, tax effort measures the extent to which a state utilizes its available tax base. These results were indexed against the U.S. average as 100. The representative expenditure system (RES) calculates the cost for a representative bundle of state and local functions, provided at a standard level of service for each state. The higher the amount, the greater a state's fiscal need. The amount for each state is divided by that for the nation as a whole and multiplied by 100 to construct a fiscal need index.

Figure 1-8. General Fund Balances Over Time



Source of Data: OFA

Using these measures to evaluate Connecticut's system, the FRBB analysis found:

- Connecticut's fiscal capacity to raise revenues is 27 percent above the national average, ranking second among the 50 states. Massachusetts and New Hampshire were also above average, ranking in the top 10.

- From 1987 thorough 1999, Connecticut has consistently been ranked among the top five states.
- Connecticut's tax effort (or burden) is 19 percent above the national average and is third highest in the nation. All the New England states, except New Hampshire, show a high tax effort and were above the national average.
- Connecticut's fiscal need was 2 percent below the national average and ranked 26th in the nation.
- Connecticut's fiscal comfort was 29 percent above the national average, ranking it second highest in the nation. All New England states, except New Hampshire, were above the national average.

The FRBB analysis suggests that, all other things being equal, the ideal situation is to have: 1) a high fiscal capacity state with a low tax effort; and 2) a high fiscal capacity and a low fiscal need (or at least a positive differential between them). Connecticut's tax system provides that situation, having a +10 differential between capacity and effort, and a +31 differential between fiscal capacity and need.

Balanced

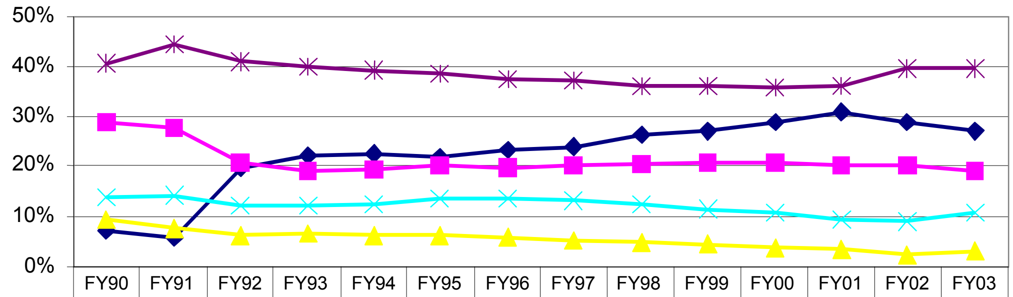
High quality revenue systems rely on a balanced mix of a variety of taxes. While not a strict rule, system balance is often measured against a "three-legged stool" framework, with each major tax – personal income, sales, and property -- contributing roughly equal portions of revenue, and other sources contributing a lesser share.

A major benefit of a system with a balanced blend of diverse taxes is its ability to provide for a broad base and low rates within each component. Balance also contributes to a system's ability to meet other principles by: avoiding too much reliance on any one tax type; helping maintain economic competitiveness through lower tax rates and/or broad component tax bases; and promoting a sense of system fairness in that tax burden is shared among many segments of taxpayers.

Like most other states, Connecticut's revenue system incorporates both wealth and consumption taxes and relies on three primary components: income taxes, both individual and corporate; sales taxes, general and selected; and property taxes. Connecticut has a balanced system in the sense it incorporates the whole range of major tax components to raise revenue and support public services. The question for continued analysis is whether there is over-reliance on any tax type.

Connecticut's reliance on each major source of tax revenues over time is shown in Figure I-9. In FY 03, the year with the most recent available data, Connecticut relied on two major taxes – the local property tax and the personal income tax, for more than two-thirds of total state and local tax revenues in FY 03. The state's general sales tax accounts for about 19 to 20 percent and has remained at about that level since FY 92.

Figure I-9. State and Local Tax Revenues By Source:



	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Personal Income	7.3%	6.0%	19.6%	22.1%	22.5%	21.9%	23.2%	24.1%	26.4%	27.2%	28.7%	30.8%	28.7%	27.0%
Sales	28.8%	27.7%	20.7%	19.0%	19.5%	20.0%	19.8%	20.2%	20.3%	20.9%	21.0%	20.3%	20.1%	19.2%
Corporate	9.2%	7.7%	6.4%	6.6%	6.3%	6.1%	6.0%	5.3%	4.9%	4.4%	4.0%	3.6%	2.6%	3.2%
All Other State	14.0%	14.3%	12.2%	12.2%	12.5%	13.4%	13.5%	13.2%	12.4%	11.3%	10.6%	9.4%	9.2%	10.8%
Local Property	40.7%	44.4%	41.1%	40.0%	39.3%	38.5%	37.5%	37.3%	36.0%	36.2%	35.6%	35.9%	39.4%	39.7%

Sources of Data: Comptroller Annual Reports and OPM

Based on 2002 Census data, the most recent available, Connecticut is more reliant on the property tax than 42 other states (and of the eight that are more reliant, three do not have a broad-based income tax). As Table 1-4 shows, in Connecticut like nearly all the states in the Northeast region, property taxes account for a higher portion of total state and local tax revenues than the national average of 30.8 percent. (The percentages in Figure I-9 and Table I-4 vary somewhat because the Connecticut-only figures are based on Comptroller and OPM data, while the state comparison information use U.S. Census data.)

Table I-4. State and Local Tax Collections by Source: Percentage of Total Taxes, 2002

	Property	Sales	Indiv. Income	Corporate	Other
U.S. Total	30.8	24.6	22.4	3.1	19.0
Connecticut	**39.6**	**20.1**	**24.4**	**1.0**	**14.8**
Northeast Region					
Maine	42.1	18.4	23.6	1.7	14.1
Massachusetts	36.5	15.5	33.1	3.4	11.5
New Hampshire	60.3	Na	2.0	10.5	27.2
New Jersey	46.3	17.3	19.8	3.2	13.3
New York	30.2	18.7	34.0	5.7	11.4
Rhode Island	40.4	20.2	22.7	0.8	16.0
Vermont	41.9	10.9	20.8	1.9	24.5
Selected Other States					
California	25.1	26.0	27.4	4.4	17.0
Colorado	29.9	29.7	25.0	1.5	13.8
Michigan	32.0	25.4	21.5	6.7	14.4

Source of Data: Federation of Tax Administrators (based on U.S. Census, 2002)

In addition, Connecticut's recent growing reliance on property tax revenue is in the reverse direction of the trend in most other states. Nationwide, the property tax accounted for 31 percent of all state and local tax collections in FY 92; in Connecticut it was more than 41 percent. By FY 02, reliance on property tax nationally was down to 29 percent but in Connecticut property tax revenues (after dropping somewhat through the 1990s) had climbed back up to almost 40 percent of the state and local total revenues.

Shifts in Connecticut's tax system balance over time are likely due to a combination of many factors. One contributor, discussed in more detail in Section 2, is the reduction in reliance on the corporate income tax as a source of state and local income. While never a major revenue source even before enactment of the broad-based state personal income tax, it did make up just over 9 percent of state and local tax collections in FY 90. Since full implementation of the income tax in FY 93, its share has dropped from just over 6 percent as little as 2.6 percent in FY 02 and just over 3 percent in FY 03. Another contributor is the lower reliance on the sales and use tax to produce substantial revenue.

Equitable

A good tax system is fair and achieves equity in two main ways: 1) the system distributes tax burden according to ability to pay (vertical equity); and 2) the system treats taxpayers of comparable circumstances similarly (horizontal equity). Like many of the other principles discussed in this section, fairness is difficult to define, let alone measure. Equity, like adequacy, is a value judgment; however, there is general agreement that a fair tax system minimizes regressivity, placing less tax burden on lower-income taxpayers.

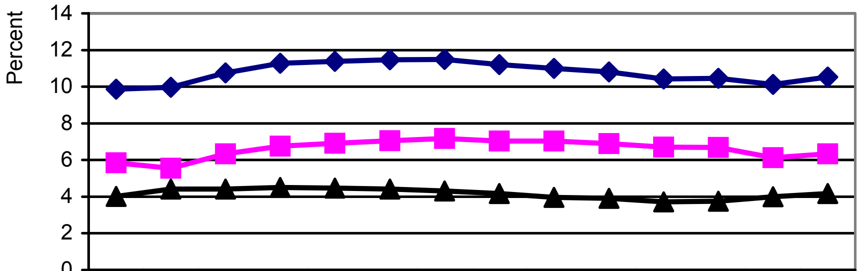
One commonly used gross measure of tax burden is the percent of personal income total state and local taxes represents. This measure is used to compare total tax burden over time as well as to make comparisons with other states. Results of program review staff analysis of the overall tax burden of Connecticut's system since FY 90 are summarized in Figure I-9.

Figure I-10 shows that all state and local taxes as a percentage of the state personal income (the top line) grew from slightly less than 10 percent at the beginning of the 1990s to almost 11.5 percent in the mid-1990s, before declining to a low of 10.1 percent in FY 02 and then increasing slightly to 10.5 percent in FY 03.

Based on the most recent available comparative data, Connecticut's overall tax burden is on par with the national average. In 2002, state and local taxes represented 10.2 percent of personal income in Connecticut and for the U.S. in total, which placed it 21st among all the states.

As shown in an earlier table, Table I-1, Connecticut along with New Jersey ranks 5th highest among the states in the Northeast in terms of state and local taxes per $100 of personal income ($10.2). Massachusetts ($9.6) and New Hampshire ($8.3) are lower, while New York ($13.1), Maine ($12.5), Rhode Island ($10.9) and Vermont ($10.8) are higher.

Figure I-10. State and Local Tax Revenues as a Percent of Personal Income



	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
State and Local Taxes	9.87	9.97	10.75	11.27	11.38	11.47	11.49	11.21	11	10.81	10.42	10.45	10.12	10.53
State Taxes	5.85	5.55	6.33	6.76	6.91	7.05	7.18	7.04	7.04	6.9	6.71	6.69	6.13	6.34
Local Property Taxes	4.01	4.42	4.42	4.51	4.47	4.42	4.31	4.18	3.96	3.91	3.71	3.75	3.99	4.18

Source: PRI analysis

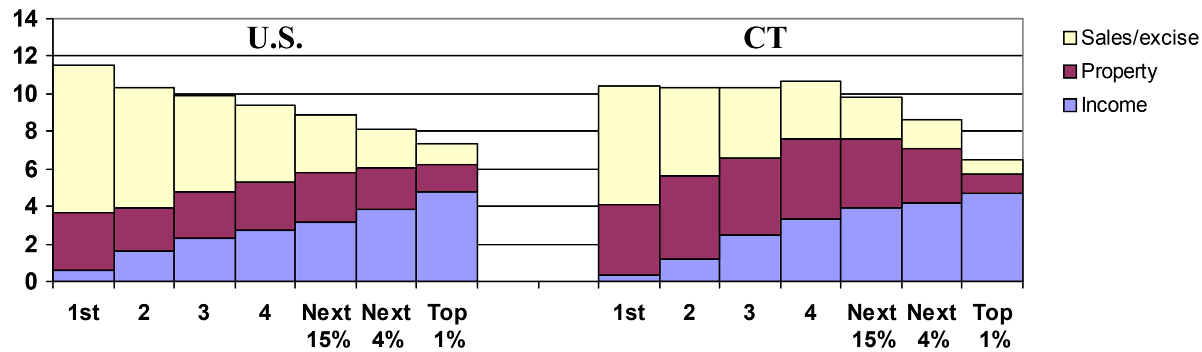
However, examining tax burden as a share of personal income or even on a per capita basis does not gauge the impact on individual taxpayers. Vertical equity raises issues about how much more (if any) people at higher income levels should pay in taxes. Taxes that are based on income, like the personal income tax -- especially those placing higher rates on higher income individuals – are more progressive, since they place a higher proportional burden on higher income groups. Other taxes, like sales, excise or other consumption taxes, are considered highly regressive, since they place more proportional burden on lower income groups.

The equity of each component tax is discussed in detail in Section 2; however, it is even more important, as most tax policy experts point out, to examine the progressivity/regressivity of an entire tax system working together in order to understand the distribution of tax burden among all taxpayers. To assess the burden the tax system places on different taxpayers, the program review committee staff relied on recent work carried out by the Institute on Taxation and Economic Policy (ITEP) that assesses tax distribution and ability to pay within all 50 states and the District of Columbia. A nationally recognized research organization funded by a number of philanthropic organizations and individual donations, ITEP's stated mission is to better inform policymakers and others on government tax and spending policy issues.

The most recent research undertaken by ITEP is presented in its 2003 report on state and local tax fairness entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States***.** The analysis, which uses 2002 data, is based on a sample of the population under age 65 in each jurisdiction that is divided into five income groups or quintiles, with the top quintile further separated into 15 percent, 4 percent and top 1 percent groupings for each of the 51 jurisdictions. Results are summarized in Figure I-11, showing the amount of state and local taxes paid by the different income groups in terms of a percentage of their income. Greater burden on the lower income groups is evidence of a more regressive state tax system, and the greater the burden a state tax system places on the top income groups the more progressive the system is considered.

Overall, the 2003 ITEP study found most state and local tax systems take a much greater share of income from the middle- and low-income groups than from the wealthy. In other words their tax systems are regressive. The ITEP study indicates that only four states require their wealthier residents to pay as much of their income in taxes as middle income groups, and only eight states tax the top income groups at effective tax rates as high as those levied on the lowest income groups. ITEP study results for Connecticut are compared with those for the U.S. on average in Figure I-11.

Figure I-11. Tax Burden Among Income Groups 2002: U.S. Average and Connecticut by Quintile



Source of Data: ITEP "Who Pays," January 2003

In Figure 1-11, each of the four bars on the left for the U.S. and for Connecticut represents an income quintile -- starting on the left with the lowest 20 percent and continuing to the right – and the last three bars together comprise the top 20 percent, with each representing the top 15, 4, and 1 percent groups. The results show that overall the average of all states' (U.S) systems tends to be more regressive, with the trend in each income group paying less as income rises very apparent in the graph.

For Connecticut's system, the trend in distribution of tax burden is less clear-cut. The three bottom income groups pay a very similar percentage of their income (about 10.3 percent) and the fourth quintile pays the highest effective tax rate (10.7 percent). At that point the effective tax rates for the top income earners fall sharply; the top 1 percent group pays an effective tax rate of 6.4 percent. It should be noted these are effective tax rates before any offset for deductions of federal income tax payments. If those were included, effective tax rates for the higher income groups would be less.

The figure also illustrates the greater portion of income the property tax represents for middle-income earners in Connecticut than similar income groups nationwide. Excise and sales taxes appear to take a smaller share of taxes paid by Connecticut lower- and middle-income groups than is the case nationwide. From the chart it appears Connecticut's income tax is more progressive than either the sales or property taxes, but its impact is not enough to make the entire system a progressive one. Based on the ITEP analysis, Connecticut's system seems to be a more proportional system, exhibiting similar effective tax rates for lower- and middle-income groups, but because it clearly has lower effective tax rates for top-income individuals, the tax system clearly becomes sharply regressive.

Simple/Promotes Compliance

Good tax systems promote compliance in part by being simple to understand and implement. More complicated systems, with numerous tax types, rates, exemptions, deductions and credits, all with related paperwork and filing requirements, increase taxpayer compliance costs and provide an incentive for avoidance. Complex systems also require more state and local resources for effective administration and enforcement.

Of course, a tax system is only as straightforward as its component parts. Section 2 describes each of the major taxes in Connecticut, including how it is calculated, available exemptions and credits, and other structural aspects that contribute to making compliance simple or difficult.

Overall, Connecticut's personal income is relatively simple compared to other states. It has only two brackets, and other than basic threshold-income exemptions, very few types of income types are exempt from tax. Further, the state's personal income tax offers only two credits, for payment of income tax to other states and cities, and the property tax credit. Connecticut policymakers have resisted what other states have done in exempting a variety of income and pensions from taxable income, and offering credits to promote certain activity or compensate for certain expenses. While these strategies may appear positive in the short-term, they reduce the taxable base, make the tax more complicated, and allow certain taxpayers to benefit from the exemptions or credits, while others must pay for that benefit, or revenues are reduced.

In contrast, the state's corporate income tax is complex. The variations in who pays and how the tax is calculated, what is considered income, the apportionment formula, and what factors apply to which businesses, and the increasing number of years when businesses can claim losses from their income all make for a complicated tax. The tax literature indicates the more complicated the tax, the easier it is to find "loopholes," and avoid the tax. While declining rates through the 1990s certainly have contributed to the decline in corporate tax revenues, the complexity of the tax and the increasing number and use of business tax credits also played a role. In 2001, the last income year that state statistics are available for corporations, businesses were able to reduce their tax liability by one-third through tax credits. Indeed, two-thirds of corporate filers paid only the minimum tax of $250.

The Connecticut general sales tax is also a relatively simple tax from the direct taxpaying consumer's standpoint since it is paid at the time of purchase; paperwork is only required from the retailers. The state excise or selected sales taxes are even simpler as they are levied at the wholesale level and unlike some other jurisdictions, Connecticut has rarely authorized any type of local excise tax. Also, unlike many other states, the state general sales tax, with several very minor exceptions, is the *only* sales tax in place in Connecticut, and there is just one tax rate (6 percent). However, Connecticut has added many exemptions to the general sales tax over the years, which can impact compliance. In addition, in all states, e-commerce (internet sales) and mail order catalogue operations have made it much easier to evade state general and selected sales taxes. As Section 2 discusses, Connecticut is participating in several interstate efforts to improve compliance with both the general and certain selected sales taxes.

In Connecticut, the property tax is only levied at the local level and it is the only tax towns are authorized to impose. While municipalities conduct their own assessments of local property values and establish their own rates, some uniformity is promoted by a state statutory requirement for a uniform rate (70 percent of true and actual value percent of fair of fair market) and local revaluation at least once every five years.

The property tax is the only tax where the payer gets an a tax bill, which may make it relatively easier in that the taxpayer has no forms to complete, no return to file, or tax to calculate. However, despite its simplicity, it is probably the most grumbled-about tax; because the tax is "lumpy", the taxpayer sees the total amount all at once. Of all the taxes, the property tax has the highest collection rate, and while there are no firm statistics, indications are that the increased prevalence of property taxes being paid through escrow accounts by banks and other mortgage holders contributes to that high rate.

Fairly Administered

A good tax system must be fairly and efficiently administered, giving taxpayers confidence that its provisions are uniformly applied. Administrative fairness is related to the simplicity of the system, and also depends on the resources available for collection and enforcement. Administration of Connecticut's state tax system by the Department of Revenue Services (DRS) is discussed in more detail in Section 4, while administrative issues related to the local property tax are highlighted in the profile of that tax in Section 2.

The corporation income tax is particularly difficult to administer for a number of reasons. The tax itself, with its many steps in calculating the taxes owed, is complex. Also, Connecticut does not require uniform filing, which makes it easier for multi-state corporations to maneuver income, business activity, and credit use to states where it is most advantageous for the company's tax purposes. Because there are so many factors, and the tax is often subject to legal and accounting interpretation rather than clear statutory and regulatory standards, many corporate tax cases are subject to negotiation.

DRS staff also express frustration at what is perceived as a practice of tax minimization and avoidance that has become commonplace in the corporate tax area. For example, the use of abusive tax shelters has become an increasing area of concern in overseeing the corporation tax (as well as the income tax). While no firm statistics are available at the state level, the federal Department of Treasury and the Internal Revenue Service indicate the use of abusive tax shelters total billions of dollars in lost revenue nationally. [7]

[7] Government Accountability Office, Report on the Internal Revenue Services: Challenges Remain in Combating Abusive Tax Shelters, October 2003. According to GAO report, "Abusive tax shelters" are varied, complex and

During the 2005 session, the Connecticut General Assembly passed legislation allowing DRS to assess penalties against promoters who make false statements in connection with such transactions and against taxpayers who fail to report a "listed" transaction (i.e., one of the types the IRS has determined to be a tax avoidance transaction) on their federal return. The law becomes effective on January 1, 2006, but DRS is currently offering an amnesty period, with reduced penalties, for persons who declare before that date.

Administration of the sales tax also can pose problems, with lost revenues from internet, catalogue, and other purchases made out-of-state, as mentioned above. Interpretations of what is taxable, what is exempt, and nonpayment of the tax, especially in cash businesses like restaurants, bars, and individual trade contractors are day-to-day issues according to DRS auditors. According to audit statistics provided by DRS, the three-year average assessments of unpaid taxes was about $117 million for sales and use tax, almost one-third of the total $356 million assessed from audits of all taxes DRS administers.

As will be discussed in Section 4, since FY 00 DRS staff has been reduced and its budget has been stagnant. It is almost impossible to determine whether Connecticut's tax system is better administered or more efficiently operated than other states since few benchmarks on administration exist. The Federation of Tax Administrators -- an association made up of the principal tax collection agencies in all 50 states and D.C. whose objective is to improve the quality of tax administration -- has formed a working group to examine such workload, efficiency, and performance measures. However, the measures are still being developed, and serve as guides, not standards, and Connecticut's role in the project is minimal.

Competitive

A state must recognize that its tax system is integral to economic competitiveness. It should neither impede a state's economic growth nor put resident businesses at a disadvantage with higher rates or compliance costs than other jurisdictions.

Some believe tax policy should promote economic development although it is not always clear what policies best achieve that goal. Other experts minimize the effect taxes and "business climate" have on economic growth, suggesting instead that tax cuts and tax incentives that state and local governments offer may undermine their ability to retain businesses and create jobs. Such research highlights that state and local taxes are only a small burden on business, and that financial incentives to reduce that burden is an inefficient use of tax revenues, because the money lost in tax revenue surpasses what the firms (and the state) gain in additional income.[8]

This research also suggests that cooperation among states is better than competition, and that attention to needed public services like good transportation infrastructure, and a well-educated population, may actually aid in faster growth and more jobs. States may also need to reexamine their economic development and tax policies in light of a pending U.S. Supreme

difficult to detect and measure. They typically manipulate many parts of the tax code to a hide a transaction within a tax return.

[8] "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development", Robert G. Lynch, Economic Policy Institute, 2004, pp. 14-15.

Court ruling on the constitutionality of an Ohio business tax credit program. Last year, the U.S. Court of Appeals for the Sixth Circuit ruled in the case of *Cuno v. Daimler-Chrysler* that Ohio's tax credits for investment in new machinery and equipment violated the federal Commerce Clause. The outcome of this case has implications for tax credit laws in all states.

A number of organizations rate and rank states on their "business climate" or "competitive environment." Generally, they produce widely different rankings so it is not clear whether their results are reliable or accurate measures of a state's capacity or potential for economic growth. However, they are often cited and sometimes used as rationale for changing state tax policies. One of the most well known is published by the Tax Foundation, a private, non-profit research organization with a primary focus on taxes and the impact of tax expansion on private sector growth.

The foundation defines the most competitive states as those that raise sufficient taxes without at least one of the three major state taxes in its structure – personal income, corporate, or sales, In contrast, the states at the bottom of the foundation's ranking have multiple-rate corporate and income taxes, above average sales tax rates that exempt few business-to-business purchases, and few taxing or spending limits. In its most recent report, the Tax Foundation ranks Connecticut 37th using this criteria, neither in its top-10 most competitive nor among the 10 states ranked least competitive.

Connecticut's tax system was significantly modified throughout the 1990s to improve its business climate. As discussed in more detail in Section 2, corporate income tax rates were dropped (from 11.5 percent to 7.5 percent), certain businesses (pass-through entities like limited liability corporations) were exempted from the corporate tax, and the numbers and types of business tax credits were expanded. At one time Connecticut's corporate tax ranked high among the states in terms of corporate burden, but it now compares well with other states. In 2003, Connecticut ranked 25th in terms of the corporate income tax as a percent of gross state product. Further, between 1998 and 2003, Connecticut corporate tax revenues as a percent of gross state product dropped 77 percent, the second greatest decline in the nation.

The importance of business taxes and credit use in creating an advantageous economic climate is subject to debate. Tax burden is only one factor in affecting the economic climate in a state and its importance in business location decisions is also the subject of considerable research and discussion. While lowering tax rates and expanding business credits have reduced corporate tax revenue and business tax liability, it is unclear whether these measures have increased the state's economic competitiveness.

The state's personal income has grown since the early 1990s, and Connecticut remains the state with the highest per capita income in the country. However, the increase in personal income over the period 1993-2003 is less than the rise in U.S. personal income, and Connecticut's job growth lags behind almost all other states in the creation of jobs as the Federal Deposit Insurance Corporation reported in June of this year. Further, Connecticut ranks behind 33 other states in the growth of its gross state product from 1999 to 2003.

When Connecticut introduced the personal income tax, there were predictions it would make the state less competitive as wealthy individuals, such as business owners and highly paid employees of local companies, might leave or decide not to locate in the state. These negative pronouncements did not materialize – while Connecticut's overall population has increased only slightly (3.6 percent) from the 1990 to 2000 census -- it has not appeared to prompt wealthier individuals to relocate.

As outlined in the Section 2 personal income tax profile, using 2002 IRS data, the average federal AGI income for all filers in Connecticut is $64,724 – 40 percent higher than the U.S. average ($45,974), and 9 percent higher than the second highest state, New Jersey ($59,159). Further, Connecticut's income tax rate structure, highlighted in Table 1-5 below, appears competitive with neighboring states and may even be attractive to high-income earners whose employment might limit their residence choice to one of the states in the tri-state area.

Table I-5 Comparison of Upper-Income Tax Rates for Joint Filers in New York, New Jersey, and Connecticut

State	Rate	Taxable Income level
New York	7.25% 7.7%	$150,001 -$500,000 over $500,000
New Jersey	6.37% 8.97%	$150,001 -$500,000 over $500,000
Connecticut	5%	Over $20,000

Neutral

Another aspect of a good state tax system is that it be neutral, and that tax policy not be used to influence market decisions or economic behavior. Mainly states use revenue systems to influence budgets through tax deductions, exemptions and credits, and through earmarking or dedicating funds for specific activities. These types of policy strategies shift tax burden from a set of taxpayers selected for favorable treatment to others who pay to make up the lost revenue. Selected sales taxes like the excise taxes on alcohol and tobacco are not neutral intentionally; they are aimed at certain taxpayer groups or activities, and many are designed to influence behavior.

As discussed earlier in this section, policymakers have resisted, for the most part, using the personal income tax for selected exemptions, credits and the like, and generally filers at certain income levels will be paying the same amount of Connecticut state income tax. The same cannot be said of the corporate income tax. As Section 2 points out, the corporate income tax has been altered many times -- through exemptions and credits and the apportionment formula -- to benefit certain types of businesses.

Connecticut's tax system has also for the most part avoided the practice of earmarking funds. The state's Special Transportation Fund, funded with motor vehicle related taxes and fees, as a major exception. Unlike some other states, especially those that have strict tax and expenditure limitations in place, Connecticut has not turned to raising very specific types of revenues and designating them for special services or capital projects.

Accountable

A high quality revenue system is accountable, with tax policies that are open and transparent. It should be clear and explicit to taxpayers how all revenues are raised. Taxpayers should be notified of impending changes, and proposed changes should be well publicized so they can be debated before being enacted.

The local property tax has always been considered the most accountable to taxpayers since the taxpayer sees the bill and is often keenly aware of what local services it pays for. Further, as the property tax discussion in Section 2 points out, many towns are not allowed to pass a budget without approval through a town meeting or referendum and often, local budgets take more than one vote to be approved. While these measures may procedurally hold up budget adoption, town officials are held accountable to local voters for their fiscal decisions, including making difficult spending cuts if necessary.

At the state level, a major feature of accountability in Connecticut's tax system was built in with the 1991 income tax and budget reform legislation. Since that time, a spending cap limits the annual growth in budget expenditures to the greater of: 1) the five-year average growth in personal income; or 2) the 12-month rate of inflation as measured by the consumer price index. During the period of economic growth in the late 1990s, the spending cap was instrumental in curbing new spending and adding surplus revenues to the state's Budget Reserve ("rainy day") Fund. This type of accountability helps save taxpayers from facing increased taxes when the state faces bad economic times.

Accountability for state tax policies is also provided through the statutorily mandated tax expenditure report. The legislature's Office of Fiscal Analysis is required to produce a report every two years listing state tax credits and exemptions and the amount of lost revenue each represents. The report also shows the number of persons or businesses that benefit from each of these tax expenditures.

Some experts argue that this type of report does not go far enough. First, the tax expenditure report does not receive the same scrutiny or level of discussion in the legislature as the budget does, even though the total state tax expenditures amount to billions of dollars in forgone revenue. Second, those who benefit from tax expenditures, especially those involving business tax credits, are anonymous, identified only by total numbers of filers. Those who call for improved transparency suggest that businesses that claim these credits should be identified, and required to annually advocate for their continued use. Even absent that level of accountability, the legislature has not analyzed or evaluated the use of corporate tax credits to ensure they are proving successful and are worth continuing.

Two actions taken during the 2005 legislative session should improve the transparency of state businesses taxes and generally strengthen accountability for the tax system. Public Act 05-215, the budget implementation bill, created a new group, the Business Tax Credit and Tax Policy Review Committee, to oversee business tax expenditures. The committee comprises 14 members including: the chairs and ranking members of the Finance, Revenue and Bonding Committee, one member appointed by the governor and one by each of the legislative leaders, and the commissioners of revenue services, economic development, and labor or their designees. The committee is charged with studying and evaluating existing credits and their benefits, and is authorized to request certain information from DRS on the particular business taking the credit, although not identification by name and/or address.

Another act, P.A. 05-262 requires the legislature's two fiscal committees to meet annually in November to consult and receive information on the state's fiscal condition and outlook including: estimates of revenue; spending and ending balances by fund for the current biennium and for the three years after; the tax credits projected for the same period; estimated deficiencies, and projected budget reserve balances; and bond authorizations and issuances and their effect on debt service. The increased information made available through this act and the tax policy committee should strengthen planning, evaluation, oversight capabilities of the finance committee and the legislature as whole.

Summary

The main findings from the program review staff assessment of all the tax system principles are summarized in Table I-6. The points contained in the table raise questions for further examination and highlight potential issues.

Table I-6. Preliminary Staff Findings Regarding Connecticut's Tax System	
Criteria/Definition	**Summary of Preliminary Staff Findings**
Complementary	
Objectives of tax system should be consistent and system must recognize limitations and responsibilities of local government	• No significant overlap in state and municipal tax bases • Local government revenue-raising authority limited to property tax but no constraints on levels of taxing or spending • No formal recognition of total cost of state mandates • State does not fully fund grants to municipalities, notably education and Payment in Lieu of Taxes (PILOT) reimbursement
Reliable	
Revenues should be stable, certain, and sufficient	• State tax system's revenues are more volatile than the economy as a whole, subject to more dramatic highs and lows, but the property tax adds a measure of stability • Connecticut's tax system is more volatile than the U.S. average • Corporate income tax and excise taxes have been the most prone to legislative changes • Total tax system revenues have matched or exceeded growth in the economy and inflation • State tax revenues have in most, but not all, years matched expenditures
Balanced	
The major taxes (personal income, sales, and property) should be contributing a nearly equal proportion to total revenues	• Connecticut levies all the major taxes, but the system is most reliant on the personal income and the property tax • Connecticut's revenue system is more reliant on the property tax than 42 other states – three of the states that are more reliant do not impose an income tax • Connecticut's reliance on the sales and corporate tax has declined considerably during the 1990s
Equitable	
Overall tax system should minimize regressivity	• State and local taxes as a percent of personal income have declined from the mid-1990s • The income tax is mildly progressive but it does not offset the regressivity of the state's sales, excise, and local property tax • Lower- and middle-income residents pay more in taxes as a percent of income than high income earners
Promotes Compliance	
System should be easy to understand and minimize compliance costs	• The personal income tax contains two brackets and very few exemptions and credits compared with other states • Except for a few narrow state excise taxes, the state sales tax is the only general sales tax, and only one rate is applied • The property tax has many exemptions, but taxpayers are most familiar with the amount, frequency, and purpose of this tax • The corporate income tax is complex and prone to avoidance • Higher than average excise taxes increase vulnerability to evasion

Table I-6. Preliminary Staff Findings Regarding Connecticut's Tax System	
Criteria/Definition	**Summary of Preliminary Staff Findings**
Fairly Administered	
System should be relatively easy to implement and uniformly applied	• According to DRS, the corporate income tax is difficult to administer and prone to avoidance • The sales tax can be avoided through internet sales, cash transactions; the tax's many exemptions create confusion. • It is nearly impossible to tell if Connecticut's tax system is efficiently or effectively administered compared to other states • Property tax administration is fairly straightforward, though the timing of assessments may affect uniformity and fairness
Economically Competitive	
Tax burden should not be very different from other states	• Taxes on business have been reduced significantly and are not considered more burdensome compared to other states • Personal income tax rate structure is lower than neighboring states
Neutral	
System should not influence economic decisions (spending or investment)	• The personal income tax has few exemptions or credits • The corporate income tax has been changed many times and contains many exemptions and credits for certain businesses • The sales tax contains many exemptions and tax holidays intended to influence behavior • The only major earmarking occurs with the Special Transportation Fund, which is mainly supported by a tax on gasoline • Excise taxes are designed to influence behavior, but are a relatively small part of the tax system
Accountable	
System should be explicit in how revenues are raised, and changes should be well publicized, and costs and benefits of tax policy should be examined.	• Recipients of corporate income tax credits and exemptions are not publicly known, nor are the credits evaluated to see if they are having the intended effect • Passage of the property tax requires a public meeting and possibly a referendum to pass • Little opportunity within state government to assess or monitor efficiency or effectiveness of current system or evaluate impact of proposed changes • State spending cap provides some measure of fiscal discipline and public disclosure

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Section 2

Profile of Connecticut's Major Component Taxes

Connecticut relies on six major taxes to support its public services at the state and local level. While revenues from gaming and those raised from fees are an important source of financing services, they are not considered taxes and are not part of the scope of study. The six major taxes profiled in this section are the:

- general sales and use tax;
- excise taxes – motor fuel, alcohol, and tobacco;
- personal income tax;
- local property tax;
- corporate income tax; and
- estate and gift taxes.

Each of these taxes has been introduced at different periods in the state's history, and each has gone through major changes -- in terms of its construction, the rates and base, and the revenues raised -- since first being implemented. This section profiles each of the component taxes by: identifying when the tax was first initiated and any major changes or modifications to the tax; describing who pays the tax, how it is calculated, what the rate is, and what the tax applies to; who or what is exempt from the tax; how the tax is collected; revenue trends; and a comparison of the major features of each component tax with those in other states.

Profile of the Sales and Use Tax

Background

During the Great Depression, income generated from the states' primary source of revenue, the property tax, fell by 40 percent. The *sales tax* was developed at this time to provide the states with an alternative revenue source. Between 1932 and 1938, 29 states implemented the tax (although five allowed it to expire after a year or two). Later, the post-World War II economic climate again negatively affected state revenues and created a strong demand for public services. In response to continually increasing demands on state revenue, another 16 states implemented a sales tax. There are currently 45 states with a sales tax in place.

The *use tax* was developed in 1937 to supplement the sales tax by capturing some of the revenue lost from out-of-state purchases. The use tax is meant to help in-state merchants remain competitive with merchants located in lower-tax jurisdictions or those not required to collect a sales tax. The state of Connecticut adopted the sales and use tax in 1947.

Taxable Items

The sales tax is imposed on tangible personal property,[9] which can be broken down into three main categories:

- consumer goods or household purchases;
- business purchases; and
- services.

The *use tax* is applied to the same goods when they are purchased outside of the state and are then brought into Connecticut for use. Like other states, Connecticut exempts certain items from it sales tax to make the tax less regressive. Currently, there are over 115 exemptions. Examples of taxable items and exemptions are detailed in Appendix A.

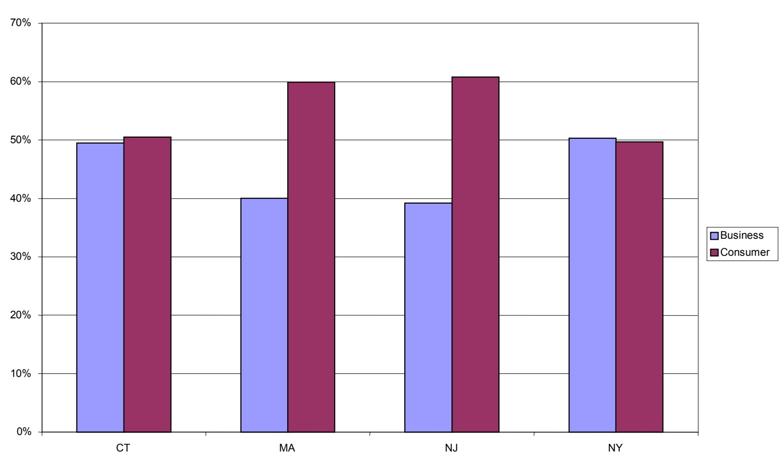
Payment

In Connecticut, as elsewhere, both individual consumers and businesses pay sales and use taxes. In FY 03, consumers paid 51 percent and businesses paid 49 percent of the state's total revenue from the sales tax.

These figures, issued in a report by the Council on State Taxation (COST),[10] are based on estimates using the Ernst & Young 50-state sales tax model -- which computes state-specific, industry-specific flows of business inputs and investment purchases and compares those to estimates of household purchases by category of spending -- to develop a separate sales tax matrix for each state. The matrix incorporates state sales tax laws and is applied to levels of transactions to produce estimates of total sales and use taxes on business inputs, business investment purchases, and consumer expenditures.

Using these estimates, Figure II-1 compares the distribution of the sales tax burden between businesses and consumers in Connecticut with neighboring states. The comparison shows that businesses and consumers pay about an equal share of the sales tax in Connecticut and New York, while consumers pay a greater share in

Figure II-1: Business vs. Consumer Share



Source: (January 2005) COST, Sales Taxation of Business Inputs, p.5

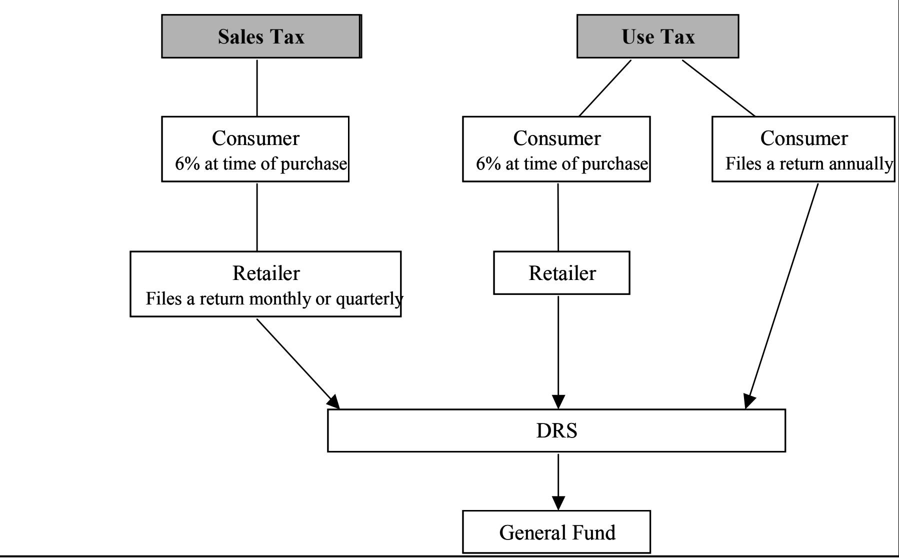
[9] Tangible personal property is property which may be seen, weighed, measured, felt or touched or which is in any other manner perceptible to the senses including canned or prewritten computer software and the distribution, generation or transmission of electricity. (CGS § 12-407(13))
[10] Council on State Taxation, *Sales Taxation of Business Inputs: Existing Distortions and the Consequences of Extending the Sales Tax to Business Services* (January 2005), p.5.

Massachusetts and New Jersey. This indicates that more business inputs and investments are subject to the sales tax in Connecticut and New York than in surrounding states.

Tax Collection

Consumer. Figure II-2 illustrates the process by which sales and use tax revenues are collected. Consumers pay the sales tax to the retailer or vendor at the time of the purchase or transfer of goods or services.

Figure II – 2: Sales & Use Tax Collection



Retailers and vendors. Retailers or vendors must file a Sales and Use Tax Return (form OS-114) with the commissioner of revenue services monthly (on or before the last day of the month). If their total tax liability for a year is less than $4,000, retailers must remit the tax quarterly (CGS § 12-414). In cases where the use tax is not paid upon the exchange, the consumer must file a return once during the calendar year. The use tax is declared either on the Connecticut Income Tax forms CT-1040 and CT-1040EZ or separately on the Connecticut Individual Use Tax Return (form OP-186).

The state of Connecticut requires all vendors engaging in sales transactions or with a physical presence within the state to obtain a permit from the Department of Revenue Services. The permit fee is $50. Permits issued on or after July 1, 1985 but prior to October 1, 2003 expire biennially on the anniversary date of issuance, while permits issued on or after October 1, 2003, expire on the fifth anniversary date of the issuance of the permit. In FY 03, there were 172,830 permitted sales tax vendors (of which 25,290 vendors filed monthly, 63,015 filed quarterly, and 84,525 filed annually).

Direct payment permits. The Department of Revenue Services also offers anyone who makes a high volume of taxable purchases the opportunity to apply for a direct payment permit for a $20 fee. This type of permit can reduce the cost and time of administering the tax for both the business and for DRS. The permit functions like the direct deposit option offered by most employers. DRS and the permittee establish an effective sales and use tax rate and a forecast of volume to establish an agreed-upon base for which the permittee will pay taxes. DRS staff regularly audit these permittees and perform audit tests that would demonstrate any changes to the base over time that might affect the amount of tax they must report.

Calculation

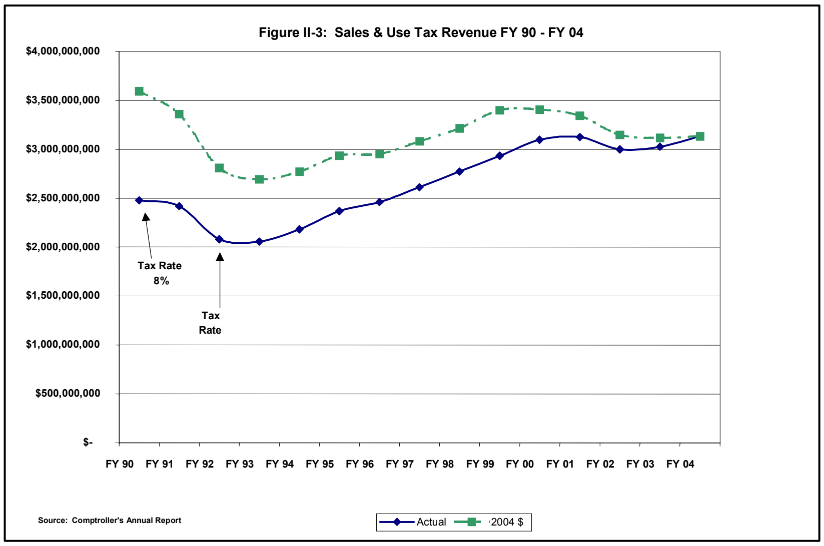
With three exceptions, Connecticut has one statewide sales and use tax rate of 6 percent on gross receipts of retailers from sales, rental or leasing, and on certain business services. Unlike many other states, there are no additional local sales and use taxes in Connecticut.

The exceptions to the six percent rate are:

- 4.5 percent on the sale of a motor vehicle to a nonresident member of the U.S. military serving on active duty in Connecticut or his/her spouse;
- 1 percent on computer data processing services; and
- 12 percent on lodging (e.g., hotel rooms).

Revenue

In FY 03, Connecticut's sales and use tax brought in \$3.03 billion in revenue, or 19.2 percent of the total state and local tax revenues. In FY 04, the amount increased 3.6 percent to \$3.13 billion. Figure II-3 illustrates the trends in sales and use tax revenue in actual dollars and in inflation-adjusted dollars from FY 90 to FY 04.



Connecticut experienced a sharp decrease in sales and use tax revenue between FY 90 and FY 92. The drop likely occurred for three reasons: 1) the sales tax rate was reduced 25 percent -- from 8 to 6 percent; 2) the personal income tax was introduced, leaving taxpayers with less disposable income for purchases; and 3) the state was still in the economic recession of the early 1990s. Revenues steadily increased between FY 93 and FY 01, before slumping in FY 02 and FY 03, and then recovered in FY 04. However, over the long term, FY 90-FY 04, sales tax revenues have declined in real terms due to inflation as the figure shows. If sales and use tax revenues were measured in 2004 dollars, there is a decline of about \$400 million from FY 90. The decline in revenue is likely the result of an increasing number of exemptions, a shift away from consumption of taxable tangible goods toward tax-exempt services, and the increased consumer preference for purchasing goods online.

The bulk of the revenue from the sales and use tax is deposited into the General Fund. However, since 1998, a portion of the sales tax collected by the Department of Motor Vehicles on motor vehicle sales between individuals (not dealers) is transferred from the General Fund to the Transportation Fund in the following dollar amounts:

- $10 million in FY 00;
- $20 million in FY 01;
- $30 million in FY 02; and
- $40 million in FY 03 and thereafter.

Figure II-4: Sales and Use Tax: Growth Rates in Collections

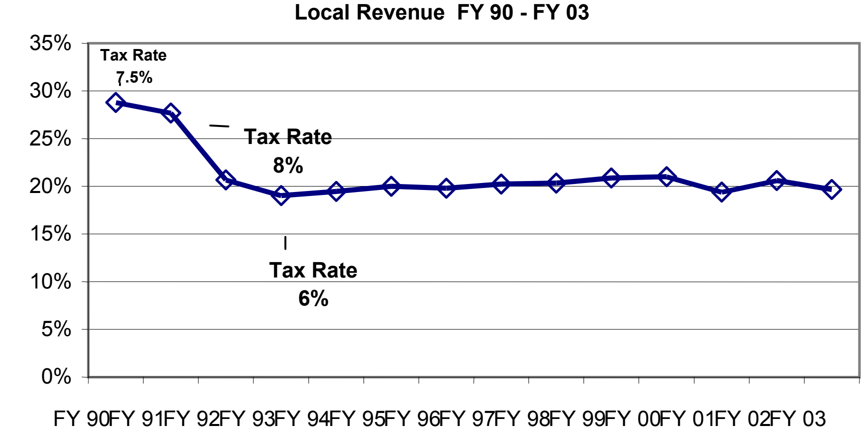
Source: OFA

Figure II-4 illustrates the actual percent change in sales and use tax revenue from year to year since FY 89. (For FY 00 – FY 04, the changes in gross collections are before transfers to the transportation fund.) The figure also shows the percent changes reflecting adjustments for the impact of legislative modifications to the rate and base, such as adding or eliminating exemptions.

Trends in Revenue and Rates

The revenue collected from the sales and use tax makes up about 20 percent of total state and local revenue. (See Figure II-5). The percentage the sales tax contributes to overall revenues has been decreasing over time-- in FY 89, the ratio was almost 30 percent; by FY 03, it had fallen to slightly less than 20 percent.

Figure II-5: Sales & Use Tax Revenue as a Percent of Total State & Local Revenue FY 90 - FY 03

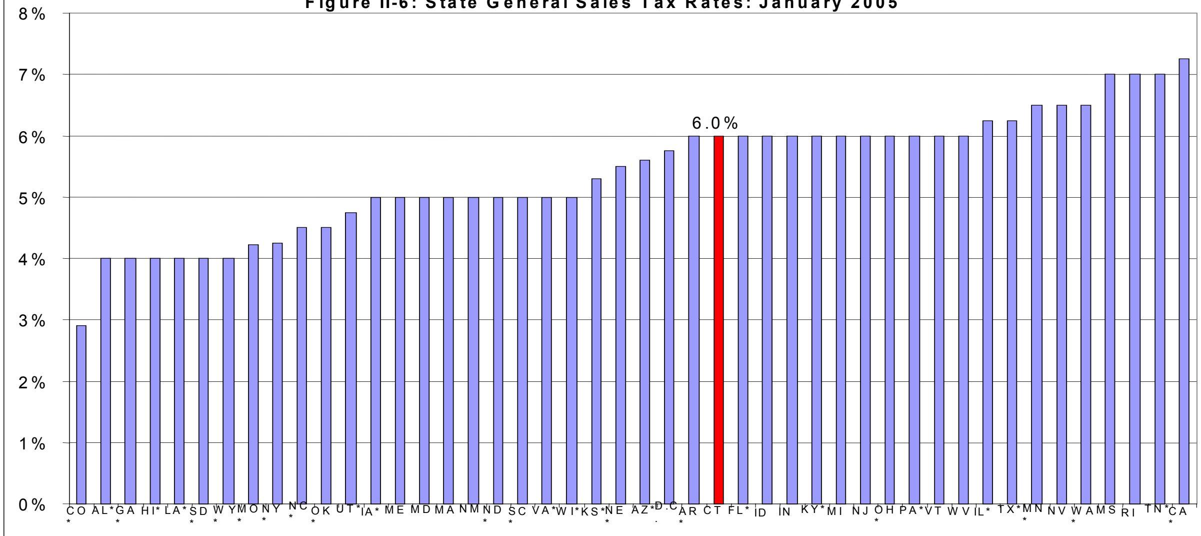


Source: Comptroller's Annual Report

Of course, the personal income tax, introduced in 1991, has resulted in a major shift in the portion of each component tax out of the overall tax collected, as discussed in Section 1.

The sales and use tax rate is currently 6 percent. The rate was initially set at 3 percent when the taxes were implemented in 1947. It peaked at 8 percent in 1990 and was then adjusted to 6 percent in 1992, after the implementation of the state income tax.

Figure II-6: State General Sales Tax Rates: January 2005



Source: Federation of Tax Administrators.

*Indicates the presence of local rates within the state that are excluded from the statewide rate presented in the figure.

Connecticut Compared to Other States

Rates. A total of 45 states have implemented a sales tax. (Alaska, Delaware, Montana, New Hampshire, and Oregon do not levy a sales tax.) Figure II-6 presents the current statewide sales tax rates across the country. Connecticut is one of 12 states that impose a 6 percent rate. Thirty-one states also permit local sales taxes; of those, 21 states have a lower statewide sales tax rate than Connecticut. However, the total sales tax rate in those states may not be less, because the figure does not present the local sales tax rates.

Base. Some states including New Mexico, Iowa, Hawaii, and South Dakota tax a broad number of goods and services, with few exemptions. For example, Hawaii and New Mexico tax nearly all services (of which there are over 150) allowing the states to set a lower sales tax rate. These states have what economists consider a broad base.

Revenue. Table II-1 demonstrates where Connecticut ranks among states that collect a sales tax. The rankings are based on sales tax revenues as a percent of "state and local" or "state only" collections. The first column shows that Connecticut -- collecting only 20 percent of its total revenue from sales tax -- ranks 35 out of the 46 states (and the District of Columbia) that collect sales tax.[11] The second column shows that Connecticut (at 30.4 percent of state-only taxes) ranks 30th out of the 45 states that collect sales tax.

Table II-1: State Rankings Based on Sales Tax Collections					
2002 State & Local Collections			2004 State-Only Collections		
Percent of Total Revenue		Rank	Percent of State Revenue		Rank
Top Five States			Top Five States		
Washington	47.3%	1	Tennessee	61.3%	1
Tennessee	45%	2	Washington	60.6%	2
Arizona	40.1%	3	Florida	56.4%	3
Louisiana	39.7%	4	South Dakota	55.2%	4
Arkansas	39.3%	5	Texas	50.3%	5
U.S.	24.6%		U.S.	33.4%	
Bottom Five States			Bottom Five States		
Connecticut	20.1%	35	Connecticut	30.4%	30
Virginia	16.2%	42	Maryland	23.9%	41
Massachusetts	15.5%	43	Massachusetts	22.4%	42
Maryland	13.5%	44	New York	21.9%	43
Vermont	10.9%	45	Virginia	20.9%	44
Alaska	5.9%	46	Vermont	14.5%	45
Source: Federation of Tax Administrators					

Major Exemptions. Below is a breakdown of the number of states (including Connecticut) exempting these main categories from their state sales tax.

- **Food:** 28 states (Illinois, Missouri, and Tennessee tax food at a reduced rate while Kansas allows for the disabled, elderly and low-income households to receive a refund)
- **Prescription Drugs:** 44 states (Illinois taxes them at a reduced rate)
- **Motor Fuels:** 31 states (Georgia taxes this at a reduced rate)
- **Services:** 25 states (Connecticut taxes certain services, including services to businesses)
- **Clothes:** 7 states (Connecticut exempts clothes up to $50 per item, Massachusetts exempts clothes up to $175 per item, and Vermont exempts clothes up to $110 per item)
- **Sales Tax Holidays:** 12 states have them; they range in duration from two to nine days.
- **Cigarettes:** all 45 states tax cigarettes (Connecticut applies a separate excise tax to this product in place of the sales and use tax)
- **Computer Software (Canned):** 43 states

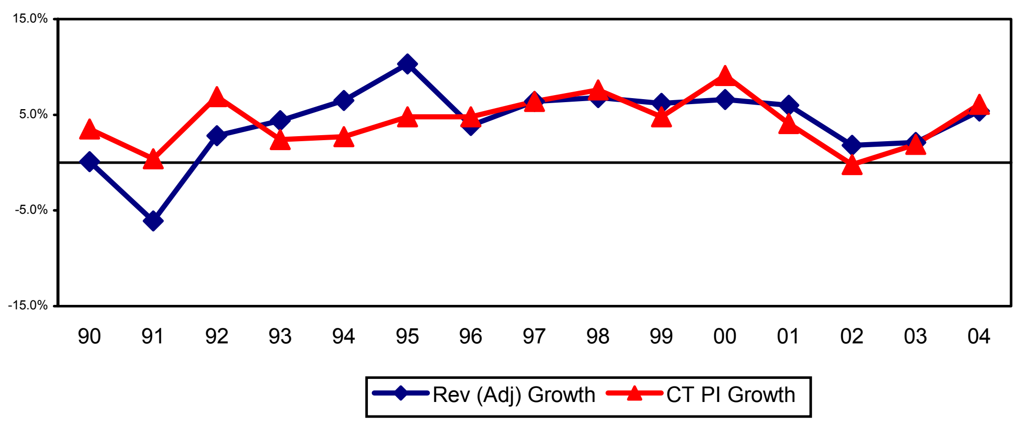
[11] Alaska does not levy a state sales tax. However, a sales tax is collected by several municipalities.

- **Computer Software (Custom):** 31 states (Louisiana established that for FY 04 50 percent would be subject to tax, in FY 05 25 percent, and from FY 06 and on into the future it would be exempt)

Preliminary Assessment: NCSL Principles

Adequacy. Figure II-7 illustrates how the sales and use tax has generally mirrored the economy by comparing the sales and use tax revenue to the state's personal income growth over time and adjusting for legislative changes. It shows a deep drop in the early 1990s followed by a significant increase from FY 93 to FY 95. Some of the increase may be explained by pent-up consumer demand after coming out of the economic recession of the early 1990s.

Figure II-7. Annual Percent Change in Adjusted Sales & Use Tax Revenues and Connecticut Personal Income (current dollars)



Sources of Data: U.S. BEA and OFA

Over the long term, however, Connecticut's sales and use tax revenues have not kept pace with growth in the economy (personal income). From FY 90 to FY 04, the cumulative growth in the state's personal income was 61.8 percent, while the sales and use revenue in actual terms (without legislative adjustments) grew by 42.4 percent, and inflation was 43.7 percent. The substantial lag in sales and use tax revenue growth behind personal income in that recent 15-year period is reflecting what appears to be happening nationwide.

According to the National Conference of State Legislatures (NCSL), the amount of personal income spent on taxable goods has decreased nationwide. In 1945, consumption of goods comprised 67 percent of personal income and consumption of services was approximately 33 percent. In 1983, goods and services were equal at 50 percent of personal income. By 2002, the shift in consumer behavior became evident as 41 percent of personal income was spent on goods and almost 60 percent on services. Losses from internet purchases alone (not including interstate catalog sales) for state and local government were estimated at $13.3 billion for 2001 and predicted to increase to $44.2 billion by 2005.

Reliability/Volatility. In Connecticut, the revenue stream provided by the sales and use tax is fairly steady, contributing roughly 20 percent of total state and local revenue. Program review staff measured the sales tax volatility over the long-term and for the more recent FY 93 – FY 04 (post-income tax) period. Adjusting for legislative modifications, the year-to-year long-term average annual growth rate in sales tax revenues from FY 75 to FY 04 was 7.0 percent, and the standard deviation (the average difference around the trend rate) was 5.1 -- meaning that the sales and use tax is only somewhat volatile. For the post-income tax period, the average annual change was 5.5 percent, and the standard deviation was only 2.3. Thus, while the sales tax has had a somewhat lower average annual growth rate in recent years, it has become less volatile and more predictable.

Equitable. The sales and use tax is highly regressive, meaning low-income individuals typically spend a larger share of their income on sales tax than individuals with higher incomes. To combat the regressivity, Connecticut exempts many items considered necessities including: food, health care services and medicine, utilities used in residences, and clothing and footwear under $50. In addition, during "tax free" week, all apparel under $300 an item is not taxed. As a result of these efforts, Connecticut's sales and use tax appears less regressive than other states.

Using the ITEP data on tax burden discussed in Section 1, Figure I-11 shows that sales and use taxes take considerably less from Connecticut's lower- and middle-income groups than is the case nationally. (The ITEP data includes excise tax burden as well.) For example, the lowest quintile in Connecticut pays 6.3 percent of its income in sales and use taxes; the same group nationwide pays 7.8 percent. The middle quintile in Connecticut spends 3.7 percent, while that group nationwide spends 5.1 percent on sales and use and excise taxes.

Promotes Compliance. For consumers the tax is fairly simple, since they pay the tax on the items at the time of purchase. The forms, filing process, and availability of taxpayer support services to both consumers and vendors help to promote compliance. However, the number of exemptions and exclusions, lack of specificity in statutory language, and short time period between enacted legislative changes and implementation dates can complicate the tax for consumers, businesses, retailers, and DRS tax administration and auditing staff.

Economic Competitiveness. Connecticut imposes a slightly higher sales tax rate than some of its neighbors and it makes fewer exemptions for businesses. Table II-2 provides comparison data on the number of services by category that is taxed by Connecticut and its neighboring states. Of particular note is the high number of taxable services in Connecticut compared to neighboring states like Rhode Island and Massachusetts.

Table II-2: Number of Taxed Services by Category in Connecticut and Selected States									
State	**Utilities**	**Personal Services**	**Business Services**	**Computer Services**	**Admissions/ Amusements**	**Professional Services**	**Fabrication, Repair & Installation**	**Other**	**Total**
CT	10	9	20	6	10	0	11	14	80
DE	9	20	33	6	10	9	19	37	143
MA	9	1	4	0	1	0	2	2	19
NH	6	1	0	2	0	0	0	2	11
NY	4	4	13	1	5	0	14	15	56
RI	10	1	6	3	4	0	3	2	29
Source: FTA, Tax Administrators News, 2004 Survey on State Taxation of Services, (May 2005).									

There are differing views on who should pay the sales tax, and whether who actually pays affects economic competition or not. One opinion is that the tax should only apply to "final consumption" by consumers and not apply to business inputs. "Final consumption" means the "final sale in the production and distribution of goods and services." Opponents of sales taxes for business argue that imposing a sales tax on business inputs causes "pyramiding" or "cascading" meaning the tax is applied to each item used in the production and distribution of a good, which increases the cost of conducting business. In response, businesses either decide to pass the additional cost on to the consumer by raising prices or decide to move the business or its activities out of the state. Proponents of sales taxes for business do so because they favor broadening the sales tax base by removing existing exemptions and lowering the tax rate. Four states broadly tax goods and services for both businesses and individuals: New Mexico, Iowa, Hawaii, and South Dakota.

Simplicity. Unlike the 31 states that permit sales taxes at county or town levels, Connecticut levies only a state-level sales tax and (for the most part) at a single rate. The single tax helps ensure that all consumers know what the sales tax is, and the rate. Again, what detracts from the simplicity is the number of exemptions, and whether an item is taxable or not.

At present there is a national movement toward simplifying the design of state sales taxes even further under the Streamlined Sales Tax Project. The goal of the project is to demonstrate uniformity among the various states' sales taxes to Congress to achieve legislation that permits the states to collect sales tax on interstate commerce such as internet, catalog purchases, and lessen the complications associated with doing business in multiple states. It requires using standardized definitions for terms (e.g. clothing, food, computer software, etc.) and eliminating thresholds (taxing items at different rates) as Connecticut does for clothing. Of the 45 states that levy a sales tax, 40 are involved in the project at various levels. Per executive order from then-Governor John Rowland, Connecticut became involved in the project as a "participating state" meaning Connecticut is involved in the project but has not implemented the required statutory changes. The categories of more active participation are:

- Full Member States – fully in compliance (IN, IA, KS, KY, MI, NE, NC, OK, SD, WV, MN)
- Associate Member States – generally in compliance but have a delayed effective date (NJ, ND, UT, TN, OH, AR, WY)
- States that Enacted Compliance Legislation – not yet certified or fully compliant (NV and VT)

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Profile of Excise Taxes

Background

Excises taxes, which are also known as selected sales taxes, are levies applied to specific consumer items, often in addition to a state's general sales and use tax. In comparison to income and general sales taxes, selective sales taxes are not a major revenue source for most states. Table II-3 shows all selected sales tax collections nationwide averaged about 16 percent of total state tax revenues in 2004. It is important to note these revenue figures, which are the best available comparative data for selected sales taxes only reflect state level tax collections and do not include any local taxes.

State reliance on selected sales tax revenues ranged from a high of almost 34 percent in New Hampshire, a state with neither a statewide general sales tax or a personal income tax, to a low of 7.4 percent in Wyoming. Connecticut, at 17.2 percent, is similar to the national average in its reliance on all selected sales tax revenues and ranked 21st among all states in such tax collections in 2004.

Table II-3. State Reliance on All Selective Sales Taxes: 2004

Rank	State	Percent of Total State Tax Collections
1	New Hampshire	33.6
2	Nevada	32.9
3	Texas	29.8
4	West Virginia	28.6
5	Montana	26.9
21	**Connecticut**	**17.2**
46	Oklahoma	11.6
47	Georgia	10.6
48	Massachusetts	10.3
49	California	8.7
50	Wyoming	7.4
	U.S. Total	**16.1**

Source of Data: FTA

States impose many different types of selected sales taxes but the most common ones are excise taxes on alcoholic beverages (liquor, beer, and wine), tobacco products (cigarettes, cigars, snuff, and pipe and chewing tobacco), and motor fuels (gasoline, diesel, and other motor vehicle fuels). These three types of excise taxes are in place in some form in all states including Connecticut. Nationally, alcohol, tobacco, and motor fuel excise taxes, which account for about half of the revenues generated by all state selected sales taxes, making up about 8.5 percent of the total state tax collections.

The key features of Connecticut's alcoholic beverage tax, cigarette and tobacco products tax, and motor fuels taxes are summarized below. A summary of the committee staff's preliminary assessment of the three state excise taxes in terms of NCSL principles is also provided.

Calculation and Payment

Like nearly all excise taxes, Connecticut alcohol, cigarette, and motor fuels excise taxes are calculated on a per unit basis; liquor, wine, and beer as well as gasoline and other motor vehicles fuels are taxed per gallon while cigarettes are taxed per pack. In contrast, nearly all tobacco products other than cigarettes are taxed as a percentage of wholesale price. With the exception of the motor fuel tax program that applies to interstate motor carriers (which is handled through quarterly returns filed by vehicle owners), all three types of excise taxes are paid monthly at the wholesaler/distributor level and included in the product purchase price.

Revenues Produced

The state's three major excise taxes are very small revenue components of the total state and local tax system. In FY 03, collections from the alcohol, tobacco and motor fuels taxes together accounted for less than 5 percent of total state and local tax revenues. The three taxes are more significant within the state budget, producing $788 million in revenues in FY 04. This represented 7.6 percent of that year's total state level tax collections. The portion of tax revenues contributed to the state budget by these three selected sales taxes however, has dropped from and has remained well under l0 percent following enactment of the Connecticut's personal income tax in 1991.

Of the three, the motor fuels tax consistently contributes the largest amount of revenue, providing nearly 60 to over 75 percent of total excise tax collections each year. In FY 04:

- revenues from the state's alcoholic beverage tax totaled about $44 million, or less than one percent of all state level tax revenues;
- the state's cigarette and tobacco product taxes raised almost $280 million, which represents less than 3 percent of total state level tax revenues for that year; and
- the state's motor fuel taxes produced nearly $465 million, which represents 4.5 percent of total state level tax revenues for that year. While relatively small in terms of dollars collected, Connecticut motor fuel taxes are the state's fourth largest single tax revenue source.

Major Changes

Increases in the state cigarette tax rate have been frequent over the past 15 years and usually were made in response to a fiscal crisis. Most recently, the cigarette tax was more than doubled through two substantial per pack rate hikes enacted in 2002 and 2003 to help address state budget shortfalls. In contrast, tax rates on liquor, wine, and beer have been in place since the 1970s, were raised significantly in 1984 and 1989, but have not changed since. Motor fuel tax rates were raised five cents in one-cent increments during the mid-1990s. A series of rate cuts put into effect between 1998 and 2001 subsequently reduced the motor fuel tax from $0.39 to $0.25 per gallon, the current rate.

Other State Comparison

Alcoholic Beverage Tax

- Connecticut is one of 32 "license" states that regulate private wholesale and retail sellers of liquor, wine, and beer (alcoholic beverages) and impose excises taxes on distributors of these products. (The other 18 states operate monopoly systems and control and tax alcohol sales through government agencies and stores.)

- Connecticut's excise tax on liquor ($4.50 per gallon) is among the higher rates in the country, while its wine and beer rates ($0.60 per gallon and $0.19 per gallon, respectively) are close to the national median rates.

- Within the Northeast region (New England plus New York and New Jersey), Connecticut's liquor tax is 2nd highest, its beer tax is the 3rd highest, and its wine tax is about in the middle (the same or lower than four states and higher than three).

Cigarette and Tobacco Products Taxes

- Like all other states, Connecticut imposes an excise tax on cigarettes as well as other tobacco products such as cigars, snuff, and pipe and chewing tobacco.

- As of January 2005, Connecticut's cigarette tax of $1.51 per pack was, with Massachusetts's, the sixth highest in the U.S. and significantly higher than the national median of $0.70. Many believe this high rate makes the state's tobacco tax revenues vulnerable to erosion from smuggling and Internet sales.

- Within the Northeast region, Connecticut's cigarette tax rate is higher than four of the seven other states; its tax on other tobacco products is among the lowest.

Motor Fuels Taxes

- Connecticut, like all other states, imposes an excise tax on motor fuels through two similar but separate programs: a motor fuels tax, a per gallon levy included in the price paid at the pump; and a motor carrier road tax that applies, at the same per gallon rate, to certain vehicles generally engaged in interstate commerce and is based on their reported mileage and fuel purchases.

- As of January 2005, Connecticut's per gallon gasoline tax rate of $0.25 was the 10th highest in the country.

- Connecticut has the fourth highest gasoline tax and third highest diesel and gasohol taxes in the Northeast region.

Preliminary Assessment: NCSL Principles

Neutral

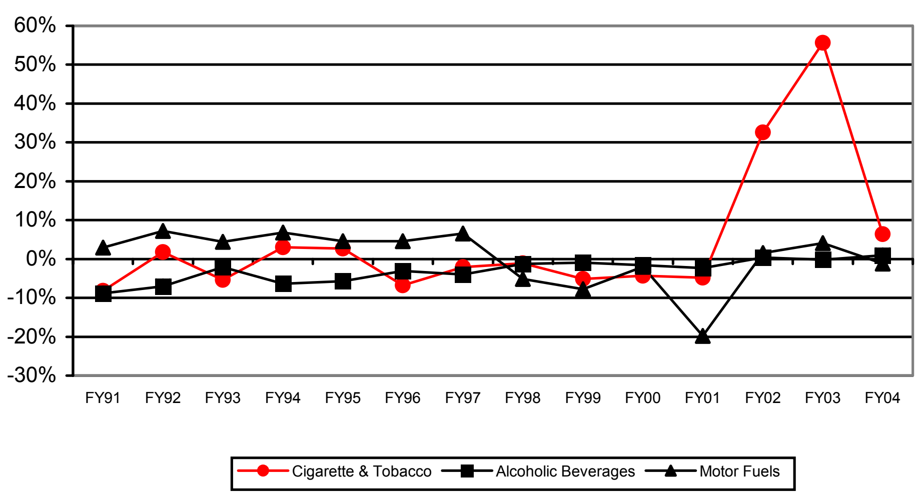
In theory, selected sales taxes are one way to charge consumers directly for the benefits of a government service. For example, the excise tax on gasoline can be viewed as a user charge for public roads if revenues are earmarked for highway construction and maintenance. In some cases, selected sales taxes are imposed on specific activities or products to discourage negative behaviors like smoking or drinking and to help offset their social costs ("sin taxes"). Excise taxes like the ones applied alcoholic beverages and tobacco products, therefore, are not intended to be neutral, in contrast to the guiding principles for high quality revenue systems.

Equitable and Reliable

Excise taxes are regressive and tend to grow more slowly than the economy. This is because they usually are applied on a per-unit basis (e.g., cents per pack or per gallon) rather than as a percentage of price. Consumers pay the same rate regardless of their income and, unlike the ad valorum general sales tax, the amount of tax paid is unrelated to the value of the item.

Per-unit excise tax collections only grow if consumption or rates increase. Nationwide, consumption of alcohol and tobacco products is declining or flat; sales of motor fuels have been effected by increasing fuel efficiency of new vehicles. The lack of sales growth or a rate hike means excise tax revenues will be eroded just by inflation. Figure II-7, which shows revenue growth, adjusted for inflation, over time for Connecticut's three main excise taxes, all of which have unit-based rates, illustrates this situation.

Figure II-7. Connecticut Excise Tax Revneues:
Annual Inflation-Adjusted Growth



Source of Data: Comptroller Annual Reports; U.S. BEA

Given the trends shown in the figure, Connecticut excise taxes are not reliable or adequate as revenue sources for public programs with steadily increasing costs. To sum up:

- Alcoholic beverage tax revenues, when adjusted for inflation, are, like alcohol sales nationwide, declining over time. Connecticut's alcoholic beverage tax, which has experienced no significant changes in either its rate or base since FY 90, has had virtually no growth in revenues over the same time period shown in the chart. Actions to preserve the reliability and adequacy of this revenue source (e.g., rate increases) have not been taken since1989.

- Cigarette and tobacco product tax collections, when adjusted for inflation, show negative growth during this timeframe except when the cigarette tax rate was doubled during FY 02 and FY 03. Revenue growth when adjusted to remove the impact of the legislated rate increases has been negative in 11 of past 15 years. Therefore, Connecticut's cigarette tax is neither a very reliable nor adequate revenue source.

- Motor fuel tax revenues are not keeping pace with the state economy measured by personal income and real growth has been negative every year since FY 98 when a series of rate reductions was first enacted. A steep drop in real motor fuel tax collections in FY 01 reflects a cut of seven cents per gallon rate (22 percent) as well as the effects of a poor economy. Year-to-year fluctuations in tax collections are considerable even taking into account legislated rate changes. Adequate and reliable revenue growth is further compounded by the fact motor vehicles are becoming more fuel efficient, meaning consumption, the current base for motor fuel taxes, will decline over time.

Simple/Promotes Compliance

Administration of excise taxes tends to be easier than for other sales or income taxes. In general, taxes are collected at the wholesaler/distributor level, making the number of taxpayers relatively small. Also, since the 1990s, there has been an international cooperative agreement in effect that simplifies the reporting and collection of fuel taxes from interstate motor carriers and another national project to promote uniformity in state motor fuel tax programs is underway. Connecticut is a participant in both efforts.

However, frequent changes to the rate and base of excise taxes complicate agency administration and taxpayer compliance, in addition to reducing tax revenue certainty. In general, when states need to raise revenues there tends to be less resistance to higher excise taxes than any increase in broader based and more visible general sales and income taxes. Increases in state cigarette and other "sin taxes" were common in the most recent national economic downturn. As noted earlier, Connecticut has increased its cigarette tax six times since FY 90, and during 2002 and 2003, changes enacted to help address the state's budget shortfalls more than doubled the per pack tax rate. The state's motor fuel taxes have also been subject to both increases and reductions almost every year over the past decade; additions and modifications of tax exemptions have occurred as well.

If excise tax rates become too high, tax avoidance including black-market sales and smuggling can become a serious problem requiring expensive, labor intensive enforcement efforts. Enforcement of all types of sales taxes is becoming more complicated as electronic commerce becomes more prevalent. State tax agencies, including Connecticut's Department of Revenue Services, now find it necessary to monitor Internet sales, particularly of high excise tax items like cigarettes and alcoholic beverages, to achieve taxpayer compliance.

Economic Competition

As discussed earlier, Connecticut's excise tax rates tend to be among the higher ones in the country although most are comparable to those of neighboring states. High rates are a concern for local businesses selling the products subject to the state's alcohol, tobacco, and motor fuel taxes, particularly those located near borders. Whether further increases would put Connecticut businesses at a competitive disadvantage is an important consideration for policymakers.

Accountable

Excise taxes, because they are applied at the wholesale level and included in the purchase price, are not easily identified by consumers. Less visible taxes like the alcohol, tobacco, and motor fuels taxes have less taxpayer accountability.

Profile of the Personal Income Tax

Background

Forty-one states and the District of Columbia have imposed a broad-based personal income tax. The personal income tax (PIT) plays an increasingly pivotal role in raising revenues for state government. In the 1950s, when states first began enacting taxes on personal income, the tax accounted for less than 10 percent of total state tax revenues. By 1998, the state personal income tax was contributing about 34 percent of total state tax revenue, and had become the single largest source of revenue for the states.

Connecticut did not enact its comprehensive income tax until 1991. The General Assembly had passed an income tax in 1971, but there was such a public outcry that it was repealed within 24 hours. However, facing a $1 billion budget deficit in 1991, the legislature narrowly passed the tax on personal income in Connecticut. The first two years were years of adjustment; thus most analysis conducted in this profile and assessment begins with FY 93. The statutory provisions for Connecticut's personal income tax are contained in chapter 229 of the Connecticut General Statutes.

Features of Connecticut's Personal Income Tax

Who it covers: Full-time residents (including estates and trusts) who have earned and/or unearned income and part-time residents and non-residents with Connecticut-source income.

What it covers: All income -- both ***earned*** (i.e., wages and salaries), and ***unearned*** (i.e., capital gains, interest and dividends) – is taxable. Prior to 1991, Connecticut taxed only unearned income.

Persons must file if they:

- had Connecticut income tax withheld from their wages;
- made estimated Connecticut income tax payments;
- were required to pay the federal alternative minimum tax; or
- meet Connecticut's gross income test, which in 2004 was:
  - $24,000 for married persons, filing jointly;
  - $19,000 for heads of household;
  - $12,000 for married persons filing separately; and
  - $12,625 for single filers.

How the Tax is Calculated

Connecticut's income tax is linked to the amount of ***federal Adjusted Gross Income*** (AGI) on a filer's federal income tax return. This figure is the starting point for calculating Connecticut income tax, and, therefore, all the definitions for federally adjusted gross income apply first to arrive at that amount. Then, several additions or subtractions to federal AGI (like loss or gain on the sale of Connecticut state or local bonds) are applied to arrive at ***Connecticut AGI.***

To compute ***Connecticut taxable income,*** the filer subtracts the personal exemption (i.e., the gross income limits listed above) for this/her filing category from his/her Connecticut AGI. If the result is zero or less, no taxes are owed.[12] If the amount is a positive number, the state uses two tax rates that apply to different income brackets as shown in Table II-4.

Table II-4. Connecticut's Personal Income Tax: Filer Categories, Income Categories and Rates

Category of Filer	Connecticut Taxable Income	**Tax Rate**
Single or married filing separately	Up to $10,000	3%
	Over $10,000	$300 flat amount plus 5% of taxable income more than $10,000
Head of household	Up to $16,000	3%
	Over $16,000	$480 flat amount plus 5% of taxable income more than $16,000
Married filing jointly	Up to $20,000	3%
	Over $20,000	$600 flat amount plus 5% on taxable income more than $20,000

However, the amount of tax a person actually pays may be offset by statutorily specified "credits" based on a sliding scale. Under C.G.S. 12-703, a personal tax credit ranging from 1 percent to 75 percent is available to all categories of filers up to certain income levels. This credit is deducted from the tax liability. The range of credits in 2004 by category of filer is shown in Table II-5. Consequently, these exemptions mean that taxpayers are not charged the full rates until their income exceeds the "no credit" amount shown in Table II-5.

Table II-5. Personal Credits by Filer Category

Category of Filer	Maximum Credit (75%)	**Minimum Credit (1%)**	No credit
Single or married filing separately	If AGI > $12,625 but < $15,570	If AGI > $54,000 but < $55,000	AGI > $55,000
Head of household	If AGI >$19,000 but < $24,000	If AGI > $78,000 but < $78,500	AGI > $78,500
Married filing jointly	If AGI > $24,000 but < $30,000	If AGI > $100,000 but < $100,500	AGI >$100,500

[12] The personal exemption for single filers will increase by a few hundred dollars per year until it reaches $15,500 in 2010. The other exemptions will remain the same.

Exemptions and Credits

Threshold/base exemptions. As discussed above, persons with incomes below specified thresholds are exempt from filing, while others are eligible to have their taxable income and tax liability reduced through the personal exemptions discussed above. Annually, over the next few years (until 2010) the exemption amounts will decrease by $1,000 for each additional $1,000 of AGI filers have, until the exemption is removed at a certain AGI. Table II-6 summarizes the reduction for each category of filer and lists the AGI level above which the exemption is no longer available.

Table II- 6. Personal Exemption Reductions

Category of Filer	Reduction in Allowable Personal Exemption	AGI where Exemption Eliminated
Unmarried individual	$1,000 for each $1,000 over $12,750 AGI	$36,000
Married filing separately	$1,000 for each $1,000 over $24,000 AGI	$35,000
Head of Household	$1,000 for each $1,000 over $38,000 AGI	$56,000
Married, filing jointly	$1,000 for each $1,000 over $48,000 AGI	$71,000

Source: C.G.S. Sec. 12-702

Other income exemptions. Income from ***social security*** is exempt for single filers, or married persons filing separately whose federal AGI is less than $50,000, as well as for heads of household if their Connecticut AGI is less than $60,000. If Connecticut AGI is higher, social security income is partially exempt. Fifty percent of ***military retirement income*** retirement income will be exempt, beginning in 2008.

Credits

Other income tax payments. All income tax paid to other jurisdictions (i.e. other states and cities), but not federal income tax or tax paid in a foreign country, is subtracted from income tax liability in Connecticut.

Property tax credit. Any Connecticut filer who is required to pay state income tax who has also paid personal property tax on an automobile or primary residence in Connecticut is eligible for a credit against their actual tax liability. The amount of the credit depends on property tax paid and the filer's adjusted gross income. The percent of property tax paid that can be taken as a credit declines as income increases -- maximum credit was $350 for tax year 2004. (State budget adopted during 2005 session sets maximum at $400.)

Alternative Minimum Tax (AMT): If a Connecticut filer has paid the federal alternative minimum tax, the Connecticut income tax owed is also calculated using that as a base. The AMT rate in Connecticut is the lesser of:

- 19 percent of adjusted federal alternative minimum tax; or
- 5.5 percent of adjusted federal alternative taxable income.

While it is not possible to determine the number of filers that pay the AMT form state DRS data, IRS federal return data for 2003 indicate the percentage of Connecticut filers paying the AMT was about 3.8 percent.

How the Tax is Paid

Tax returns must be ***filed annually by*** April 15th with the Department of Revenue Services. Generally, for wage earners a certain amount of tax liability is ***withheld in payroll taxes*** throughout the year, which employers then submit to DRS. Upon submitting the return, filers either get a refund if they have already paid more than what they owed in taxes, or they pay any remaining portion of tax liability not covered by withholding.

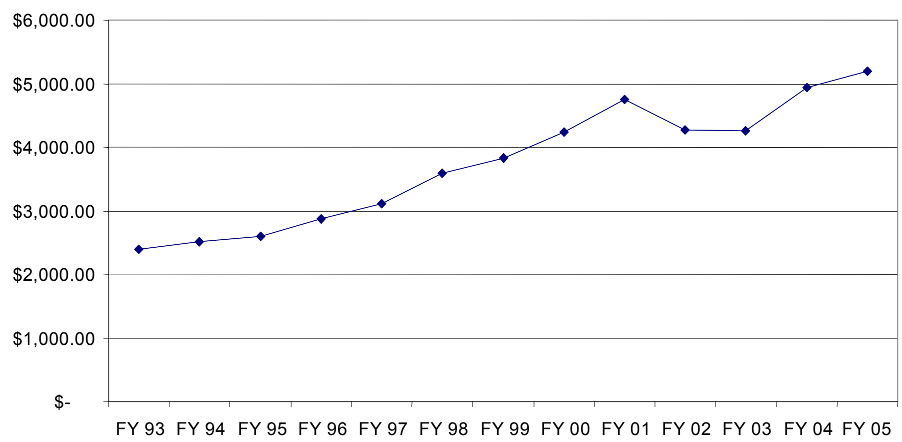
Certain taxpayers must make ***quarterly estimated payments*** if their income tax liability (after credits) is more than $1,000 and the filer expects the withholding amounts will be less than the required annual payment. The state requires filers to pay the lesser of 90 percent of the income tax due on their current return, or 100 percent of the income tax due on the previous year's return.

Number of Taxpayers: FY 04 --1.39 million filers (for income year 2003)

Revenue Collected: FY 04 -- $4,943,298,949 (for income year 2003)

As Figure II-8 shows, the personal income tax revenue has grown dramatically in the 13 years depicted. In FY 93, the tax generated about $2.3 billion; by FY 05 that had more than doubled – to $5.1 billion. Aside from FY 02 –when the revenues from the personal income tax seriously dropped from the previous year and FY 03, which was basically the same as FY 02 – the yearly increases have been steady and substantial.

Figure II-8. Connecticut Personal Income Tax Revenue FY 93 - FY 05



Source: Comptoller's Annual Reports and Office of Fiscal Analysis

Major Changes in Income Tax.

- **1993 –** established an alternative minimum tax = 23 percent of federal AMT
- **1994 –** changed the alternative minimum tax to 19 percent of federal AMT or 5 percent of federal adjusted alternative minimum taxable income
- **2003 --** made several changes including the rate increase from 4.5 percent to 5 percent and reduction of exemptions

Rate Changes

Since the income tax was first established, many of the changes have been to the income brackets subjected to the two different rates, as outlined in Table II-7.

Table II-7. Changes to PIT Rates and Income Categories

Year	Rate	$ Taxable Income by Filer Type		
		Single	*Head of household*	*Joint*
1991	1.5%			
1992	4.5%			
1995 (effective 1996)	Establishes 2 rates – 3% on certain income 4.5% on rest	3% on first $4,500	3% on first $7,500	3% on first $9,000
1997	Increases income levels for the 3% over 3-year period 4.5% on rest	3% on first $6,250	3% on first $10,000	3% on first $12,500
1998	4.5% top rate	3% on first $7,500	3% on first $12,000	3% on first $15,000
1999	4.5% top rate	3% on first $10,000	3% on first $16,000	3% on first $20,000
2003	Top rate increased to 5%	Over $10,000	Over $16,000	Over $20,000

Changes in Exemptions:

- 1997 --One-half of taxable Social security becomes exempt in 1998
- 1999 -- 100% of taxable Social Security is exempt for taxpayers with Connecticut AGI under $60,000 for joint filers and $50,000 for singles
- 1999 – Phase-in of standard deduction increases before reaching taxable income to occur between 1/1/00 to 1/1/07
- 2002 -- Phase-in delayed two years – to be completed in 2009
- 2003 – Phase-in to be completed by 2010
- 2005 – exempts half of military retirement income from the income tax, and delays by two years scheduled income tax reductions for single filers

Comparison with Other States

Forty-one states and the District of Columbia have a broad-based state income tax. Seven states – Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming -- have no income tax and two states—New Hampshire and Tennessee -- tax only unearned income. States structure their personal income tax in many different ways. Appendix B provides a state-to-state comparison of some of the major features of the income tax. Some of those features and variations are summarized below.

Filing Thresholds. Twenty-seven states use the federal adjusted gross income as the base, or starting point, for their income tax, while 10 states use the federal taxable income as the base. In most states, people may have a certain amount of income before they are required to file a return and/or pay a tax on their income. Many states use the same thresholds as the federal government for filing. (For filers under age 65, those are: $7,950 for single filers; $11,450 for head of household; and $15,900 for married filing jointly.) Connecticut has much higher filing thresholds.

Brackets. One of the primary ways a state income tax structure differs is the number of income brackets. A shown in the table below, the number of these brackets varies from one rate (flat tax) which six states have, to 10 rate brackets in Missouri. Table II-8 below shows number of states using different rates. Connecticut is the only state to use two rates. For a full listing of state's rates and income brackets, see Appendix B.

Table II-8. A State Comparison of Rates and Brackets

Number of Rates/Brackets	Number of states	Lowest %	Highest % bracket
1 (Flat Rate)	6	3%	5.3%
2	1—CT	3%	5%
3	7	2%	9%
4	7	2%	8.5%
5	5	2%	9.5%
6	7	1%	8.97%
7	2	2%	7.7%
8	2	0.5%	7.8%
9	3	0.36%	8.98%
10	1	1.5%	6%
Source: Federation of Tax Administrators, January 2005			

Exemptions and credits. Other than base threshold and personal exemptions built into the income tax structure, Connecticut does not offer many exemptions for types of income. As mentioned previously, Social Security is exempt, but only if a filer's total income falls below a certain level. Refunds on state and local taxes are exempt for all filers (and in the future, only half of military retirement pensions will be taxable). Many other states treat certain types of income (e.g., retirement, private and public pensions) differently from wage income.

Connecticut's income tax offers only two credits – income tax payments to other states and localities, which are not capped, and payments for local property tax, which are capped at $350 per filer, with the percentage of that $350 reduced at higher income levels. The number and types of credits given in other states vary widely, but all have more than Connecticut. The table below summarizes the number of credits by category and the states that fall in those categories.

Table II-9. Comparison of Credits in the Personal Income Tax	
Number of Credits	States
Less than 5	CT
5-10	AL, DE, DC, KY, MD, MI, MN, NE, NJ, PA, WV
11-15	CO, ID, IL, IN, MA, NM, ND, OH, VA, WI
More than 15	AZ, AR, CA, GA, HI, IA, KS, LA, ME, MS, MO, MT, NY, NC, OK, OR, RI, SC, UT, VT,
Source of Data: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions*, January 2005	

The greater the number of exemptions, the more the tax base is reduced, and the greater the value of credits, the less that is collected in taxes. In 2002, for example, the exemptions for Social Security reduced Connecticut's taxable income by approximately $1.2 billion, and the property tax credits in 2003 reduced revenues collected by about $272 million.

Profile of Connecticut Income Tax Filers

Based on IRS data for all states for income year 2002, program review staff profiled Connecticut compared to other states using a variety of factors to assess income and filing status.

Federal Adjusted Gross Income. Connecticut ranked highest in terms of adjusted gross income, with $64,724 -- 9.4 percent higher than the next-highest state, New Jersey, and about 40 percent higher than the national average AGI.

Table II-10. Lowest and Highest States by Avg. Federal AGI (total AGI in $millions)			
	# Filers	Tot. AGI	Avg. AGI
MISSISSIPPI	1,163,632	$39,276,788	$33,754
MONTANA	429,570	$14,508,848	$33,775
WEST VIRGINIA	748,020	$26,136,779	$34,941
ARKANSAS	1,119,779	$39,715,629	$35,467
NORTH DAKOTA	301,040	$10,733,301	$35,654
UNITED STATES	130,836,098	$6,015,047,033	$45,974
NEW YORK	8,613,811	$454,581,808	$52,774
MARYLAND	2,589,664	$139,952,530	$54,043
DISTRICT OF COLUMBIA	278,412	$15,294,026	$54,933
MASSACHUSETTS	3,075,666	1$74,588,374	$56,764
NEW JERSEY	4,072,512	$240,924,251	$59,159
CONNECTICUT	1,663,015	$107,637,662	$64,724

Connecticut ranked third highest in terms of the percentage of filers who claim deductions, (44 percent). Connecticut had a substantially greater percentage than the national average (35 percent), but below Maryland and New Jersey.

Table II-11. Highest and Lowest States by Percentage of Filers Taking Deductions	
MARYLAND	49%
NEW JERSEY	45%
CONNECTICUT	44%
MINNESOTA	42%
COLORADO	42%
OREGON	42%
UTAH	42%
United States	35%
LOUISIANA	22%
WYOMING	21%
NORTH DAKOTA	20%
WEST VIRGINIA	19%
SOUTH DAKOTA	18%

Comparing Connecticut to other states using percent of adjusted gross income that comes from unearned income like dividends, interest, and capital gains, Connecticut ranks sixth, at 9.4 percent, and is considerably higher than the national average of 7.9 percent.

Table II-12. Highest and Lowest States: Percent of AGI is Unearned Income	
WYOMING	15.5
NEVADA	12.5
FLORIDA	12.1
MONTANA	11.0
DISTRICT OF COLUMBIA	9.5
VERMONT	9.5
CONNECTICUT	9.4
UNITED STATES	7.9
MICHIGAN	5.9
LOUISIANA	5.8
MISSISSIPPI	5.7
WEST VIRGINIA	5.5
ALASKA	5.0

Finally, Connecticut ranked highest among all the states in terms of the percentage of filers with high incomes. Fully 34 percent of filers had federal AGI of more than $200,000; the national average was 21 percent.

Table II-13. Lowest and Highest States with Percent of AGI over 200K	
WEST VIRGINIA	9
NORTH DAKOTA	11
IOWA	12
NEW MEXICO	12
MISSISSIPPI	12
UNITED STATES	21
MASSACHUSETTS	26
NEW JERSEY	27
NEW YORK	30
DISTRICT OF COLUMBIA	32
CONNECTICUT	34

Preliminary Assessment Using NCSL Principles

Volatility. The Connecticut income tax is based on all personal income, and that income can be from many sources. A booming stock market, a robust real estate market, and wage increases in a thriving job market can all signal great growth in the personal income tax. But busts in any of those segments of the economy can also spell deep troughs in the revenues collected, making the personal income tax one of the more volatile taxes.

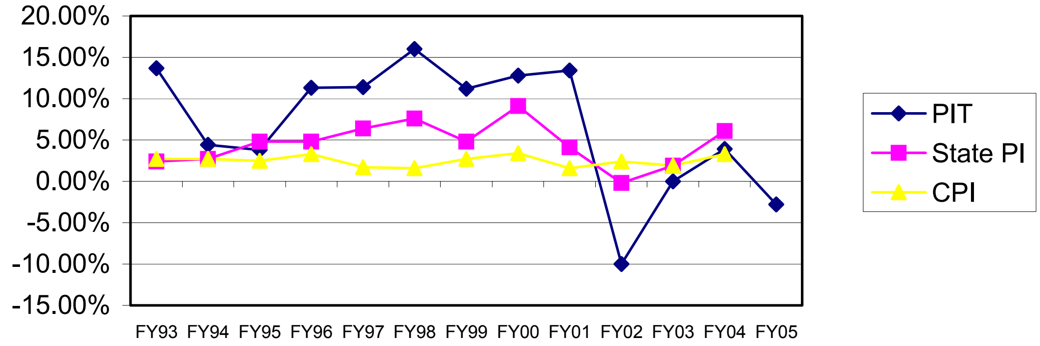
Program review staff measured the annual percent change in the PIT between 1993 and 2005 and compared that to the standard deviation (or how much variation there is from the average or mean). (Although the PIT began in 1991, it took some time for the administration and collection of the tax to become well established. Therefore PRI staff did not include 1991 or 1992 in the measurement.) This analysis uses OFA legislative adjustments to the PIT; thus the changes being measured are those responding to the economy. Twelve years is not a long period to measure volatility, and people will caution that it may not include more than one economic cycle, but since the PIT was begun in 1991, it is the only period that can be captured.

Table II-14. Personal Income Tax: Average Annual Growth Rate and Standard Deviation FY 93- FY 05	
Total Percent Growth for Period	89%
Average Annual Percent Change	6.85%
Standard Deviation	7.7
Range	26

The statistics in the table indicate there is considerable volatility in the PIT revenue stream in Connecticut. While the average annual growth was 6.85 percent, the standard deviation was almost 8, which means that two-thirds of the time the annual growth rate fell between –1 percent and +14 percent. The other third of the time it was outside that range. The greater the standard deviation, the less stable the revenue source and the more difficult to accurately forecast the total revenues from the tax.

The volatility in the personal income tax is more readily seen in Figure II-9, which tracks the changes in personal income tax revenues, compared to the state's economy, using personal income in Connecticut as the measure. While PIT revenue generally trends similarly to the state's personal income, the changes are much more dramatic – the increases higher and the declines deeper.

Figure II-9. Annual Percent Changes in Personal Income Tax Revenues, State Personal Income and Inflation



Source of Data:Comptrollers Reports, U.S. BEA, and U.S. BLS

Analysis later in this section will show that Connecticut's PIT is heavily reliant on top income filers for paying the bulk of the tax. Thus, Connecticut's income tax is more volatile than most states due to the characteristics of our distribution of income and filers compared to other states. For example, Connecticut is:

- the state with the highest federal AGI,
- the state with the highest percentage of filers with AGI above $200K, and
- one of the highest state in terms of percentage of AGI from "unearned income" (i.e, capital gains, taxable interest, and dividends).

Adequacy

The figure above was illustrative of the volatility of Connecticut's income tax compared to the economy (personal income). The figure also demonstrates that the income tax is adequate – it has been growing faster than the economy, and it has far outpaced inflation (i.e., consumer price index for the Northeast) by a wide margin. Table II-15 shows the comparative aggregate percentage growth in the three indicators over the last 12 years.

Table II-15. Total Percent Growth – 1993 -2004	
Connecticut Personal Income Tax Revenues	91.9%
State Personal Income	54.5%
Inflation (CPI-U Northeast)	29.8%

Simplicity

Based on federal return. Connecticut's income tax is a relatively simple one. First, Connecticut, like the vast majority of states, ties its PIT to the tax filer's federal return. Connecticut uses federal adjusted gross income as its starting point. Thus once a Connecticut filer has completed his or her federal return, the federal AGI is used on the first line on the state tax return, and income does not need to be calculated twice. This also makes the tax easier to administer since the income can be easily verified with federal return information.

Few exemption and credits. Connecticut's tax is also simple in that it has few credits or exemptions. There are the basic income thresholds and standard deductions described earlier in the income tax profile. Those exemptions and deductions are built into the tax tables prepared by the Department of Revenue Services and displayed on the DRS website, making it easy for filers to calculate the taxes they owe.

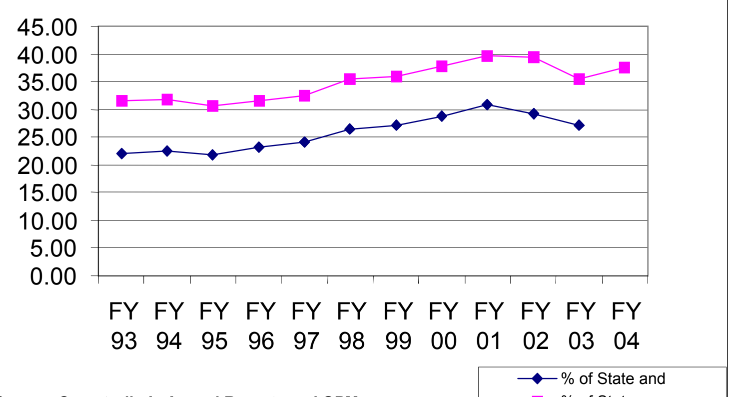
Two rate brackets. Connecticut's income tax has only two rates -- 3 percent and 5 percent -- applied to different income brackets by filer type. Having only two rates adds to the simplicity of the tax.

Withholding. Because the income tax is withheld in employees' paychecks, and employers submit that to the DRS, payment of the tax is relatively easy to comply with. In Connecticut, about 80 percent of the tax is collected through withholding and 20 percent through estimated payments.

Balance

Because the growth in the personal income tax has been so significant, it is contributing an ever-greater share of the state's revenue stream. As Figure II-10 illustrates, the reliance on the income tax as a percentage of all state and local revenue has increased from about 23 percent in FY 93 to slightly more than 30 percent in FY 01, before declining to about 28 percent in FY 03. Revenues from the PIT make up an even greater share of state GF revenues – from a low of 30 percent in FY 95 to about 40 percent in FY 01 and FY 02.

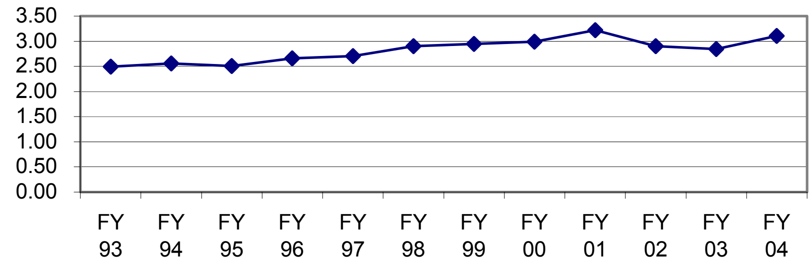
Figure II-10. Percentage of Revenue from Personal Income Tax



Source: Comptroller's Annual Reports and OPM

While income tax revenues have more than kept pace with the economy, the tax revenues as a portion of the state's personal income has been relatively stable. As shown in Figure II-11, the ratio has increased from about 2.5 percent in FY 93 to slightly more than 3 percent in FY 04; and thus as a burden on the economy it is about the same.

Figure II-11. Income Tax Revenues as a Percent of Personal Income



Source of Data: Comptroller's Reports and Bureau of Economic Analysis

To compare this with the national average and those of neighboring states, staff used ratios for 2002, the last year comparable data are readily available. In that year, Connecticut ranked somewhat above the national average of 2.3 percent, but below neighboring states like Massachusetts (3.2 percent) and New York (4.5 percent), and Maine (3 percent).

Table II-16. Connecticut's Personal Income Tax Revenue as a Percent of Personal Income A Comparison with Other States FY 02

State	Percent	Rank
Connecticut	2.5%	20
US Avg.	2.3%	--
Massachusetts	3.2%	8
New York	4.5%	1
New Jersey	2.1%	35

Source of Data: Census Bureau 2002

Equity and Fairness

Progressivity. One of the measures of fairness of a tax is whether it is "progressive" -- taking a greater share of individuals' incomes at higher income levels than at lower levels. Program review staff assessed the progressivity of Connecticut's income tax in a couple of different ways. The Department of Revenue Services provided income tax data for all Connecticut resident filers -- aggregated and categorized into $1,000 income increments -- for 1995, 1999 and 2003. Committee staff analyzed these data using the Suits index, a widely used measure in tax analysis to determine the progressivity of taxes on a scale from a -1 (very regressive) to a +1 (most progressive), with 0 being a flat or proportional tax. The analysis of Connecticut's income tax produced the following results, shown in the table below.

Table II-17. Assessment of Connecticut's Personal Income Tax Using Suits Index

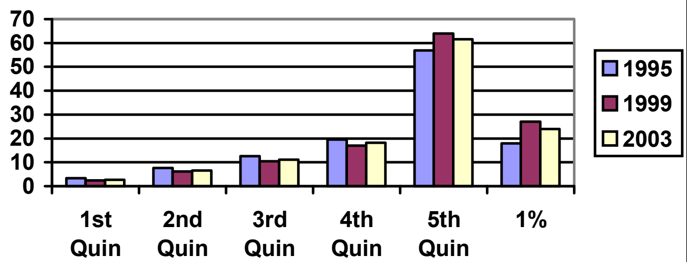
Year	Index Results
1995	.12 – slightly positive, slightly progressive
1999	.14 – slightly positive, slightly progressive
2003	.12 –slightly positive, slightly progressive

It is important to note that this analysis of progressivity is based only on incomes and taxes paid by Connecticut filers. It cannot measure the impact of the tax structure on those exempt from filing because of lower incomes.

Effective tax rates. Another way of looking at the fairness of the income tax is the ratio of taxes paid of adjusted gross income, (i.e., the effective tax rate, by different income groupings. To calculate this, program review staff first divided the total number of income filers into roughly equal quintiles (5 groupings, roughly 20 percent each), and also separated the top 1 percent out as a subcategory for analysis.

Figures II-12 and II-13 show the distribution of total income and taxes paid by quintile (and top 1 percent) for the three years. As figure II-12 shows, the bottom quintile of filers accounts for less than 5 percent of the AGI income in all three years, while the top quintile accounted for at least 50 percent in all three years and more than 60 percent in 1999 and 2003. In fact, in the latter two years, the top 1 percent accounted for more than 25 percent of the income.

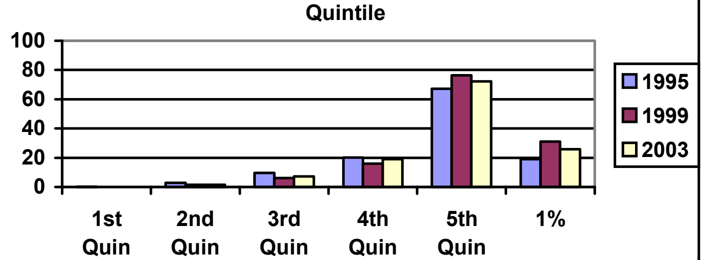
Figure II-12. Distribution of Income: Percentage by Quintile



Source of Data: DRS

Figure II-13 shows similar results regarding the distribution of taxes paid. The bottom quintile paid little of the total taxes. (In fact, it is not measurable in the graph.) The top quintile paid more than 70 percent of all income taxes in 1999 and 2003, and the top 1 percent of filers paid at least 20 percent in all three years.

Figure II-13. Distribution of Tax Share: Percentage by Quintile



Source of Data: DRS

Table II-18 on the following page shows for 1995, 1999 and 2003: the number of filers in each group; the income groupings; the average income for the group; average tax paid for the group and the tax paid as a percent of AGI, or the effective tax rate, for the group.

Table II-18. Distribution of Income, Taxes Paid and Effective Tax Rates by Quintile: 1995, 1999 and 2003					
1995	# filers	Income group	Avg income	Avg Tax Paid	% AGI in tax
Quintiles	245,994	$0-17K	$9,670	$10.54	0.11
	238,087	>$17K - $29K	$22,853	$272.88	1.19
	244,886	>$29 -$45K	$36,488	$864.97	2.37
	246,870	>$45 - $70K	$56,124	$1,796.65	3.2
	246,694	>$70 - $2m+	$163,498	$6,000.78	3.62
Top 1%	11,208	>$400K	$1,134,784	$37,495.56	3.3
Total	1,222,531		$58,031	$1,802.00	3.11
1999	# filers	Income group	Avg income	Avg. Tax Paid	% AGI in tax
Quintiles	266,296	$0-17K	$9,310	$4.48	0.04
	269,239	$17.01-$31K	$23,860	$167.83	0.70
	272,331	$31.01-$50K	$39,695	$675.84	1.70
	273,342	$50.01-$82K	$64,089	$1,779.93	2.70
	272,945	$82.01 -$2m+	$242,477	$8,495.24	2.24
top 1%	13,607	>$550K	$2,051,230	$69,321.63	3.4
Total	1,354,153		$76,369	$2,241.77	2.93
2003	# filers	Income group	Avg income	Avg.Tax Paid	% AGI in tax
	291,764	$0-$18K	$9,628	$3.59	0.04
	277,161	$18,01-$33K	$25,316	$198.21	0.78
	278,766	$33,01-$54K	$42,623	$907.77	2.13
	279,207	$54,01-$90K	$69,914	$2,384.24	3.41
	269,805	$90,01-$2m+	$244,684	$9,378.81	3.83
top 1 %	13,333	>$550K +	$1,927,535	$68,112.43	3.53
Total	1,396,703		$76,784	$2,509.61	3.27
Source of Data: DRS					

Some of the key findings from the distributional analysis of the income tax are:

- the threshold of income for the top 1 percent of filers increased sharply from $400,000 in 1995 to $550,000 in 1999, but has remained at that level in 2003;
- the average income for the top 1 percent in 1999 was slightly more than $2 million; it was below that in 2003 at $1.9 million;
- the average income for all filers in 2003 -- $76,784 -- had hardly increased from the $76,369 average AGI of 1999; due largely to the drop in income for the top 1 percent;
- the effective tax rates are slightly higher at greater income levels, reinforcing the results of the Suits index, showing that the income tax as structured is slightly positive and thus slightly progressive; and
- the slight increase in the progressivity of the tax in 1999 (as shown by the Suits index) was due to increased income for the top 1 percent, rather than a structural tax change.

Economic Competitiveness

When the income tax was imposed in 1991, there were fears it would drive wealthier individuals from the state. This has not happened. While Connecticut's overall population has increased only slightly (3.6 percent) from the 1990 to the 2000 census, Connecticut's wealth ranking remains high. The profile of Connecticut's income outlined earlier in this section, using 2002 IRS data, shows that the federal AGI income for all filers in Connecticut is $64,724 – 40 percent higher than the US average of $45,974, and 9 percent higher than New Jersey at $59,159.

Connecticut's personal income tax rate structure is competitive, and may even be attractive to high-income earners whose employment might limit their residence choice to one of the states in the tri-state area. Table II-19 presents the top rate comparison for joint filers in New York, New Jersey and Connecticut. It shows even at income levels of $150,000, there is a rate advantage to Connecticut's tax over the other states.

Table II-19. Comparison of Upper-Income Tax Rates for Joint Filers in New York, New Jersey, and Connecticut

State	Rate	Taxable Income Level
New York	7.25% 7.7%	$150,001 -$500,000 over $500,000
New Jersey	6.37% 8.97%	$150,001 -$500,000 over $500,000
Connecticut	5%	Over $20,000

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Profile of Connecticut's Local Property Tax

Background

While the property tax plays no role in providing the state government with revenue, it is the basic and critical revenue source used to provide local services. Consequently, Connecticut municipalities rely heavily on the property tax. Since many services provided by county governments in other states are the responsibility of municipalities in Connecticut, local governments are an important component of Connecticut's system of governance. They also provide a medium through which local preferences for public services can be expressed.

Some basic characteristics of the property tax in Connecticut are described below. In addition, a preliminary analysis of how the tax performs against the NCSL criteria is provided.

What The Tax Covers

All real property and tangible personal property is taxable unless expressly exempt. Real property includes land and improvements that are permanently attached to land. Personal property is all property not classified as real property, such as machinery, equipment, furniture, fixtures, and motor vehicles. Intangible property, such as copyrights, stocks, and bonds, is not taxed in Connecticut.

How The Tax Is Calculated

The property tax calculation is dependent on a determination of the value of property in a municipality and of the tax (or mill) rate. In Connecticut, all property taxes are assessed at the town level. Although some towns also have special taxing districts, the assessor of each town is ultimately responsible for establishing the value of each property, even if an assessment company is hired to assist the assessor. The Office of Policy and Management (OPM) has developed certain assessment practices and procedures and provides for the training and certification of tax assessors and assessment companies. There is no state law that requires an assessor to be certified, but a certified assessor must sign off on and approve each town's grand list annually.

Valuation. Because the value of property fluctuates over time, state law requires towns to periodically reassess or revalue property. Reassessment allows towns to appropriately assign tax burden. Generally, real and personal property is taxed based on its present true and actual or fair market value. Each municipality must assess all property for local tax purposes at a uniform rate of 70 percent of true and actual value. Except in a few cases, the state does not employ a classification system of taxation -- that is, the same rules apply to the assessment of residential, commercial, industrial, and other types of property.

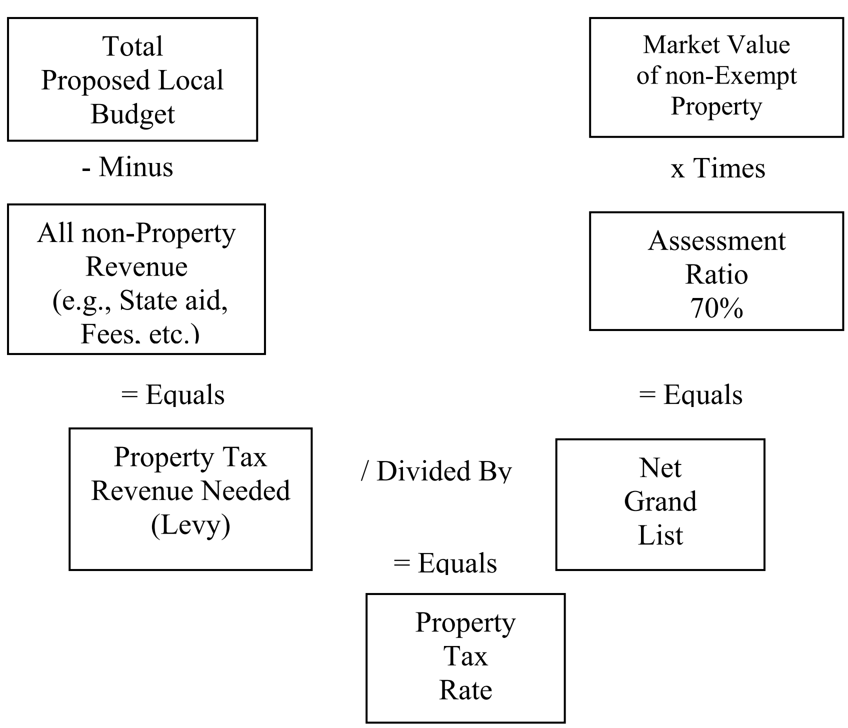
Frequency. Each town must revalue real property (e.g., land, homes, and office buildings) every five years (a requirement that started in October 2003). Personal property, such as motor vehicles, is revalued annually. Personal property typically owned by individuals (e.g., clothing, furniture) is exempt, but businesses are required to pay taxes on most of the personal property owned by the business.

At least one every 10 years a revaluation of real property must be based on a physical inspection; during intervening years towns can use statistical means. The Office of Policy and Management may impose a 10 percent penalty for failure to implement a revaluation. A town may apply to OPM for a delay in implementing a revaluation based on a reasonable cause as outlined in statute, or if a municipality shows a "good faith effort" toward implementing the required revaluation. A bill passed in 2003 permitted a delay in certain revaluations in that revaluations required to be implemented as of October 1, 2003, 2004, and 2005 do not have to be performed prior to October 1, 2006. To date, a total of 43 towns have deferred revaluations under this provision.

Reassessment relief. There are three mechanisms that serve to mitigate the impact of revaluation:

- two options allow towns to use different methods in determining gradual increases of assessed values of real property over a four-year phase-in period; and
- municipalities are allowed to implement a tax relief program that gives owner-occupants of one- to three-family homes a tax credit equal to the amount by which their property tax exceeds 1.5 percent of the property's fair market value, provided the municipalities also imposes a 15 percent surcharge on all other property owners. Only Hartford uses this mechanism.

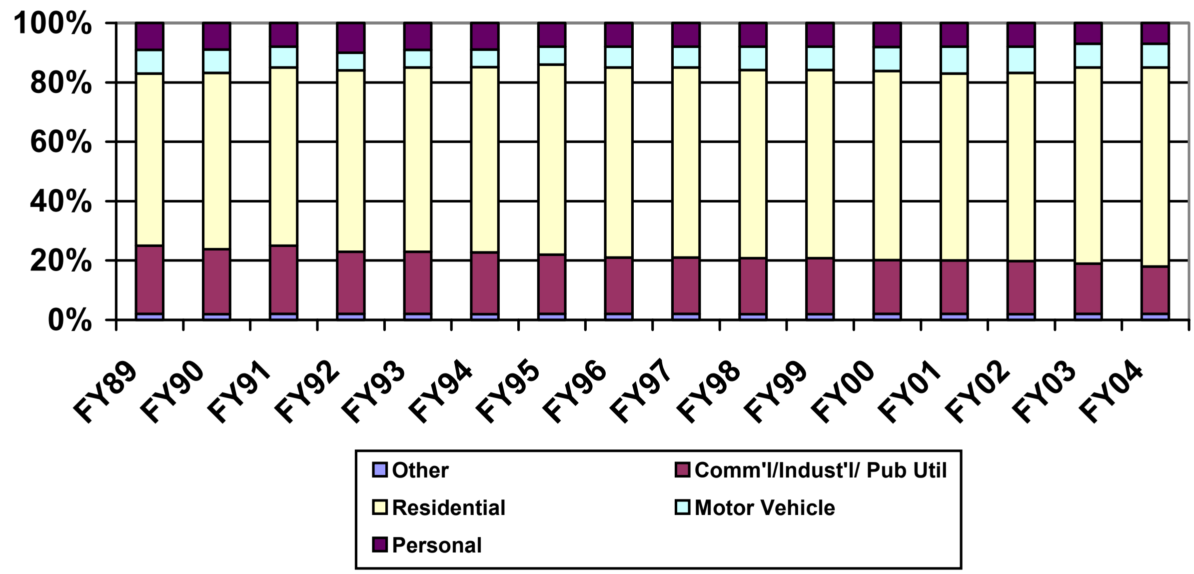
Figure II-14. How Property Tax Rates are Determined



Rate. The tax rate is expressed as a mill rate with one mill equal to one thousandth of a dollar. This means one mill is equivalent to one dollar of tax for every $1,000 of assessed value. The mill rate is calculated by dividing the net grand levy by the town's net grand list. The net grand levy is the amount of money a town needs to raise through property taxes, that is total expenses minus federal and state aid, fees, and other revenue. The net grand list is comprised of a town's total taxable property (i.e., the grand list is the annual record of all taxable and tax – exempt property; the net grand list is the grand list minus exemptions and adjustments). Figure II-14 illustrates how the tax rate is calculated and the relationship to assessed property value.

Appeals/Disputes. Taxpayers are entitled to an appeal process if they dispute the assessed value of their property. Practically speaking, the taxpayer typically begins the process with an informal hearing with the firm performing the assessment or town assessor. This meeting can usually resolve obvious errors, such as the number of bathrooms or the size of a building. The taxpayer may continue the appeal to the local Board of Assessment Appeals. A taxpayer who wants an assessment reduced must be willing to appear in person or be represented by an attorney or agent and be willing to answer questions under oath. Taxpayers who feel aggrieved by the board's decision may appeal to the Superior Court and must do so within two months of the board's final decision.

Figure II-15. Connecticut's Property Tax Base



Source: OPM Municipal Fiscal Indicators for years indicated

Who pays the tax? Figure II-15 shows the types of property included in the statewide tax base. Residential property represents the largest percentage of the base (67 percent) followed by commercial/industrial/public utility property (16 percent) and motor vehicles (8 percent). Since 1989, the residential portion of the tax base has increased from 58 percent to 67 percent (or a 16 percent increase), while the commercial/industrial/public utility portion of the base has declined from 23 to 16 percent.

Payment method. Municipalities may determine whether the property tax is due in a single installment, semiannually, or in quarters. Typically, the first installment is due on July 1. In addition, many taxpayers have their tax placed in an escrow account as a condition of obtaining a mortgage and effectively pay a portion of taxes every month, while the mortgage company makes the payment to the town.

Exemptions/Credits, PILOT, and Tax Relief Programs

There are many methods that can be employed to exempt, reduce, or assist with the payment of property taxes. They include:

- various property tax exemptions or credits;
- exemptions that are reimbursed by the state;
- property tax relief programs; and
- statutorily authorized delays after revaluation.

Credits and Exemptions. Several specific exemptions and credits against property taxes are mandated by statute. Municipalities are also authorized to adopt certain exemptions and credits by local ordinance. Exemptions can be organized by eligibility factors, such as age or physical impairments; property type, such as manufacturing equipment; or location and use of property. Major property tax exemptions include: agricultural products and equipment, charitable organizations, disabled persons and senior citizens, government property, and manufacturing. Property tax exemptions are summarized in Appendix C.

Table II-21 below lists the major state-mandated exemptions that municipalities must grant to property owners. These exemptions are divided among totally exempt property, such as state government property, and property that is partially exempt because the owner or the property meets specific statutory criteria, such as individuals who are visually impaired. These exemptions totaled about $42 billion in FY 03 or about 16 percent of the total value of the statewide grand list.

Municipalities are authorized to provide additional exemptions. However, no information on these exemptions is provided to the state nor does any other organization quantify the use of these local options on a statewide basis.

Table II-21. Statewide Property Tax Grand List Total and Partial Exemptions			
Exemption Type	**FY 03 Estimated Reduction ($ Millions)**	**% of Total Exemptions**	**% Grand List Exemption**
Totally Exempt Property			
Municipal	$13,968.85	33.03%	5.190%
State	6,627.43	15.67%	2.462%
Private Colleges & General/Chronic Disease Hospitals	4,795.50	11.34%	1.782%
Religious	3,382.54	8.00%	1.257%
Scientific, Educational, Literary, Historical, Charitable	3,093.39	7.31%	1.149%
Federal	903.34	2.14%	0.336%
Connecticut Resource Recovery Authority	408.00	0.96%	0.152%
Cemeteries	351.17	0.83%	0.130%
Nonprofit Camps & Recreational Facilities	297.03	0.70%	0.110%
Hospitals & Sanitoriums	183.81	0.43%	0.068%
Volunteer Fire Dept.	149.78	0.35%	0.056%
Railroad	69.22	0.16%	0.026%
Agriculture & Horticultural	58.08	0.14%	0.022%
Veterans Organizations	49.54	0.12%	0.018%
American National Red Cross	14.97	0.04%	0.006%
CT Student Loan Foundation	5.03	0.01%	0.002%
Total Tax Exempt Property	**$34,357.68**	**81.24%**	**12.77%**
Partial Exemptions			
Phase-In Residential Properties	$2,654.77	6.28%	0.986%
Manufacturers and Trucks	2,319.69	5.48%	0.862%
Economic & Developmental - Non Reimbursed	960.48	2.27%	0.357%
Phase-In Non Residential Properties	584.58	1.38%	0.217%
Non Reimbursed Veterans	487.29	1.15%	0.181%
Environmental & Developmental – Reimbursed	326.14	0.77%	0.121%
Reimbursed Ad Vets - Non Income	183.08	0.43%	0.068%
Solar Energy & Pollution Control	132.46	0.31%	0.049%
Reimbursed Ad Vets – Income	92.91	0.22%	0.035%
Personal Property Tax Exemptions	56.48	0.13%	0.021%
Farm & Mechanics	43.23	0.10%	0.016%
Miscellaneous	32.14	0.08%	0.012%
100% Disabled Non Reimbursed	24.21	0.06%	0.009%
Various Exemptions for Individuals	19.76	0.05%	0.007%
Blind	10.65	0.03%	0.004%
100% Disabled Reimbursed	4.21	0.01%	0.002%
Residential Fixed Assessments	3.56	0.01%	0.001%
Total Partial Exemptions	**$7,935.66**	**18.76%**	**2.95%**
Grand Total Grand List Exempted	**$42,293.34**	**100.00%**	**15.73%**
Source: Office of Policy and Management and LPRIC calculations			

State formula grants. There are a number of programs that provide a payment from the state to municipalities for the loss of tax revenue due to state mandated real and personal property exemptions. Generally, these are called payment in lieu of taxes (PILOT)[13]. The payment is equal to a percentage of the amount of taxes that would have been paid if the property were not exempt from taxation. Some of the properties and programs subject to PILOT are:

- state-owned property;
- private colleges;
- distressed municipalities; and
- manufacturing machinery and equipment.

In addition, there are a number of state grants that assist municipalities in paying for various services, some are mandated (e.g., education) and others are not (e.g., town road aid). Appendix D lists the major programs for which the state provides reimbursement or grant payments to municipalities, the amount required by statutory formulas, and the amount and rate of actual reimbursement. It can be noted:

- not all PILOT programs, even when fully funded according to statutory formulas, are intended to reimburse municipalities for their entire loss of revenue due to state mandated exemptions. Consequently, municipalities receive less than they would if the exemptions did not apply;

- over the last several years, the state has not fully funded all of its grants according to the original statutory formulas. In FY 05, for example, the state reimbursed municipalities 82.5 percent of the total owed for various PILOT grants; and

- in FY 05, total reimbursement for all major state statutory formula grants, including the Mashantucket/Mohegan fund and education, was about 92 percent of what was owed under the statutory formulas.

Tax relief programs. Various state and local programs are available to provide some property tax relief for certain individuals. Several programs are targeted to totally disabled persons, the elderly, and indigent taxpayers, though the largest program, the property tax credit, applies to a broad range of taxpayers.

- *Freeze program* – The freeze program was established by the state in 1967, but because of a lack of funding it stopped accepting new applicants in 1979. This program freezes a qualified homeowner's property tax at the amount of those taxes in the year in which the person first filed for benefits. To qualify a homeowner (or spouse) must be at least 65 years of age (or be a surviving

[13] Connecticut has a specific program that is called PILOT related to reimbursements for state owned buildings, but in this document the term is used generically.

spouse must be over 50) with an annual income of $6,000 or less. In FY 05, $1.6 million was paid out by the state to 128 municipalities on behalf of 910 individual participants.

- *Circuit breaker for elderly and disabled*- This program provides a property tax credit, based on income, for homeowners who are over 65 years of age or are totally disabled and have incomes that do not exceed $27,140 for unmarried individuals and $33,000 for married couples. Credit amounts are up to $1,250 of property tax bills for married couples and $1,000 for single persons. In FY 04, $20.5 million was paid out by the state to 175 municipalities/special taxing districts on behalf of 43,657 participants. (A related program provides a grant to certain elderly and disabled renters based on income and is paid to the individuals.)

- *Local tax relief*- Municipalities have the option to provide a number of exemptions or abatements that provide tax relief to certain individuals. For example, municipalities may provide property tax relief to disabled and elderly persons not to exceed 10 percent of the total real property tax assessed. In addition, municipalities may abate the property taxes due on an owner-occupied residential dwelling to the extent the taxes exceeds 8 percent of the taxpayer's income. The owner must agree to reimburse the municipality for the amount of the taxes abated with 6 percent interest or a rate set by the municipality. Tax relief provided under these provisions is not reimbursed by the state.

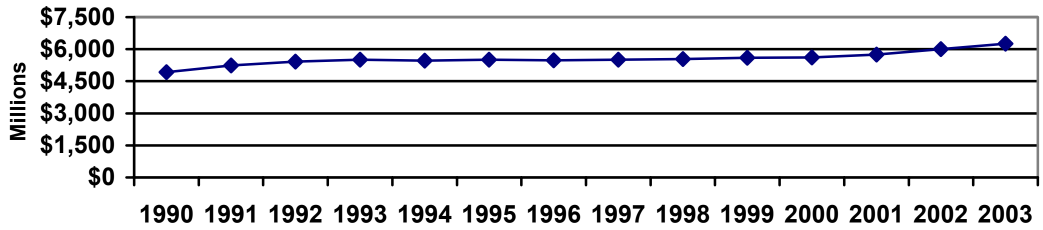
- *Property tax credit* - Since 1995, residents who pay property taxes on a residence or motor vehicles and also pay state income taxes are entitled to a credit on their income tax liability. For calendar year 2004, the maximum credit was $350. In 2003, about 943,000 filers claimed a credit through this property tax relief program at a total cost of almost $272 million.

- *Other programs* - Other non-government sponsored (but government sanctioned) options may be available to individuals, like reverse mortgages, to help elderly residents turn property equity into an income stream that can help pay property taxes.

Revenue Trends and Economic Comparisons

Local property taxes raised about $6.2 billion statewide in FY 2003, as shown in Figure II-16. Between 1990 and 2003 the amount of revenue raised from the property tax, after adjusting for inflation, increased about 27 percent as shown in the figure (from $4.9 to $6.2 billion). Over the last five years alone, the increase was about 11 percent.

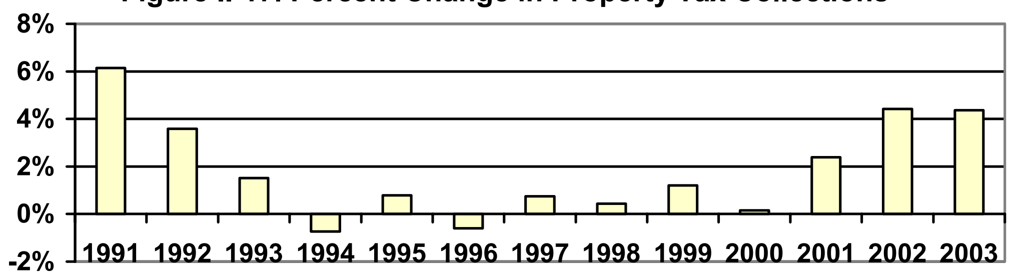
Figure II-16. Total Property Tax Revenues (2003 dollars)



Source: OPM Municipal Fiscal Indicators

The yearly changes in property tax revenues raised statewide fluctuates, as shown in Figure II-17. Over the last 13 years, the greatest yearly increase occurred in 1991 (6.14 percent). However, increases were much smaller in the mid-1990s -- and actual decreases were experienced in 1994 and 1996 with larger increases beginning in 2001.

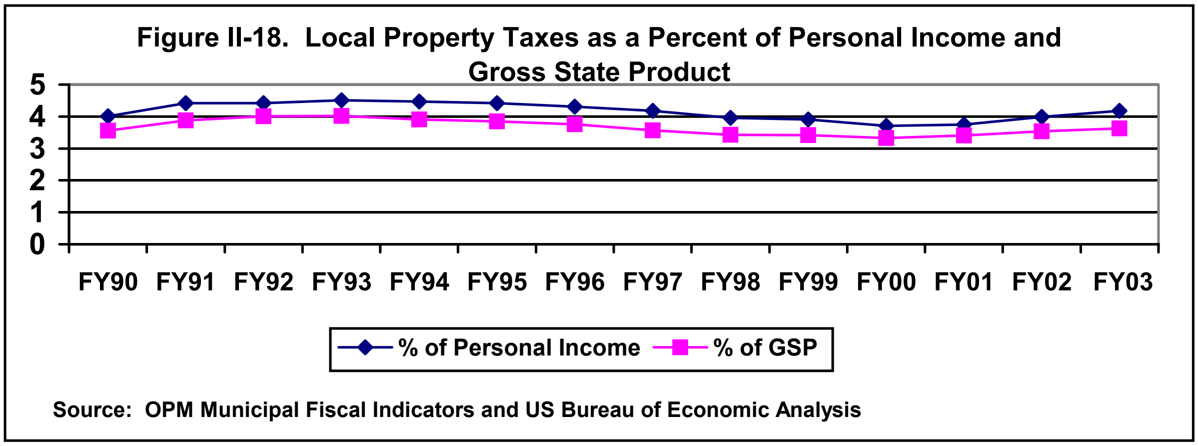
Figure II-17. Percent Change in Property Tax Collections



Source: OPM Muncicipal Fiscal Indicators

It is important to consider tax growth in terms of overall economic changes. Property tax revenues often grow in relation to a surging economy because new buildings are built, demand for housing increases, and existing property increases in value. Economic growth also leads to income growth. Consequently, comparing property tax levels as a percent of income and gross state product are more appropriate than just nominal dollar changes.

Figure II-18 presents total property tax collections as a percent of total state personal income and as a percent of the gross state product since the early 1990s. In general, property revenues as a proportion of both those measures rose slightly in the early 1990s and declined from the mid-1990s through 2000. But by 2003, both measures returned to nearly the same percentage as they began in the early 1990s.



Connecticut collects a higher percentage of personal income in property taxes than the national average. For the nation as a whole, from 1990 through 1999, property tax collections averaged less than 3.25 percent of national income. In Connecticut, the average for that time period was 4.26 percent or about 30 percent more.[14]

Other State Comparisons

The local property tax is the one of the few taxes levied in all states and is the principal source of tax revenue for local governments in all 50 states. Thirty-five states also impose a statewide property tax.[15] Connecticut does not. The following analysis compares Connecticut's property tax to the top five states, the bottom five states, and the U.S. average on a variety of comparative measures.

Table II-22. Property Taxes as a Percent of Total State and Local Taxes, FY 2002

Rank	State	Percent
1	New Hampshire	60.3
2	New Jersey	46.3
3	Maine	42.1
4	Vermont	41.9
5	Texas	41.6
9	**Connecticut**	**39.6**
	United States	30.8
47	Arkansas	15.5
48	New Mexico	15.5
49	Alabama	15.2
50	Delaware	14.9
51	Hawaii	14.5

Source: Federation of Tax Administrators based on U.S. Census Bureau 2002 State and Local Government Finances. Rankings include the District of Columbia.

[14] David Bradley, *Property Taxes in Perspective*, Center on Budget and Policy Priorities, March 17, 2005

Property tax and overall state revenue. As noted previously, Connecticut's local property tax accounts for about 40 percent of total state and local revenue and that reliance has increased recently, but is at the same level as a decade ago.

As Table II-22 shows, this places Connecticut ninth highest in state comparisons, and three of the states that rank higher have no broad-based income tax.[16] This contrasts with the situation in most states where reliance on the property tax has declined as a proportion of local government revenue as well as a proportion of combined state and local government tax revenue. Nationally, as a percent of total state and local government revenue, the property tax has decreased from about 50 percent of collections in the 1940s to about 31 percent in 2002.[17]

Property taxes per capita and compared to income. Table II-23 compares state property taxes on a per capita basis. On this measure, Connecticut ranks second highest in the nation at about $1,800 compared to the national average of about $1,000.

Table II-23. Property Taxes per Capita, FY 2002

Rank	State	Per Capita
1	New Jersey	$1,907.50
2	**Connecticut**	**$1,760.30**
3	New Hampshire	$1,755.30
4	Maine	$1,499.70
5	New York	$1,413.70
	United States	$991.80
47	Louisiana	$434.20
48	Oklahoma	$429.50
49	New Mexico	$415.60
50	Arkansas	$375.10
51	Alabama	$331.40

Source: NCSL, Ranking of State-Local Revenue and Expenditure Data, based on U.S. Census Bureau 2002 State and Local Government Finances. Rankings include the District of Columbia.

Property taxes compared to income. When property taxes are compared to personal income in Table II-24, Connecticut ranks seventh highest in the nation at $4.10 per $100 of personal income. The national average is $3.10.

[15] Daniel Tschopp, Steven C. Wells and Douglas K. Barney, *Property taxes: Trends and Alternatives*, Special Report, Tax Analysts, May 23, 2005.
[16] New Hampshire, Texas, and Alaska
[17]Tschopp, et al, supra

Table II-24. Property Taxes Per $100 of Personal Income, FY 2002		
Rank	State	**Per $100 of Personal Income**
1	Maine	$5.30
2	New Hampshire	$5.00
3	New Jersey	$4.80
4	Vermont	$4.50
5	Wyoming	$4.50
7	**Connecticut**	**$4.10**
	United States	$3.10
47	New Mexico	$1.70
48	Oklahoma	$1.60
49	Arkansas	$1.60
50	Delaware	$1.50
51	Alabama	$1.30

Source: NCSL, Ranking of State-Local Revenue and Expenditure Data, based on U.S. Census Bureau 2002 State and Local Government Finances and Bureau of Economic Analysis. Rankings include the District of Columbia.

Property taxes and local revenue. In FY 02, property taxes represented 73 percent of total taxes collected by local governments nationwide. Table II-25 reveals that Connecticut municipalities were the second most dependent on property taxes, representing over 98 percent of local tax collections, while the District of Columbia was the least at about 25 percent.

Table II-25. Local Property Taxes as Percent of All Local Taxes, FY 2002		
Rank	**State**	**Percent**
1	New Jersey	98.44
2	**Connecticut**	**98.41**
3	New Hampshire	98.00
4	Rhode Island	97.74
5	Maine	97.37
	United States	72.87
47	Oklahoma	54.31
48	Arkansas	41.87
49	Alabama	39.84
50	Louisiana	39.49
51	District of Columbia	24.89

Source: U.S. Census Bureau 2002 State and Local Government Finances. Rankings include the District of Columbia.

Table II-26. Local Property Taxes as Percent of General Own Source Revenue, FY 2002		
Rank	**State**	**Percent**
1	**Connecticut**	**83.8%**
2	Rhode Island	83.3%
3	New Hampshire	79.1%
4	Maine	77.5%
5	New Jersey	76.1%
	United States	45.1%
47	Oklahoma	29.6%
48	Louisiana	24.0%
49	Arkansas	20.6%
50	District of Columbia	19.7%
51	Alabama	16.5%
Source: U.S. Census Bureau 2002 State and Local Government Finances. Rankings include the District of Columbia.		

Property taxes as a percent of own-source revenue. Similar to many states in the Northeast, the diversity of Connecticut's municipal revenue is very limited. When local property taxes are considered as a percent of total own source local revenue (e.g., property taxes plus fees, charges, fines, etc.), Connecticut's municipalities rank first in the nation as the most dependent on the property tax, as shown in Table II-26. This is not surprising given that Connecticut is one of only 12 states that do not authorize a local option sales or income tax or both.[18]

Average property tax payments. Based on 2002 IRS data of filers who took property tax deductions, the average amount paid in property taxes in the U.S. was about $2,800. As Table II-27 shows, Connecticut ranked third in the nation with an average of about $4,400. These findings provide a limited snapshot of a national comparison because nationwide only about 35 percent of all federal filers itemize.

Table II-27. Average Property Taxes Paid by Federal Income Tax Filers Taking the Property Tax Deduction, 2002				
Rank	**State**	**Avg. Prop. Tax**	**Avg. AGI**	**% of AGI**
1	New Jersey	$5,582.32	$59,159	9%
2	New York	$4,597.02	$52,774	9%
3	**Connecticut**	**$4,429.50**	**$64,724**	7%
4	New Hampshire	$4,416.67	$49,720	9%
5	Texas	$4,088.00	$43,546	9%
	United States	$2,812.53	$45,974	6%
47	Louisiana	$1,036.65	$37,102	3%
48	Hawaii	$1,008.05	$41,329	2%
49	West Virginia	$953.56	$34,941	3%
50	Arkansas	$884.48	$35,467	2%
51	Alabama	$751.26	$38,472	2%
Source: IRS, Selected Data for 2002. Rankings include the District of Columbia.				

[18] National Conference of State Legislatures, *A Guide to Property taxes: Property Tax Relief*, November 2002.

Other significant features and differences compared to other states[19]

- *Homestead exemptions/credits*. Homestead exemptions reduce the amount of assessed property subject to taxation for residential property, while homestead credits provide a state-financed (typically) rebate to taxpayers or a credit to property owners. Fourteen states offer homestead credits, and 40 states offer homestead exemptions. Connecticut provides for a property tax credit on income tax for all filers with an income tax liability (though reduced at higher income levels) and grants limited exemptions to certain populations (e.g., veterans). Various local option exemptions are also available.

- *Circuit breakers*. Circuit breakers provide property tax rebates or credits targeted to low-income homeowners and/or renters, and to the elderly. Typically, when property exceeds a certain percentage of the taxpayer's income, states provide a rebate. Thirty-five states offer circuit breakers. Connecticut has a circuit breaker program, described earlier in this section, that targets the elderly poor and people who are disabled.

- *Property tax deferrals*. Tax deferral programs allow a taxpayer over a specified age to defer taxes until the property is sold or the taxpayer dies. The deferred tax becomes a lien against the property. Twenty-four states offer property tax deferral; Connecticut does not offer a tax deferral program, but a local option deferral program is allowed under statute.

- *Property tax rate limits, assessment limits, and freezes*. Property tax rate limits establish a maximum amount that a mill rate may increase per year, while tax freezes prevent increases in property taxes when certain conditions are met. Assessment limits curb how much assessed values may increase per year. Forty-two states have programs that limit or freeze assessed property values, property tax rates, or property taxes -- 31 have tax rate limits, 20 have caps on increases in assessed property values, and 23 have limits on property taxes. Only eight states, including Connecticut, do not have statewide limits that apply to all property taxpayers or residents.

- *Assessment ratios and differential rates*. As described earlier, municipalities typically assess property at fair market value and then multiply that amount by a percentage (70 percent for all Connecticut property, except as noted). This is called the assessment level or ratio. Eighteen states apply lower legal assessment ratios for residential property than for commercial or industrial property for the purposes of calculating taxes. Seven states apply lower property tax rates to residential property. Both practices result in shifting the local tax burden from residential owners to other property owners. In

[19] Based on David Baer, *State Programs and Practices for Reducing Residential Property Taxes*, AARP May 2003, and NCSL*, A Guide to Property taxes: Property Tax Relief*, November 2002.

Connecticut, only Hartford has a lower rate for certain residential property. In addition, forest land, open space, and other agricultural land is assessed differently.

Recent Major Changes to the Tax

- 2002 - Increases to local option property tax reductions for low income wartime veterans or surviving spouses; granted certain manufacturers in defense-dependent towns a property tax exemption, which entitles towns to partial state grant; and expanded housing projects in Adriaen's Landing eligible for property tax benefits.

- 2003 - Permitted a delay in certain revaluations so that revaluations required to be implemented as of October 1, 2003, 2004, and 2005 do not have to be performed prior to October 1, 2006; increased maximum income levels and amount of exemption for local option veteran's property tax exemptions; and created local option exemption for farm buildings.

- 2004 – Changes how forest land qualifies for tax relief; expanded optional property tax relief for certain volunteers to include canine search and rescue teams; and made various changes to veterans' and disabled exemptions.

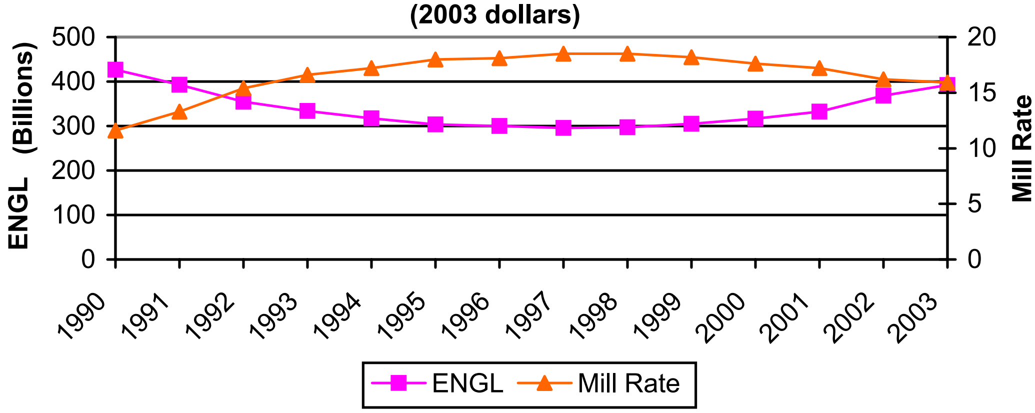
Preliminary Analysis of NCSL Criteria

Reliability/Volatility

Generally, the property tax is the most stable and reliable of all the major taxes. In simple terms, the property tax base cannot be moved, a key factor in considering stability. Volatility is measured by the annual change in growth rates and the standard deviation around the rate of annual changes over time. For the property tax, both the changes in the revenue produced and the changes in the equalized net grand list were measured. The equalized net grand list (ENGL) is the estimate of the market value of all taxable property in a municipality. It can be thought of as a measure of a town's total taxable wealth. Because towns revalue property at different times, equalizing the tax base allows for town-to-town comparisons. Although recently, there has been some rapid appreciation in property values, it usually takes several years before such changes are reflected in a town's grand list. Unlike sales and income taxes, changes in consumption patterns do not affect property tax liability.

Change in ENGL. Figure II-19 shows the value of all property in Connecticut since 1990. Inflation-adjusted property values based upon the statewide ENGL, declined through the early to late-1990s and the equalized mill rate increased. As property values rose, the equalized statewide mill rate dropped. While in Connecticut considerable variation is possible on a town-by-town basis, the total value of property has nearly recovered to its 1990 level. It is important to note that ENGL values have a built-in lag of two years; that is the FY 2003 equalized grand list represents the equalized value of the grand list in 2001.

Figure II-19. ENGL and Equalized Mill Rate 1990-2003 (2003 dollars)



Source: OPM Municipal Fiscal Indicators

As shown in Table II-28, the average growth rate for ENGL since 1990 has been 2.15 percent, though over the last five years it has been 8.3 percent and the standard deviation is 5.85.

Table II-28. ENGL: Growth Rate and Standard Deviation, 1990-2003	
Total Percent Growth for the Period	28.0%
Average Annual Percent Change Since 1990	2.15%
Average Annual Percent Change Since 1999	8.31%
Standard Deviation	5.85
Source: LPRIC calculations based on OPM municipal Fiscal Indicators	

Change in property tax revenue. As shown in Table II-29, the average growth rate for property tax revenues has been about 4.6 percent and the standard deviation of local property tax revenue growth is 2.47 percent. This means that for most of the time (68 percent) the average revenue growth has been between about 2.1 and 7.1 percent. The ENGL or what the property tax is based on has been somewhat more variable than the tax collected. This is most likely due to the slow to negative growth in the ENGL in the early to mid-1990s, compared to the more recent appreciation.

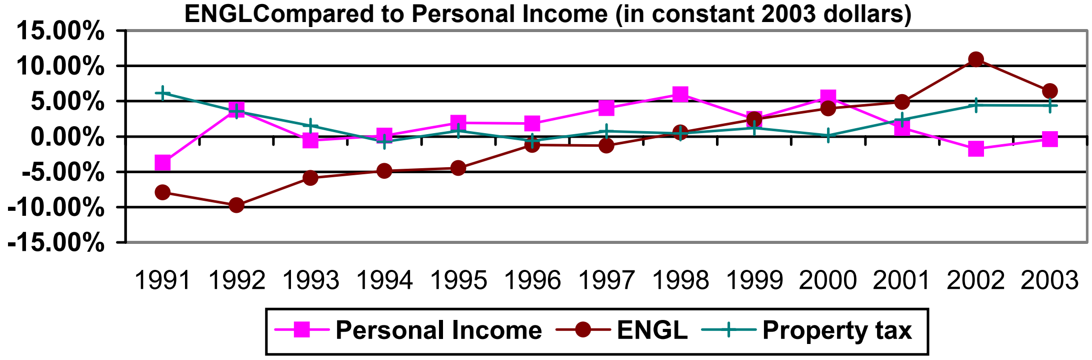
Table II-29. Property Tax Revenue: Growth Rate and Standard Deviation 1990-2003	
Total Percent Growth for the Period	59.8%
Average Annual Percent Change since 1990	4.6%
Average Annual Percent Change Since 1999	5.0%
Standard Deviation	2.47
Source: LPRIC calculations based on OPM Municipal Fiscal Indicators	

Adequacy

Adequacy is calculated by comparing overall growth in tax revenue to growth in the economy, as measured by personal income. Again, a comparison of both property tax revenues and ENGL are provided below. Figure II-20 compares the annual percent change in property tax collections and ENGL to personal income. From an adequacy perspective, ENGL measures the strength of the local tax base.

- ENGL growth is negative, in inflation adjusted terms, until 1998.
- Beginning in 2001, both the ENGL and property tax collection growth begin to outpace personal income.

Figure II-20. Annual Percent Change in Property Tax Collections and ENGLCompared to Personal Income (in constant 2003 dollars)



Source: OPM Municipal Fiscal Indicators, US Bureau of Economic Analysis, and LPRIC Calculations

The comparison can also be illustrated in actual, non-inflation adjusted terms. Table II-30 shows the comparative aggregate percentage growth in ENGL (property value), property tax collections, state personal income, inflation, and municipal expenses. Total growth in ENGL has nearly matched inflation and been about half the growth of personal income and total local expenditures. Property tax collections have exceeded the growth in income, inflation, and total local expenditures.

Table II-30. ENGL, Property Tax Revenues and Municipal Expenses: Total Percent Growth, 1990-2003	
Total Percent Growth for ENGL	28.0%
Total Percent Growth For Property Tax Revenues	59.8%
State Personal Income	55.7%
Inflation (CPI-U)	32.5%
Total Local Education Expenditures	64.5%
Total Local Operating Expenditures	41.1%
Total Local Expenditures	53.7%

Note: Total local operating expenses consist of total local expenditures less education expenditures
Source: OPM Municipal Fiscal Indicators, US Bureau of Economic Affairs, and LPRIC calculations

Equity and Tax Burden

Determining if the property tax is equitable is a complicated and difficult analytical exercise. Briefly, equity is defined in both horizontal terms -- similar taxpayers in similar circumstances have similar tax burdens -- and vertical terms -- taxpayers in different economic circumstances have different tax burdens. A regressive tax takes a larger percentage from a low-income taxpayer than from those with a high income, while a progressive tax takes a higher percentage of income from wealthier taxpayers. A proportional tax obtains a constant percentage of income across different income levels. As noted earlier, a fair tax system should minimize regressivity and the tax burden on low-income households.[20]

Views on tax burden. Economists do not agree as to whether the property tax takes a higher percentage of income from poor households than from wealthier ones.[21] There is not always agreement on how to handle certain analytical issues, such as the identity of the taxpayer and the measure of income.

- **Taxpayer**. Equity measures require a determination as to who ultimately pays the tax. The person who is legally responsible for a tax (legal incidence) may not be the person who ultimately pays the tax (economic incidence). For example, a landlord who is legally responsible for paying a property tax increase, will often pass this cost to the tenant through increased rent. Taxes on businesses and other nonresidential property can result in indirect burdens on other taxpayers, through higher prices or in lower labor earnings or capital income.

- **Ability to pay**. In addition, equity requires that tax burden be compared to the ability to pay but the definition of "ability to pay" is a knotty question. Income, like wages and pensions, is typically used as a measure of ability to pay. Many argue that wealth is a better indicator, and thus would include investments, savings, and even the value of property into the equation. Additionally, some criticize the use of annual income preferring instead long-term or lifetime income in comparing tax burden.

Old view. Generally, under the "old view," economists believe the property tax is regressive because property tax liability is not dependent on income, but on the value of property.

New view. Many economists adhere to the "new view" that the property tax is really a tax on capital. As such, it is largely a progressive tax because high-income households own a disproportionately larger share of the property stock

[20] NCSL, Tax Policy Handbook for State Legislatures, Second Edition, April 2003
[21] Ronald Fisher, State and Local Public Finance, Second Edition, and Joan Youngman, Enlarging the Property Tax Debate – Regressivity and Fairness, State Tax Notes, October 7, 2002

Benefits tax. It should also be noted that there is an alternative view that considers residential property tax a "benefit tax." This concept is based on the connection between the source of revenue (property) and the benefits received (services). The tax cost reflects the value of services received. If residents select locations based on the tax and services offered, then incidence cannot be considered separately from the provision of public services under this perspective.

The program review committee study will not resolve property tax equity measurement issues discussed above. The arguments among economists are presented to critically inform the analysis that follows in that they may contribute to a fuller but imperfect understanding of how property tax burden is distributed. The results of two recent studies are presented along with basic measures of property tax burden. One study examines how taxes relate to income groups on a statewide basis, while the other study and subsequent measures calculated by program review staff relate taxes to towns arranged by household income and per capita income.

ITEP study. The Institute of Taxation and Economic Study of incidence of state and local taxes in Connecticut in 2002, discussed in Section 1, shows that the property tax is regressive as measured by the impact on different income groups. The lowest 20 percent of families pay 3.8 percent of income on property taxes, while the top 1 percent of taxpayers pay 1 percent of income toward property taxes.

Connecticut Economy study. A study authored by James Stodder and published in the Connecticut Economy (Fall 2002) examined Connecticut's property taxes in relation to property wealth and household income. The study concluded that the property tax in Connecticut was regressive with respect to wealth – towns with higher property values pay a lower rate – but rates were nearly flat when considered in relation to household income.[22]

Table II-31 Property Taxes per Capita, 2003

Per Capita Income Decile	Residential Portion per Capita	Total Property Tax per Capita
First	$671.95	$1,279.75
Second	$876.84	$1,357.37
Third	$850.86	$1,389.80
Fourth	$1,059.51	$1,577.30
Fifth	$1,163.53	$1,673.31
Sixth	$1,259.29	$1,888.29
Seventh	$1,423.57	$1,935.57
Eighth	$1,492.09	$2,202.45
Ninth	$1,794.73	$2,330.62
Tenth	$2,591.68	$3,125.47
Statewide	*$1,261.18*	*$1,785.16*

Source: OPM Municipal Fiscal Indicators, Connecticut Economic Resource Center, and LPRIC calculations

[22] James Stodder, *How Regressive Are Connecticut's Property Taxes*, The Connecticut Economy, Fall 2002, page 8.

Other tax burden calculations. Using another approach to analyze the burden of the property tax, committee staff grouped Connecticut municipalities by their 2003 estimated per capita income levels by deciles, ranging from the lowest (first) to the highest (tenth). Each decile contains 17 towns except the first, which has 16. Recalling the caveats above, per capita income is often used as a measure of ability to pay. All tables compare burden based on total property taxes in each town, and some tables separate the taxes paid on residential property. Generally, separating the residential portion provides some indication of the tax burden borne *directly* by residents versus business in a particular town.

Property taxes per capita. One of the simplest measures of tax burden is property taxes for each individual in a town or "per capita." Table II-31 shows total property taxes per capita rise from about $1,280 in the first decile to $3,125 in the tenth. The pattern is the same when just residential property is considered. This may reflect the fact that towns with high income may purchase more public services per capita than poorer towns and are more likely to pay for those services from the property tax.

Property taxes as percent of ENGL. Tax burden can also be expressed as a ratio of taxes paid to the equalized value of property (ENGL) in each town. This percentage is also referred to as the effective tax rate. By calculating tax burden on an equalized basis, valid comparisons can be made across jurisdictions, which revalue property in different years. The equalized value may also be viewed as a measure of wealth, and thus, also a measure of a town's fiscal capacity.

Table II-32. Property Taxes and Equalized Value, 2003

Per Capita Income Decile	ENGL Per Capita	Property Tax as Percent of Equalized Value (Effective Total Tax Rate)
First	$53,222	2.40%
Second	77,385	1.75%
Third	89,692	1.55%
Fourth	98,354	1.60%
Fifth	107,056	1.56%
Sixth	131,731	1.43%
Seventh	134,073	1.44%
Eighth	174,251	1.26%
Ninth	159,959	1.46%
Tenth	366,458	0.85%
Statewide	*$127,435*	*1.40%*

Source: OPM Municipal Fiscal Indicators, Connecticut Economic Resource Center, and LPRIC calculations

Table II-32 lists the value of the equalized net grand list by decile on a per capita basis and property taxes as a percent of ENGL. Generally, the ENGL per capita, or fiscal capacity, increases across all income deciles. The table shows the property tax as a percentage of equalized value at the lowest decile is 2.4 percent and at the highest is 0.85 percent. The bottom five deciles have higher effective tax rates (percentages) than the top five deciles. Therefore, towns with higher per capita income tend to have a lower effective tax rate.

*Property taxes in relation to income***.** Another measure used to assess tax burden in Connecticut towns is to compute property taxes per $1,000 of personal income. This measure uses income, not wealth, as an indicator of ability to pay on a town-wide basis. This differs from the ITEP study, which compares burden on an individual basis.

Table II-33. Property Taxes and Income, 2003		
Per Capita Income Decile	**Residential Property Taxes per $1,000 of Income**	**Total Property Taxes per $1,000 of Income**
First	$37.23	$70.91
Second	$37.80	$58.51
Third	$33.70	$55.04
Fourth	$38.47	$57.27
Fifth	$40.41	$58.12
Sixth	$40.86	$61.26
Seventh	$42.86	$58.27
Eighth	$40.21	$59.36
Ninth	$42.73	$55.49
Tenth	$37.72	$45.49
Statewide	*$40.48*	*$57.30*
Source: OPM Municipal Fiscal Indicators, Connecticut Economic Resource Center, and LPRIC calculations		

The ratios in Table II-33 are calculated based on the aggregate of taxes of all the towns in each decile, divided by the aggregate of all income earned by all the residents in those towns. The table shows, except for the top and bottom deciles, total property taxes per $1,000 of income is not related to income. In comparing the top to the bottom deciles, though, the tax appears regressive.

However, residential property taxes per $1,000 of income appear fairly proportional across the deciles. It is important to note that the effect of federal tax deductions and credits may alter the outcome of this finding to the extent higher-income families are more likely to take such deductions.

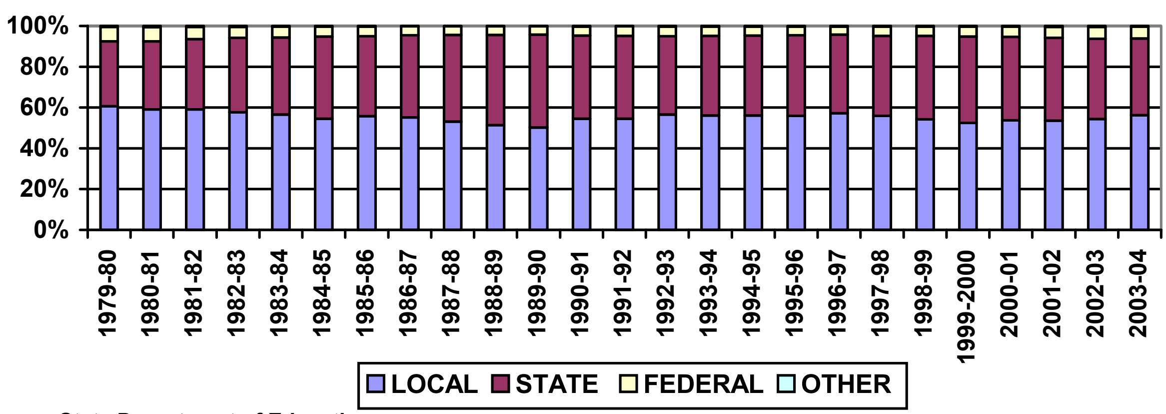
Property tax and education tax rate. As Table II-34 shows, on average, education expenses, by far, are the largest single expenditure for Connecticut municipalities. In 2002, 57 percent of all municipal expenditures went to education. It is useful to consider the impact of education expenses on the mill rate among municipalities on a relative basis.

Table II-34. Municipal Spending in Connecticut by Function				
	Fiscal 2001	**Percent of Total**	**Fiscal 2002**	**Percent of Total**
Education	$4,717.5	56.7%	$5,014.4	57.1%
Public Works	649.3	7.8	669.0	7.6
Debt Service	617.2	7.4	664.4	7.6
Police	551.1	6.6	569.4	6.5
Fringe Benefits	505.2	6.1	530.0	6.0
General Government	300.2	3.6	324.5	3.7
Fire	315.6	3.8	320.4	3.6
Other Expenditures	204.5	2.5	206.2	2.3
Parks & Recreation	141.8	1.7	148.6	1.7
Health & Social Services	137.0	1.6	142.9	1.6
Libraries	111.6	1.3	118.4	1.3
Planning & Development	71.7	0.9	72.2	0.8
Total Expenditures	**$8,322.70**	**100.00%**	**$8,780.50**	**100.00%**

Note: Based on budgeted amounts
Source: Connecticut Policy and Economic Council, *Connecticut Municipal Profiles,* 2001/2002 (most recent years available)

Even though education is a state responsibility and towns receive some financial assistance from other sources, the majority of funding for education in Connecticut has and continues to come from local government sources. As shown in Figure II-21, in FY 04, local governments contributed 56 percent of total education costs, while the state contributed about 38 percent and the balance was from the federal government and other sources. Furthermore, the state share has been declining. In FY 00 the state share was 42 percent, and in FY 90, it was nearly 46 percent.

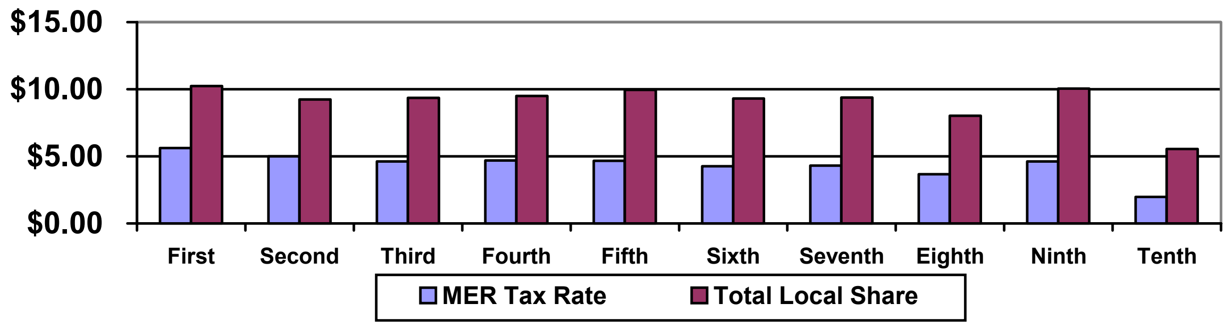
Figure II-21. Local,State,Federal and Other Share of Education Revenues, 1980-2004



Source: State Department of Education

Education mill rate. The local share of all current education expenditures was obtained from the State Department of Education for each town in the state in order to compare relative educational effort among towns. These local expenses were divided by each town's ENGL to determine each town's education mill rate on an equalized basis. This represents a measure of tax effort for education, the largest municipal expenditure.

Figure II-23. Equalized Mill Rate for Total Local Share of Education Expenses and MER by Wealth Decile, 2003



Source: State Department of Education, OPM Muncipal Fiscal Indicators, and LPRIC calculations

Figure II-23 shows the rate by decile for the local expenses that support the minimum education requirement (MER) and for total regular local education expenses. The MER represents the minimum level school districts are required by the state to spend in certain areas. The MER consists of all regular public elementary and secondary educational expenditures except those related to special education, state and federal grants (except ECS and federal impact aid) transportation, most construction and debt service expenditures, and adult education.[23] Total local education expenses represent all expenditures above the MER, including special education and transportation. All municipalities spend above the minimum.

The tax rate to support the *MER* is highest in the lowest five income deciles compared to the highest income five deciles. The tax rate to support *total* local education expenditures is lowest by far in the top decile; it is well below all other income deciles and nearly half that of the first decile.

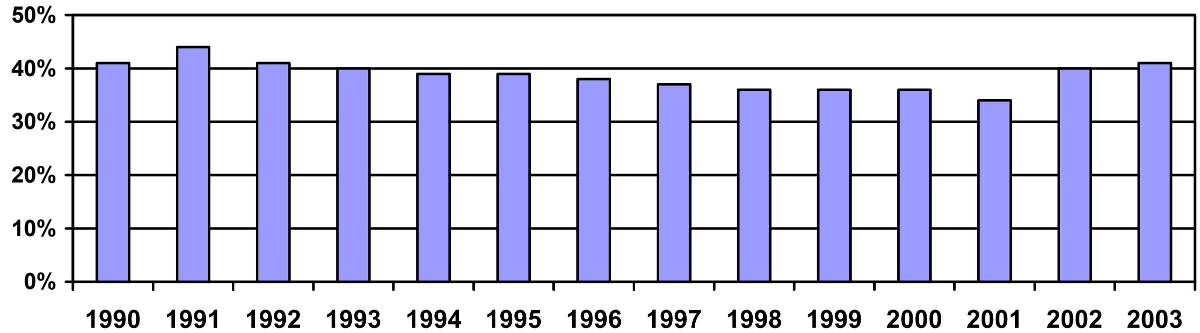
Balance

Connecticut is very reliant on the property tax as a source of total state and local government revenue. Property tax as a percent of all tax revenues reached its high point in 1991 with almost 45 percent of all revenues coming from local property taxes, as illustrated in Figure II-24.

[23] The ECS grant has been subtracted from the MER amount for each town to isolate local expenses. Federal impact aid is funding given directly to towns to offset costs for students who reside on federal tax exempt land.

The percentage of all revenue raised by local property tax leveled off during the mid-to late-1990s and reached its low point in 2001 when less than 35 percent was raised by the local property tax. However, this trend changed dramatically during 2002 and 2003, with local property tax accounting for more than 40 percent of all state and local revenue. Still, this is the same percentage as a decade ago.

Figure II-24. Property Tax as a Percent of State and Local Government Taxes



Source: Comptroller Annual Reports, OPM Muncipal Indicators, and LPRIC calculations

Fairly Administered/Accountable/Promotes Compliance

Proper tax administration means that tax burdens are distributed among taxpayers according to the way the law intended. Professional administration enhances effectiveness of the system and improves taxpayer compliance. An accountable tax system requires that tax laws be explicit. Proposals for change must be well publicized and allow for citizen input. Overall, compared to other taxes, the property tax is fairly easy to administer and to comply with. The tax base is largely immobile and is difficult to hide, unlike income and sales transactions. The tax is accountable to taxpayers because it is due annually and the exact amount of the tax is known.

Administration. Problems with property tax administration usually relate to valuation.[24] The responsibility for property assessment in Connecticut is assigned to the town assessor. The state's role, through the Office of Policy and Management, is to certify and regulate revaluation companies, ensure revaluations are completed, and provide technical assistance to municipal assessors. There is also an appeals process that requires each municipality to maintain a Board of Assessment Appeals. Each assessment appeal typically begins with an informal meeting with the firm or town assessor conducting the assessment. The taxpayer may also continue his appeal to the Board of Assessment Appeal, and, if not satisfied with the board's decision, may appeal to the Superior Court.

[24]Several studies of Connecticut's tax system (at least eight) from 1959 through 2004 have found problems with the assessment process.

A fairness issue arises in the administration of the property tax as it relates to assessment practices. The state used to require that real property be assessed every 10 years. In 2003, the law was changed to require at least a statistical update every five years and at a minimum a physical revaluation every 10 years. The legislature has delayed full implementation of this requirement. Personal property and motor vehicles are revalued every year. Because most personal property owned by individuals is exempt, this tax is mostly a tax on business personal property.

It is important to note that changes in the real estate market during the time between revaluations will result in assessments that vary from the required 70 percent assessment ratio – that is assessed at 70 percent of market value. This means that tax burden shifts among, and even within, classes of property will not be recognized in a timely manner. Because real property is revalued on a five to 10-year cycle and business personal property is revalued annually, a shift in tax burden will occur between these classes of property each year since one mill rate is applied to all property within a town. If real estate values are increasing between revaluations, then real property is under-assessed and business personal property and motor vehicles assume a greater share of the tax burden. If real estate values decrease, then real property is over- assessed and assumes a greater share of the tax burden.

Promotes compliance. Taxpayer compliance with the property tax is straightforward. In Connecticut, the property tax collection rate for 2003 was 97.8 percent and is typically the highest rate of all taxes. It is the only tax where the government computes the value of the asset (and base) and the tax due. Unlike the income tax, the tax bill does not require the completion of forms; it is generated automatically and does not require the assistance of an accountant. If the taxes go unpaid, the government can place a lien on the property and can ultimately seize the property. In addition, payment of the property tax for many taxpayers occurs automatically thorough a mortgage company or bank when they pay their mortgage.

Accountable. Nearly all aspects of the property tax are transparent. Taxpayers know the amount, frequency, and purpose of this tax. The assessment process is open, as anyone can compare the value of a neighbor's or similar property, and the option to appeal is available. The high visibility of the tax, though, is believed to be associated with the public's discontent with it. One of the unique aspects of the property tax is that taxpayers often have an opportunity to influence the tax rate through referendum. The tax's high visibility ultimately allows citizens to evaluate and have direct input into the cost of their local government.

Connecticut municipalities have been increasing the use of referendum to adopt their budgets. In 2004, 62 municipalities adopted their budgets by referendum, while in 1999, only 48 did. In 1994, the number was 50. In addition, the number of votes taken to approve a budget has increased. In 2004, for all methods of final budget adoption (e.g., town meeting, referendum, council, representative town meeting, and other), 22 percent of municipalities took more than one vote to approve a budget, while in 2000 only 10 percent took more than one vote.

Economic Competitiveness

Typically, economic competitiveness refers to the effect of taxes on the business climate and usually has more connection with state taxes and interstate competition. However, the state has a number of major and minor property tax exemptions that are intended to provide tax relief to businesses and improve overall state competitiveness. The exemptions include:

- business inventories of manufacturers and wholesalers/retailers;
- manufacturing machinery and equipment;
- commercial trucks, truck tractors, tractors, and semitrailers; and
- cable television service companies.

Connecticut has also attempted to level the playing field a bit between manufacturers, who tend to use expensive machinery in the production process, and service and knowledge-based firms, with the five-year exemption of manufacturing equipment.

Neutral

Ideally, tax policy should minimize its impact on the economy and should not attempt to influence taxpayer behavior. As the nature of business changes to a more knowledge-based economy, there is the potential for property-intensive businesses, such as manufacturing to carry a larger tax burden because many modern businesses no longer need extensive real property holdings. Connecticut's system introduces a level of neutrality by not taxing the intangible property of service firms, such as patents and copyrights, and allowing for a credit for manufacturing machinery and equipment, as discussed above.

Connecticut also generally avoids the use of multiple classifications systems that are employed in many states. Classification systems establish different taxable values of properties depending on the type of property, which typically means commercial property is taxed at a higher effective rate than residential property, unfairly shifting the burden from one segment of taxpayers to another.

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Profile of the Corporate Income Tax

Background

In 1909, Congress passed a federal corporate income tax. By 1930, approximately 20 states (including Connecticut) had imposed a similar tax, and by 1940, about 35 states had levied a tax on the income of corporations. Connecticut is one of 45 states that currently impose a state corporate income tax.

Who Pays the Tax: Any corporation (or association taxable as a corporation) that carries on a business or has the right to do so within Connecticut, must file a Connecticut corporation tax return. There are certain types of corporations and businesses that are ***exempt from filing*** and others that must file a return but are ***exempt from paying*** the tax. Table II-34 below summarizes these categories.

Table II-34. Corporation Tax: Businesses Subject to Tax and Businesses Exempt

Subject to Tax	Exempt*/No filing required	Exempt but Must File

These companies must file a corporation tax return
 	
• Companies conducting business in Connecticut, and not organized as a business entity that is specifically exempt
• Conducting business typically includes:
    o owning or leasing property, or maintaining an office
    o having employees (or independent contractors) perform business or business-related activities in CT
• Any corporation dissolved or withdrawn from CT is subject to the tax until date of dissolution
	These companies are exempt from filing a return and paying the tax:
	
	• Insurance Companies
	• Companies (e.g., non-profits) exempt under the federal corporation tax law
	• Certain types of investment companies (e.g., those owned by savings banks or non-U.S. corporations whose sole activity is trading in stocks, etc. for their own account)
	• Cooperative housing corporations defined in federal law
	• Railroad companies
	• Subchapter S corporations and pass-through entities like limited liability corporations (LLCs) and limited liability partnerships (LLPs)
	• Domestic international sales corporations (DISCs) that make that election under federal tax laws
	
	** Many of these are exempt from the corporation business tax but are subject to another type of business tax. See below.*
		These companies must file a return in order to claim the exemption from paying the tax:
		
		• Homeowners associations (a federal income tax designation)
		• Certain political organizations and associations exempt from federal income taxes
		• Financial service companies whose corporate headquarters are located in the export zone in the City of Hartford and who conduct all their business outside the U.S.
		• Passive investment companies, as defined in statute, typically related to qualifying real estate mortgage loans
		• Independently owned companies engaged in research and design of alternative energy systems or electric-powered motor vehicles

How the Tax is Calculated

Nexus. Before the corporation tax is calculated, it must be determined whether or not the business is actually subject to the tax. The state must establish that the company has sufficient business presence -- either that it is registered in Connecticut as a corporation, or if organized out-of-state, that the company has business contact within Connecticut (i.e., **nexus** – to be required to pay the tax). While nexus is continually being redefined by case law, it typically includes companies with the characteristics listed in Table II-34.

Starting base for tax. Typically, states use two methods as a starting point to determine corporate tax liability, either: 1) a corporation's federal taxable income before net operating loss and special deductions; or 2) the corporation's net federal taxable income. Connecticut uses the first.

Federal returns. Connecticut is one of 27 states that requires a corporation to file its federal income tax return with its state corporate income tax return. A corporation must use the same accounting methods and accounting periods for Connecticut as it does for its federal income tax. In Connecticut, corporations that file a federal return must generally file their state tax returns by April 1st.

Payments. Any corporation whose estimated current year tax liability is $1,000 or more must make four estimated payments on the 15th of March, June, September, and December. These prospective payments are required to be a certain percentage of the company's prior or current year's tax liability. Once the company files its return, the estimated payments are reconciled with the amounts owed on the return, and the company either receives a refund or must make an additional payment to reach the total tax owed.

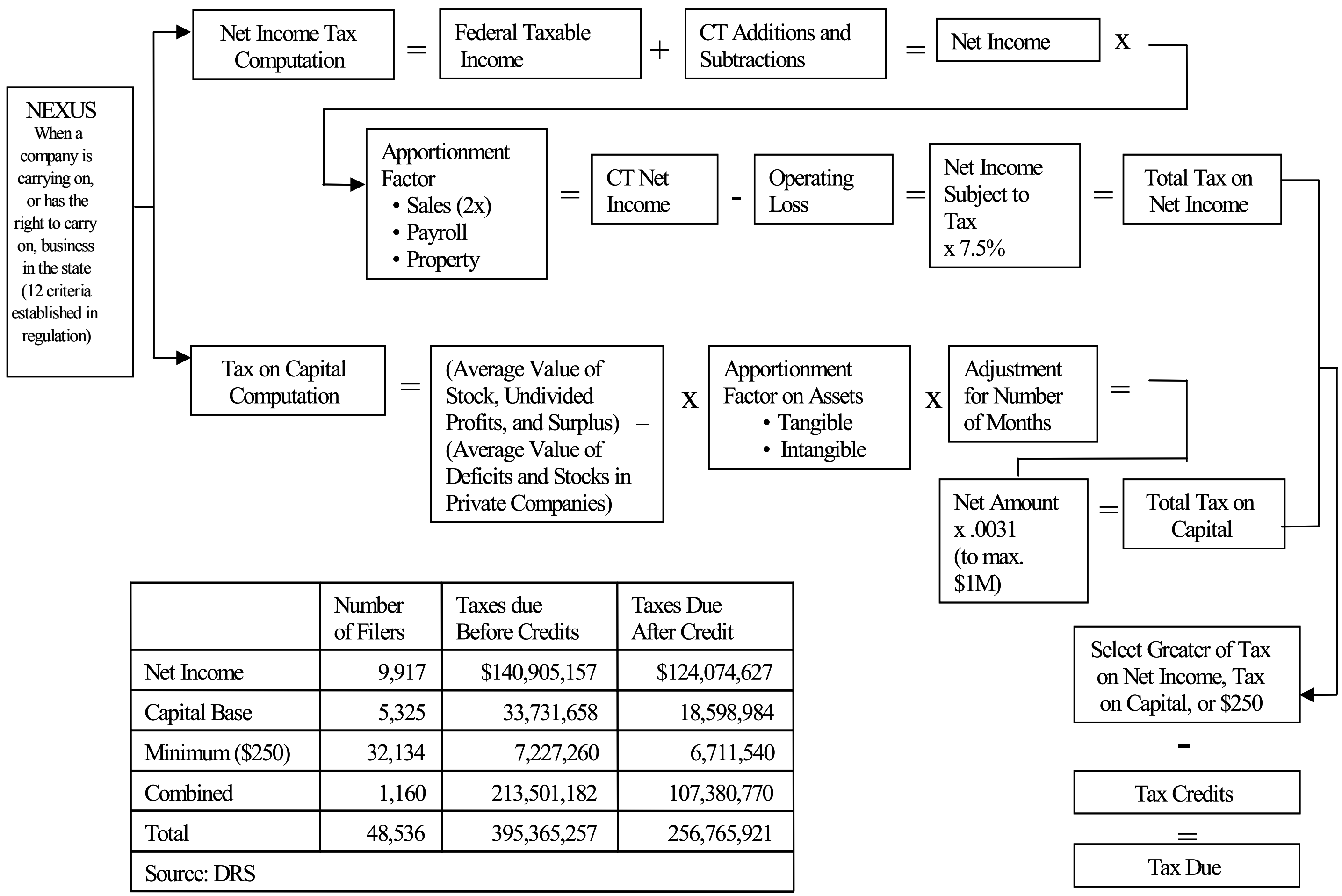
Tax Calculation Method

Many steps are taken in calculating corporate income in order to finally arrive at the amount of tax owed in Connecticut. (See Figure II-25).

Business vs. non-business income. First, business income must be separated from non-business income. The nature of a businesses income is important in the determination of nexus and in the apportionment factor discussed below. In Connecticut, all income is considered business income by statute.[25] Some states use the Uniform Division of Income for Tax Purposes Act (UDITPA) approach that allows companies to allocate or apportion all business income among the states where the company does business (i.e., has nexus) and allocate all non-business income to a single state (e.g., where it is domiciled). Still others states use the Multistate Tax Commission definition which presumes all income to be of a business nature, with the onus on

[25] Income determinations are also subject to extensive state and federal case law.

Figure II -25. Connecticut Corporate Income Tax



	Number of Filers	Taxes due Before Credits	Taxes Due After Credit
Net Income	9,917	$140,905,157	$124,074,627
Capital Base	5,325	33,731,658	18,598,984
Minimum ($250)	32,134	7,227,260	6,711,540
Combined	1,160	213,501,182	107,380,770
Total	48,536	395,365,257	256,765,921
Source: DRS			

the taxpayer to show that it is not. To some extent, these efforts provide uniformity among the states with respect to the taxation of multistate corporations.

Table II-35. State Comparison of Carryforward Periods for Companies' Net Operating Losses	
Carry forward period	Number of states (N= 44)
5 years	8
7 years	2 (NJ suspended this for 2002 and 2003)
10 years	3
12 years	1
15 years	8
20 years	19 (includes CT)
Source: 2004 Multi-state Corporate Tax Guide, Aspen Publishers	

Net operating losses: Because of the cyclical nature of many businesses, the IRS code generally allows net operating losses (NOL) on federal returns to be carried back two years and carried forward for up to 20 years. States may adopt the federal treatment of net operating loss, but states also have the option of adopting their own variations, as shown in Table II-35. For example, 24 states, including Connecticut, do not allow carry back periods. All states allow carry forward periods although three states limit the definition of an NOL, and New Jersey suspended the carryforward allowance for two years. Obviously, longer carryforward periods mean longer periods to write off losses, and thus lessen tax liability. Table II-35 shows the number of states using various carry forward periods.

Apportionment. Once the net income for the corporation is established – from the federal tax form -- it is necessary to calculate what portion of the income can be attributed to the taxing state (and therefore taxed). Most states use an apportionment formula based on three factors -- 1) payroll; 2) property; and 3) sales. Some states equally apportion among the three factors, but 24 states double-weight the sales factor, and another few states use only the sales factor. This use of sales as the only factor, or giving it extra weight benefits those corporations that have a significant physical presence in the taxing state, by lessening the weight of payroll and property in the formula.

Apportionment Formula: Connecticut uses the three factors -- with sales double-weighted – for most businesses, but uses sales as the only factor for three major business categories:

- Manufacturers;
- Broadcasters; and
- Financial service companies.

The sales factor requires a company to compare its sales in the taxing state with it sales the nation as a whole, but corporations can attribute these sales to states where they have no taxable nexus or where there is no corporation tax, These sales, called "nowhere" sales, are not taxable in a state that requires a corporation to subtract its nowhere sales from its total (*throwout)* or add those sales back into the total in the taxing state (*throwback*). In either case, the relative weight of the in-state sales is increased and so is the taxable income apportioned in the taxing state. Connecticut uses neither -- see Table II-36 for which states use.

Filing: Some states require combined (unitary) reporting, where all income from an affiliated group of businesses is combined together and then apportioned to all states where the companies do business. Connecticut does not require combined reporting, but does allow it. If a corporation chooses to file a combined return, the corporation is assessed $25,000 as a return preference surcharge. (See Table II-36 for state comparison of filing requirements)

Rate. Connecticut is one of 32 states that has a flat corporate income tax rate. It currently is 7.5 percent of net taxable income. (see table for state comparison)

Alternative calculations. Connecticut requires that corporations calculate their taxes two ways – on net income and on capital -- and pay the higher of the two amounts. However, if both amounts are less than $250, the corporation must pay the alternative minimum of $250. See Figure II-25 for calculation description.

Major Changes in Corporate Income Tax Since 1992

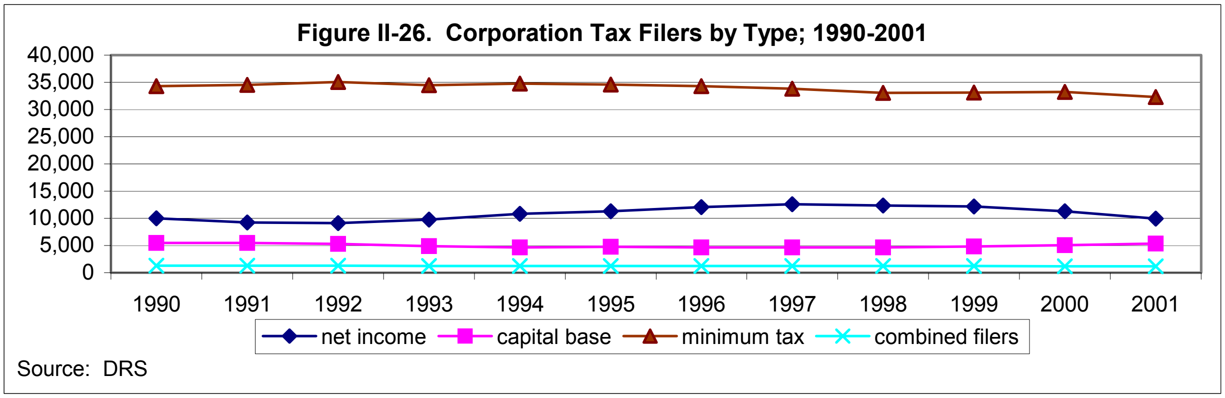
- **Rates** reduced from 11.25% in 1995 to 7.5% in 2000 (remains at that rate in 2005)
- **Surcharges** assessed in the early 1990s; reduced from 25% to 10% as of 1/1/92: eliminated 1/1/93; 20% surcharge resumed in 2003; 25% in 2004; none in 2005, but 25% will resume in 2006 and 2007. Surcharges are calculated before reductions for credits.
- **Single factor apportionment:** allowed for financial service companies (1998) and for manufacturers and broadcasters (2001)
- **Carryforward period:** for net operating losses extended from 5 years to 20 years (1999)
- **S-chapter corporations** exempt from the corporations tax (2001). Now considered a business entity – all S corporations and other entities like LLCs and LLPs that file an annual report with the Secretary of the State must pay a $250 business entity tax (2002). Rate increased to $300 in 2003; reduced to $250 for 2004 and thereafter.

Trends in Filers and Revenues

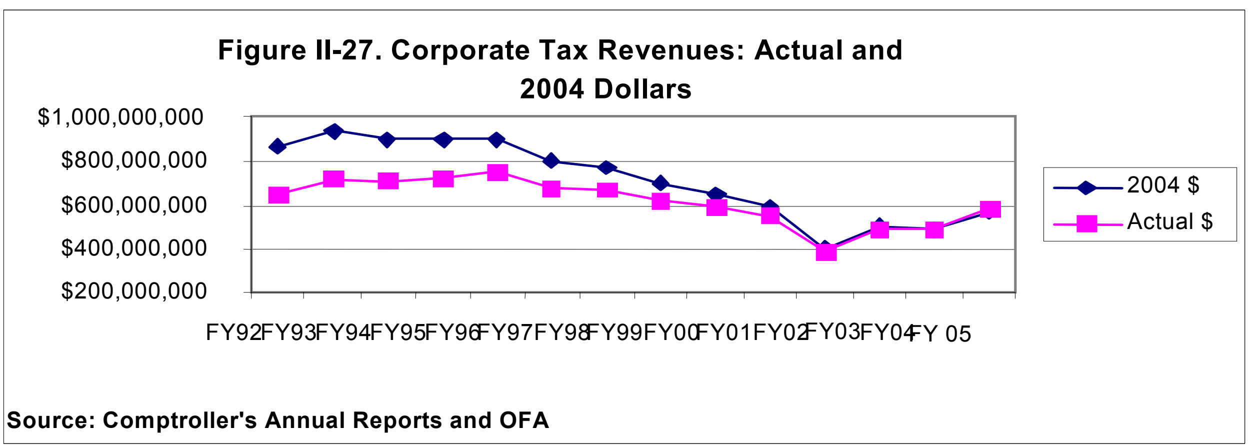
While corporate income tax revenues are available through FY 05, numbers on corporate filers by type are available only through 2001 (from DRS' last annual report for 2002-03). The trends in corporate revenues and filers are reflected in the figures below.

Filers. Figure II-26 shows the filers by type. DRS categorizes filers according to the method they use to calculate the taxes they owe: 1) net income; 2) capital base; 3) alternative minimum; or 4) combined filers. As the figure shows, by far the largest category (typically about two-thirds of filers) includes corporations paying the alternative minimum tax of $250, while the smallest number of filers is in the combined return category; that number remained relatively stable at between 1,000 and 1,200.[26]

[26] Committee staff excluded the subchapter S corporations from the analysis of corporation filer trends since these were always kept separately, and this category became exempt from the corporation tax in 2001; thus to include



Revenues. As Figure II-27 illustrates, corporate income tax revenues in Connecticut have been declining. In actual dollars, the amounts collected have declined from more than $700 million in the mid-1990s to a low of less than $400 million in FY 02, before recovering somewhat to almost $600 million in FY 05. The decline in corporate income tax revenues is more extreme if it is adjusted for inflation (measured in 2004 dollars). If measured in this way, the corporate revenues would have been worth almost $1 billion at its high point in FY 93. Many reasons are cited for the decline in revenues collected including the reduction in rates and changes in the apportionment formula. The application of the corporate income tax on subchapter S corporations was phased out over a four-year period. The Office of Fiscal Analysis has estimated that this phase out has cost between four and $7.5 million from 2000 to 2002. Another major reason is the expansion in the number and use of business tax credits discussed below.



Other Business Taxes

There are 12 other specific taxes, grouped in five categories described below, which are assessed against various types of businesses or business activities. In FY 04, collections for these individual taxes ranged from about $275,000 for the tax on railroads to $140 million for the

them would have shown a dramatic decrease in filers between 2001 and 2002 due solely to a legal change in the exemption status.

tax on foreign insurance companies (i.e., companies chartered in another state). The 12 taxes combined amounted to about $595 million in FY 04, about the same as the revenues collected from the corporate income tax. Except for the business entity tax and the tax on insurance premiums, each tax affects less than 700 companies. Figure II-28 shows the trends in collections for these taxes since 2001.

- *Unrelated Business Taxable Income Tax* – Any nonprofit corporation is liable for any business income that does not substantially relate to its tax-exempt purpose. Similar to the corporate tax, a rate of 7.5 percent is levied on the net income from the unrelated business activities. In FY 03, only 241 organizations paid this tax, and the revenue totaled $903,944.

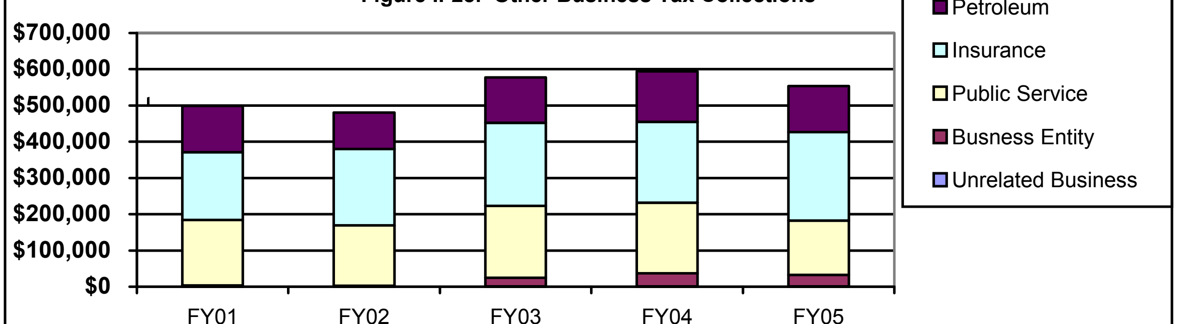
- *Business Entity Tax* – Corporations defined as limited liability companies, limited liability partnerships, limited partnerships, or S corporations are required to pay $250 annually. (In calendar year 2003, the tax rose to $300, and returned to $250 in 2004) In FY 03, 96,280 entities paid a total of $24,071,137.

- *Public Service Companies Tax* – This variable tax is imposed on the gross earnings of railroads (2-3.5 percent); gas and electric utility companies (4-8 percent); and express (2 percent), telegraph or cable (4.5 percent), and community antenna television system companies (5 percent). In FY 03, 117 companies paid a total of $197,959,721.

- *Insurance Premiums Tax* – Both authorized and unauthorized insurers as well as health care centers are required to pay a special tax referred to as the insurance premiums tax. Domestic and foreign insurance companies pay 1.75 percent of net direct premiums, while unauthorized insurers (i.e., an insurer operating without a valid certificate of authority) are taxed at 4 percent of gross premiums. Health care centers pay 1.75 percent of net direct subscriber charges. In FY 03, 1,400 companies paid a total of $229,484,101.

- *Petroleum Gross Earnings Tax* – The gross earnings of companies distributing petroleum products (e.g., gasoline, aviation and diesel fuel, crude oil, benzol, and petroleum derivatives such as paint detergents, fertilizers, and plastics) are taxed at 5.8 percent. After July 1, 2006, the tax will increase in increments to 8.1 percent on July 1, 2013. In FY 03, 660 companies paid a total of $125,451,235.

Figure II-28. Other Business Tax Collections



Source: DRS Annual Reports for 2001-2003 and DRS Draft Monthly Statement June 2004 and June 2005

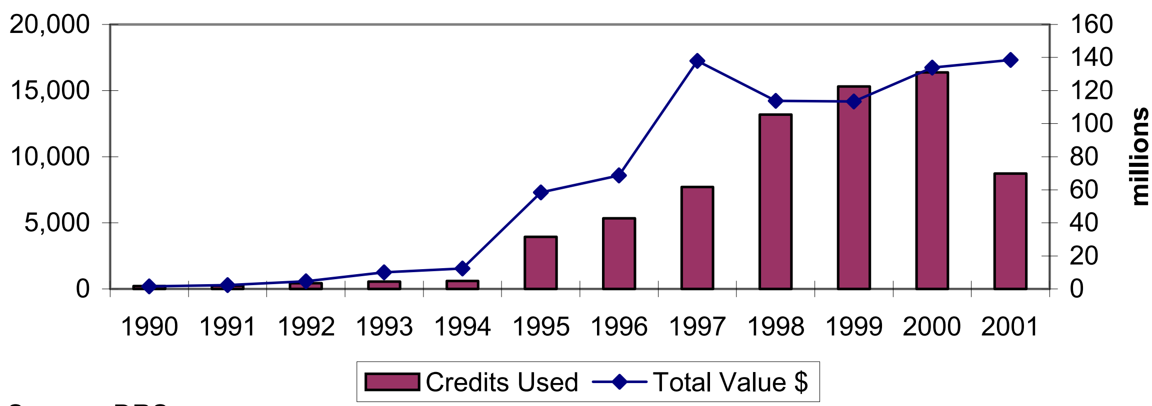
Corporation Tax Credits and Use

Connecticut, like most other states, has introduced and expanded the use of tax credits as a way of reducing a corporation's tax liability. The intended purpose of such credits is to promote economic development, foster certain types of business growth, and promote jobs.

Credits. Currently**,** Connecticut has 26 different business credits. The three most-used -- the research and development credit, the fixed capital investment credit, and the credit for property tax paid on electronic data processing equipment—account for more than three-quarters of the value of all credits. There is no limit on the number that can be used but deductions from credits cannot reduce the company's tax by more than 70 percent of the tax without credits. Further, companies cannot reduce tax liability pay below the $250 minimum. The credits must be taken in a certain order, and the DRS commissioner may disallow use of credits if the company owes any back taxes, interest or penalties.

Credit use. Figure II-29 shows the use of all credits by all Connecticut corporations since 1990. As the figure depicts, both the number of credits used and the total value have grown dramatically. The number of credits used dropped substantially in 2001 although the value of the credits did not. This decline was because S-corporations, which had been allowed to take the credits prior to 2001, no longer had to pay the corporation tax so are ineligible for the credits.

Figure II-29. Business Tax Credits -- Number Used and Total Value: Years 1990-2001



Source: DRS

Corporate Tax: State Comparison of Selected Features

Table II-36. Selected Features of Corporate Tax Structures: A State Comparison						
State	Rate(s)	Amt Collected as % of GSP (2003)	% Reduced* FY 89 - FY 03	Reporting Requirements**	Throwback of Sales	% Change in GSP 1999-03
Alabama	6.5	.18	-44	C NR	Yes	15.4
Alaska	1 - 9.4	.65	-69	C R	Yes	26.1
Arizona	6.98	.22	-27	C R	No	21.4
Arkansas	1 - 6.5	.24	-23	C NR	Yes	14.2
California	8.84	.47	-34	C R	Yes	20.2
Colorado	4.63	.11	-56	C R	Yes (certain factors)	19.1
Connecticut	7.5	.20	-77	C NR	No	15.5
Delaware	8.7	.47	-45	C NA	No	21.8
DC	9.975	.34	-19	C NR	Yes	24.3
Florida	5.5	.25	-17	C NR	No	22.4
Georgia	6	.15	-62	C NR	No	15
Hawaii	4.4 - 6.4	.06	-80	C R	Yes	20.2
Idaho	7.6	.23	-49	C R	Yes	21.1
Illinois	8.5	.34	-18	C R	Yes	11.8
Indiana	8.5	.17	-38	C NR	Yes	13.9
Iowa	6 –12	.14	-64	C NR	No	17
Kansas	4	.14	-68	C R	Yes	16.6
Kentucky	4 – 8.25	.22	-56	C NR	No	11.5
Louisiana	4 - 8	.13	-67	C NR	No	13.3
Maine	3.5 – 8.93	.22	-48	C R	Yes	20.8
Maryland	7	.18	-43	--	No	22.3
Massachusetts	9.5	.40	-48	C NR	Yes	16.5
Michigan	BAT/VAT			C NR	No	10.8
Minnesota	9.8	.29	-44	C R	No	20.2
Mississippi	3 – 5	.40	-21	C NR	Yes	12.8
Missouri	6.25	.11	-56	C NR	Yes	14.7
Montana	6.75	.18	-61	C R	Yes	22.1
Nebraska	5.58 – 7.81	.18	-33	C R	No	20.6
Nevada	None				N/A	24.8
New Hampshire	8.5	.34	-44	C R	Yes	20.6
New Jersey	9.0	.60	-6	C NR	Yes Throwout	20
New Mexico	4.8 –7.6	.17	-44	C NR	Yes	14
New York	7.5	.25	-42	C NR	No	13.8
North Carolina	6.9	.29	-51	C NR	No	20.8
North Dakota	2.6 – 7.0	.26	-37	C R	Yes	23.2
Ohio	5.1 – 8.5	.20	-54	C NR	No	11.3
Oklahoma	6.0	.11	-50	C NR	Yes	17.8
Oregon	6.6	.18	-42	C R	Yes	13.9
Pennsylvania	9.99	.27	-47	C NA	No	17.3
Rhode Island	9	.16	-57	C NR	No	24.5
South Carolina	5.0	.14	-61	C NR	No	15.4
South Dakota	$500 bank	.17	-26		N/A	20.7
Tennessee	5	.31	-25	C NR	No	16.2
Texas	F/T 2.5m	.21	-18	C NA	Yes	20.3
Utah	5	.20	-40	C R	Yes	17.7
Vermont	7.0 – 9.75	.20	-54	C R (2006)	Yes	20.7
Virginia	6	.12	-47	C NR	No	24.6
Washington	Franchise				N/A	13.8
West Virginia	9	.41	-47	C NR	Yes. Throwout	11.8
Wisconsin	7.9	.28	-43	C NA	Yes	16.2
Wyoming	None				N/A	32.3

GSP = Gross State Product. * % of reduction of the ratio of corporate tax/gsp
****CNR = Combined Not Required (but may be allowed) CR= Combined Required, C NA= Combined Not Allowed**
Sources of Data: Federation of Tax Administrators, Multistate Tax Commission; Aspen Publishing 2004 Multistate Tax Guide; BEA; February 2005 Report on Corporate Taxes by Citizens for Tax Justice and Institute on Taxation and Economic Policy, and *Taxing Smarter and Fairer,* A Report by Prof. Richard Pomp conducted for Common Cause, March 2005

Preliminary Assessment of Corporate Income Tax Using NCSL Principles:

Simplicity. The corporate income tax is not a simple tax. All filers must first calculate the tax two ways and then pay the higher of the two or a minimum tax of $250. While the rate is a flat rate of 7.5 percent, it is subject to many exemptions, variations on the apportionment formula depending on the business area, and the use of credits after the tax liability is calculated.

Administration According to the literature and preliminary interviews with Department of Revenue Services staff, the corporate income tax is a difficult one to administer. The tax has many steps in arriving at a corporation's tax liability, with each step subject to both legal and accounting interpretation on what are legitimate reductions, exemptions, losses, expenses, and credit use.

Also, according to the department, auditing a corporate income tax filing can be extremely complex and time consuming, especially if it involves a combined return (of affiliated companies). Further, DRS staff express frustration at what has become commonplace in the corporate tax area – tax planning to avoid the tax. One broad indication of the extent of the avoidance, and what it could mean in lost revenue to Connecticut, is computed from the results of the corporate audit statistics over the past three fiscal years. As Table II-37 shows, while the number of corporate audits is a small percentage (2.6 percent) of the overall number of audits conducted by DRS, the yield in corporate assessments (what is determined to be owed after an audit) is a much higher percentage of all audits.

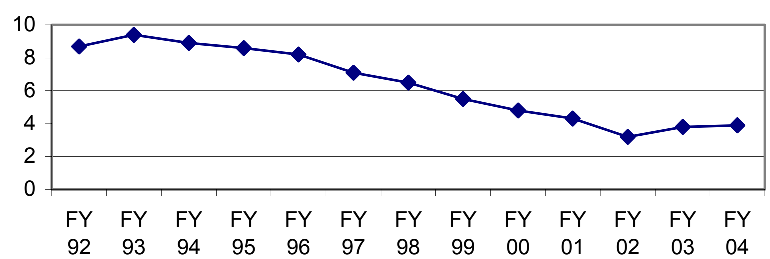
Table II-37. Corporate Audits: Three-year Average FY 03 – FY 05

Corporate	Total Corporate	% of All Audits
Number of Audits Conducted	1,972	2.6%
$ Assessed after Audit	$123,030,372	34%

Source of Data: Department of Revenue Services, Audit Division

However, almost 10 percent of the corporate audit cases have been appealed as opposed to about 4.6 percent of the sales and use tax audits, and only 2.2 percent of the audits on personal income tax are appealed, a further indication of the difficulty in administering the corporate income tax.

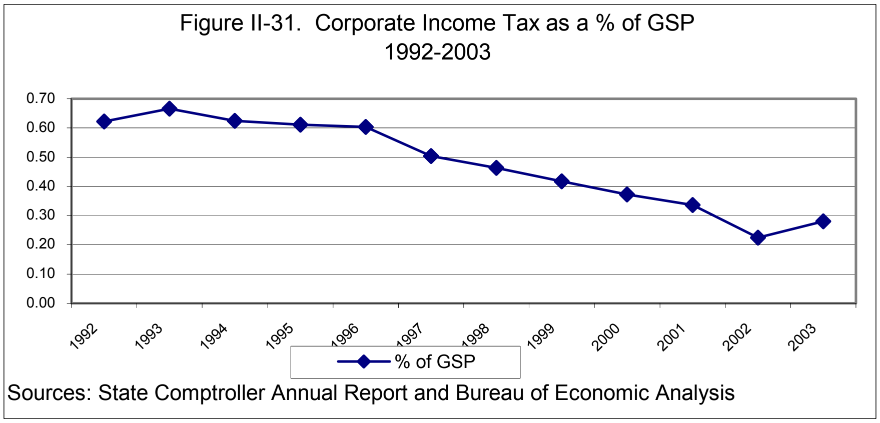
Figure II-30. Corporate Income Tax as % of State GF Revenue



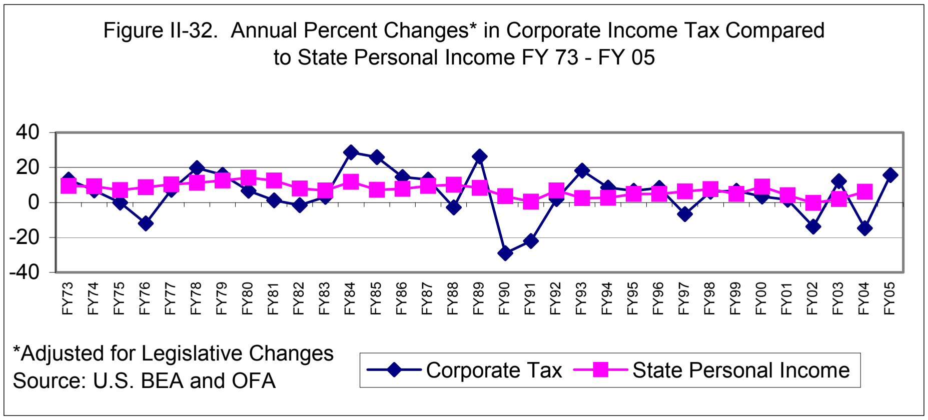
Source: State Comptroller Annual Reports

Balanced. This is a difficult concept to evaluate. Some economists and policymakers believe that corporate income should not be taxed, that only individuals should pay taxes. Figure II-30 shows what the corporation tax contributes as a percent of all state general fund revenues, that ratio has been declining dramatically – from almost 10 percent in FY 93 to about four percent in FY 04. Thus, while corporate income tax has never been a *major* source of Connecticut's revenue it has become a very *minor* source. If the reliance on corporate taxes as a percent of state and local revenues raised were measured the percent would be even lower.

Adequacy. Figure II-31 shows the corporate income tax as measured as a share of the state's economy (gross state product, which measures value of goods and services produced). As this figure shows, the ratio of corporate taxes as a percentage of GSP, has also declined dramatically, indicating that the tax has not kept pace with the state's economy. While one might argue that the ratio of corporate tax to GSP in the early 1990s was too high, by 2003 25 states ranked ahead of Connecticut.



Volatility. The corporate income tax is the most volatile of all the taxes used in Connecticut. Figure II-32 shows annual percent changes in the corporate income tax (with adjustments made for legislative changes) so that the tax is measured against changes in the economy only. As the figure shows, the corporate income tax is prone to dramatic swings while the state's economy is much more stable.



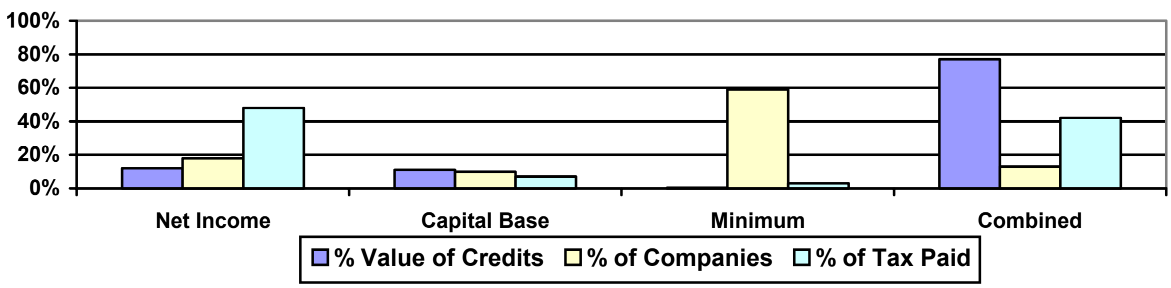
Program review staff also measured the volatility of the corporate income tax using the average annual changes (with the legislative adjustments removed) for the period between FY 93 and FY 04 and compared that to the standard deviation for the same period. While the average growth was only 3 percent, the standard deviation was 10.3 indicating the tax is fairly unpredictable and quite volatile.

Table II-38. Volatility in Corporate Income Tax – FYs 93-04	
Average Annual Growth	3.0%
Standard Deviation	10.3

Fairness and Equity. As indicated in the profile earlier, about two-thirds of corporate filers pay only the minimum tax of $250, and through the use of tax credits corporations in the aggregate are able to reduce their tax liability by one-third. It is difficult to measure how fair the burden of paying the corporate income tax is distributed even among businesses, because no information relates back to income earned, even by filer group, so no assessment can be made about any corporation's "ability to pay."

Program review staff examined the distribution of the tax credits taken by individual filers as a proportion of the total credit value for each filing group, as well as the average value, and percent of tax liability reduced by credits by type of filer. The results of the analysis are shown below.

Figure II-33. Percent Value of Corp. Credits and Companies by Method of Filing, 2001



Source: DRS and LPRIC calculations

Figure II-33 compares the percent value of corporate credits, percent of companies by method of filing, and percent of corporate income tax paid. It shows that a very small number of filers claim the over-whelming majority of credits. Thirteen percent of all companies filing a corporate income tax received 77 percent of the total value of all credits taken. Net income filers pay the most in corporate income taxes.

Table II-39 shows the average tax reduction after the application of credits by the method under which the company filed its corporate income tax. The combined filers achieved the greatest average reduction of 50 percent, followed by those that filed under the capital base method – 45 percent.

Table II-39. Average Tax Reduction by Method of Filing, 2001

Method of Filing	Number of Companies	Average Tax Before Credits	Average Tax After Credits	Percent Reduction
Net Income	9,917	$14,208	$12,511	12%
Capital Base	5,325	$6,335	$3,493	45%
Minimum	32,134	$225	$209	7%
Combined	7,255	$29,428	$14,801	50%
Source: DRS and LPRIC calculations				

Economic Competitiveness. Although there is considerable controversy over how important a factor overall tax burden is in business location decisions, state and local governments have become increasingly concerned about their tax competitiveness. Competitive tax policies are those that do not place business enterprises at a disadvantage relative to other states and increase a jurisdiction's ability to attract and retain businesses.

While rates matter less than many of the other aspects of the corporate tax structure, as discussed previously in this section, Connecticut's corporate tax rate is competitive with other neighboring states. Connecticut's 7.5 percent rate is exactly the same as New York's, below the 9 percent in New Jersey and Rhode Island, and below Massachusetts' 9.5 percent rate. Further, as Table II-40 shows, a number of the other aspects of the corporate tax in Connecticut – extended carryforward periods, the apportionment formula, with no throwout or throwback rules, all seem to create a favorable tax structure for business.

A study released in 2004, and authored by an economist at the Federal Reserve Bank of Boston, examined business tax competitiveness among the states using 2000 data for a number of different measures including: business taxes as a percent of: total state and local taxes; personal income; and business profits.[27] Table II-40 compares Connecticut to seven neighboring states in the Northeast, other comparison states, and the US average using the data from that study.

Table II-40. Business Tax Comparison Measures, FY 2000

Business Share of State and Local Taxes				Business Taxes as a Percent of Personal Income			Business Taxes as a Percent of Business Profits	
State	%	Rank		%	Rank		%	Rank
CT	**39.1**	**40**		**4.5**	**28**		**32.5**	**40**
ME	44.1	21		5.9	10		40.5	13
MA	36.1	48		3.7	47		27.5	49
NH	58.3	6		4.7	20		35.9	25
NJ	40.6	34		4.4	30		36.6	23
NY	44.4	20		6.0	8		38.8	15
RI	43.8	22		5.1	16		43.2	10
VT	45.9	17		5.3	14		42.5	11
US	**43.6**			**4.7**			**35.8**	
CA	39.9	38		4.5	25		33.7	33
CO	42.6	27		4.0	23		28.0	47
MI	38.8	41		4.3	36		34.4	31

Source: Robert Tannenwald, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?,* Public Policy Discussion Paper, Federal Reserve Bank of Boston, (August 20, 2004) Tables 1, 2, and 3.

- When state and local taxes on businesses are considered as a percent of total state and local taxes, Connecticut ranks second lowest in the Northeast and among the lowest in

[27] Robert Tannenwald, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?,* Public Policy Discussion Paper, Federal Reserve Bank of Boston, (August 20, 2004)

the nation (40th among the 50 states).[28] This indicator, however, may suffer from the fact that Connecticut industries are relatively high-wage and labor-intensive (e.g., financial services, health care, education, etc). Therefore, the household tax base is large relative to the base of taxes paid by businesses.

- A second measure compares states in terms of the ratio of business taxes to personal income.[29] A state's personal income is thought to be an indicator of its business profits.[30] Connecticut ranks 28th in the nation, about average, but third lowest in the Northeast.
- The third measure relates state and local taxes on corporations to business profits. This is arguably a better measure because presumably businesses care about how taxes affect their bottom line. However, there are not any easily obtainable state level measures of corporate profit, so that statistic had to be estimated.[31] The resulting figures for business taxes as a percent of profits in FY 00, ranks Connecticut among the lowest states in the nation (40th out of 50 states) and the second lowest in the Northeast.

It can be noted that the state's rank differs between the second (28th) and third measure (40th). Two factors seem to explain this discrepancy. One is that incomes from sole proprietorships and partners were high relative to personal income and secondly, the state has a high concentration of payroll and receipts in the highly profitable financial services industries.

Table II-41. Comparison of Corporate Tax Credits

State	Number of Corporate Tax Credits	Total Value of Credits Used[1] (millions)	Largest total credit	Total of largest credit (millions)	Total Paid in Corporate Tax (millions)	Ratio of Credit Value to Corporate Tax Paid
Connecticut	21	$175	Fixed Capital	$60	$380	46 %
Massachusetts	10	$156	Research Credit	$76	$1,301	12%
New York	21	$365	Enterprise Zones[2]	$196	$2,045	17.8%

[1] Credits used equal the amount of credit the taxpayer actually used to reduce tax liability
[2] Two programs that target enterprise zones have been combined
Sources: Connecticut estimated amounts for 2005 from *Connecticut Tax Expenditure Report 2004*, pg 8; Massachusetts estimated amounts for FY 2006 from *Tax Expenditure Budget Fiscal Year 2006*, Executive Office for Administration and Finance, Commonwealth of Massachusetts; New York estimated amounts for FY 2005 from *Annual Report on New York Tax Expenditures*, NY State Department of Taxation and Finance, pg. 33-34.

Another tool states offer to make their tax structures competitive are business tax credits. The tax credits and how they are used to reduce tax liability was explained in the profile earlier. Program review staff was able to obtain data on the use of business tax credits in two

[28] Total state and local taxes on business, including business income taxes except for personal income taxes on business income.
[29] Total state and local taxes on business include business income taxes (except for personal income taxes on business income and including other taxes paid by businesses, such as licenses, workers compensation premiums, unemployment insurance taxes, and parts of the property and sales taxes) per $1,000 of personal income.
[30] Tannenwald, p. 19
[31] For methodology see Tannenwald, p.27

neighboring states and the information is presented in Table II-41. The dollar value of tax credits in Connecticut is greater than Massachusetts, and when the value of the credits is measured against the total corporate income tax paid in 2004, Connecticut's value of credits is far higher than New York or Massachusetts.

Accountability. It is difficult to demonstrate whether or not the measures taken by the legislature to reduce the corporate income tax have produced the desired results. The tax has been reduced in terms of the actual amounts collected, and the state's reliance on the tax as a percent of state General Fund revenues, and a percent of the economy (gross state product), has also been cut. The state has also reduced the volatility in the corporate income tax, but it is difficult to say whether the burden of the tax is fairly distributed among businesses, because there is no information that connects tax liability to incomes among business.

The legislature is increasing its oversight of the business tax credits and overall business tax policy through the revamping and restructuring of a dormant committee and expanding its charge. The new committee, the Business Tax Credits and Tax Policy Review Committee, will be evaluating business tax credits, changes in the corporation tax, and modifications to business tax policy to determine if there are measurable improvements that result such as new business investment, job growth and/or retention, or other enhancement to the state's economy.

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Profile of the Estate and Gift Tax

Background

Estate taxes, along with inheritance and gift taxes, are referred to as transfer taxes since they are levies on the transfer of wealth. In addition to raising revenues, these taxes prevent permanent accumulation and concentration of extreme wealth. Estate and inheritance taxes sometimes are called death taxes since they are imposed, in different ways, on accumulated wealth when someone dies. Gift taxes apply to transfers of wealth from living donors, which often are made in anticipation of death. In general, they are designed to prevent estate tax avoidance.

Estate taxes are applied on the value of an estate before any assets are distributed to heirs. *Inheritance* taxes, also known as succession taxes, are the responsibility of each individual receiving a bequest from a deceased person. In both cases, tax rates are graduated. Estate tax rates are based on the value of the estate, while inheritance tax liability depends on the amount of the bequest and the relationship of the beneficiary to the decedent. Typically, inheritance tax rates are lower for immediate family members and highest for unrelated beneficiaries.[32] Gift taxes, like estate taxes, are also graduated based on value; payment is the responsibility of the donor.

Link to federal taxes. While no inheritance taxes are imposed at the national level, there are federal estate and gift taxes. Until recently, most states that had their own estate and gift taxes linked them to the federal taxes, using the same definitions and similar calculations, for example. In addition, as the federal tax allowed taxpayers a credit against the amount of state estate taxes they paid, most states including Connecticut based their own estate tax on the federal credit provision.

In effect, the state estate taxes that were coupled with the federal credit "picked up" revenue that would otherwise have gone to the federal government. However, changes enacted under 2001 federal legislation (the Economic Growth and Tax Relief Recovery Act) phased out the state credit over four years, eliminating it entirely as of January 1, 2005. Unless states with "pick up" estate taxes decoupled from the federal credit, their estate taxes effectively ended on this date as well.

Most states allowed their estate taxes to terminate with the federal credit repeal but 17 states including Connecticut's neighbors--New York, Massachusetts, and Rhode Island--decoupled from the federal tax by redefining their state taxes (e.g., making their redefined tax equal to the federal credit amount in effect prior to the 2001 change.) Connecticut took action to decouple from the federal estate tax temporarily but scheduled it to end on January 1, 2005. As

[32] Under Connecticut law, succession (inheritance) tax heirs were divided into four classes depending on their relationship to the decedent: Class AA -- surviving spouse; Class A – lineal parents and descendents (e.g., parents, children, grandparents, grandchildren); Class B – collateral relatives (e.g., siblings, nieces, nephews); and Class C – remote relatives and unrelated persons. Whether the succession tax applied to a beneficiary and at what rate was determined by this classification structure.

discussed below, recently enacted legislation (P.A. 05-251) established an entirely new estate tax in Connecticut with a retroactive effective date of January 1, 2005.

Current status. While transfer taxes have a long history and were common throughout the country until recently, few states currently impose either inheritance or gift taxes. In response to the federal changes noted above, 19 states and the District of Columbia had decoupled or taken other actions to impose their own estate tax as of December 2004. As of the same date Connecticut was also one of only 14 states with a succession (inheritance) tax and one of only 4 states that imposed a gift tax. Until June of this year, Connecticut was in the process of phasing out both its succession and gift taxes, in 2008 and 2010, respectively; its estate tax had already expired on December 31, 2004.

During the 2005 legislative session, the General Assembly established a new unified estate and gift tax in Connecticut and repealed the state's former gift tax as well as the inheritance tax, all effective as of January 1, 2005. The Department of Revenue Services issued forms and instructions for the new tax in late September 2005 and is continuing to develop policies and guidelines as the new tax is fully implemented and the old transfer taxes are phased out.

The main provisions of Connecticut's unified estate and gift tax, and some general features of transfer taxes, are described briefly below. A more detailed analysis of the state's new estate tax, including an assessment in terms of the NCSL principles, will be provided in the final report.

Description

The current Connecticut unified estate and gift tax applies to transfers of taxable gifts and estates that exceed a combined lifetime total value of $2 million and are made on or after January 1, 2005. For Connecticut residents, taxable gifts include real property, or tangible personal property located in the state, and intangible property wherever it is located. For nonresidents, taxable gifts only include real property or tangible personal property located in Connecticut.

Tax rates for the unified estate and gift tax, shown in Table II-42, are the same as those in effect under the state's former "pick up" estate tax, which were equivalent to federal tax credit rates in 2001. Estates, aggregate gifts made over a lifetime, or the combination of an estate and lifetime aggregate gifts that have a value of less than $2 million are exempt from the tax. Graduated rates are applied to taxable estates and gifts with higher values and range from a low of just over 5 percent to a maximum of 16 percent for estates and gifts worth over $10,100,000.

Revenues Produced

Only estimates of the potential revenues produced by the new unified estate and gift tax are available at this time. According to the Office of Fiscal Analysis, the new tax is expected to produce $108.2 million in revenues for FY 06, $149.7 million in FY 07, and $151.7 million in FY 08. These numbers represent only the collections from the new tax; they do not include any adjustments for revenues lost or gained from the former estate and gift taxes.

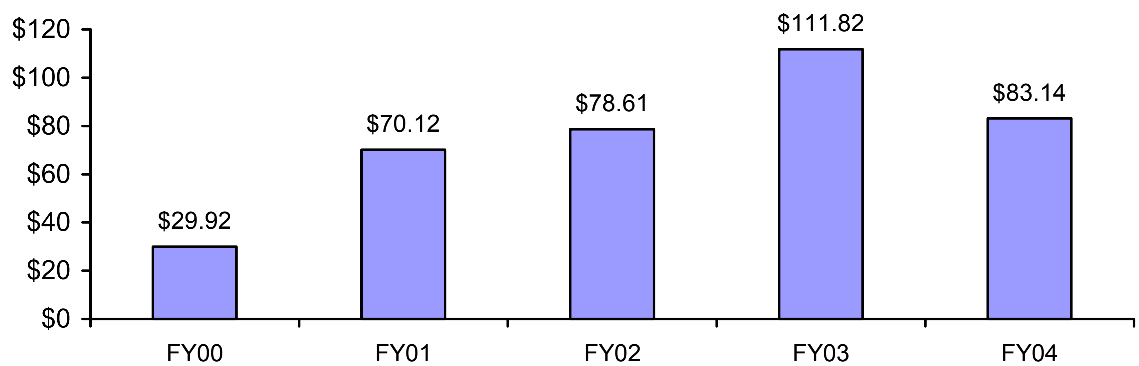
Table II-42. Connecticut Unified Estate and Gift Tax Rate Table: Department of Revenue Services

Tax Table for Form CT-706/709 Tax Table for Gifts Made on or After January 1, 2005; and for Estates of Decedents Dying on or After January 1, 2005			
Value of Gifts or Estate			
Column A Over	Column B But not over	Column C Tax on Column A	Column D Tax Rate on excess over Column A
$0	$2,000,000	None	None
2,000,000	2,100,000	5.085% of the excess over $0	
2,100,000	2,600,000	$106,800	8.0%
2,600,000	3,100,000	146,800	8.8%
3,100,000	3,600,000	190,800	9.6%
3,600,000	4,100,000	238,800	10.4%
4,100,000	5,100,000	290,800	11.2%
5,100,000	6,100,000	402,800	12.0%
6,100,000	7,100,000	522,800	12.8%
7,100,000	8,100,000	650,800	13.6%
8,100,000	9,100,000	786,800	14.4%
9,100,000	10,100,000	930,800	15.2%
Over $10,100,000	$1,082,800 plus 16% of the excess over $10,100,000		

Historically and at present, transfer taxes represent a very small portion of total revenue collections in all jurisdictions. Nationally, estate, inheritance, and gift tax revenues account for around 1 percent of state tax collections. In Connecticut, the state's former transfer taxes produced about 2 percent of all state tax revenues and just over 1 percent of total state and local revenues in FY 03.

Transfer tax revenues fluctuate dramatically from year to year because they depend on how many wealthy individuals die and leave large estates or, as part of their estate planning, decide to make taxable gifts. Figure II-34, which shows actual tax collections under Connecticut's previous estate tax over a recent five-year period, illustrates this pattern.

Figure II-34. Connecticut Estate Tax Collections: FY00-FY04 (Dollars in Millions)



Source of Data: DRS

Since the unified estate and gift tax was just enacted, comparisons of Connecticut's revenue collections with those of transfer taxes in other states is not possible at this time. Information compiled by the Tax Foundation on state estate and gift tax collections in 2004 are summarized in Table II-43. The table shows on a per capita basis, Connecticut's previous estate and gift taxes together were 4th highest in the country and, like all the Northeastern states, were higher than the national average. Whether the state will rank similarly after the new tax is fully in effect remains to be seen.

Table II-43. State Estate and Gift Tax Collections 2004: Connecticut and Selected Other States

	Collections Per Capita	**Rank Among 50 States and D.C.**	**Link to Federal Tax**
Connecticut	$37.23	4	Decoupled
U.S. Total	$19.57	-	-
Maine	$24.36	8	Decoupled
Massachusetts	$30.34	6	Decoupled
New Hampshire	$23.49	10	Linked
New Jersey	$59.32	1	Decoupled
New York	$38.28	3	Decoupled
Rhode Island	$23.42	11	Decoupled
Vermont	$23.69	9	Decoupled

Source of Data: Tax Foundation, Dec. 2004

Transfer Taxes: General Assessment

There is considerable debate about the equity of transfer taxes. Since they generally apply only to the wealthiest group of taxpayers, many consider estate, inheritance, and gift taxes to be the most progressive of all tax types. Others point out estate taxes have horizontal equity problems in that different approaches to estate planning can produce vastly different tax liabilities for individuals with very similar estates. Many opponents of estate and gift taxes believe they are unfair if they impede the ability of taxpayers to pass on farms or small businesses to family members.

Transfer tax revenues, as noted earlier, can be extremely volatile and among the most difficult of all taxes to forecast. Their stability is not a serious concern, however, as these taxes tend to be relatively small contributors to total state and local revenues.

Compliance and administration, however, can be big issues for transfer taxes if they prompt taxpayers to undertake complicated and expensive estate planning activities. Some transfer tax critics also claim that state estate taxes provide an incentive for wealthy individuals to reside where they are not imposed or where rates are lowest.

The impact of estate taxes on investment decisions as well as where taxpayer reside is another matter of academic as well as political debate. There is general agreement that transfer taxes are not economically neutral. However, some recent research indicates migration to avoid estate taxes may not be a significant problem. Program review staff will be examining this issue and the other questions related to transfer taxes further as part of its continuing assessment of the state unified estate and gift tax.

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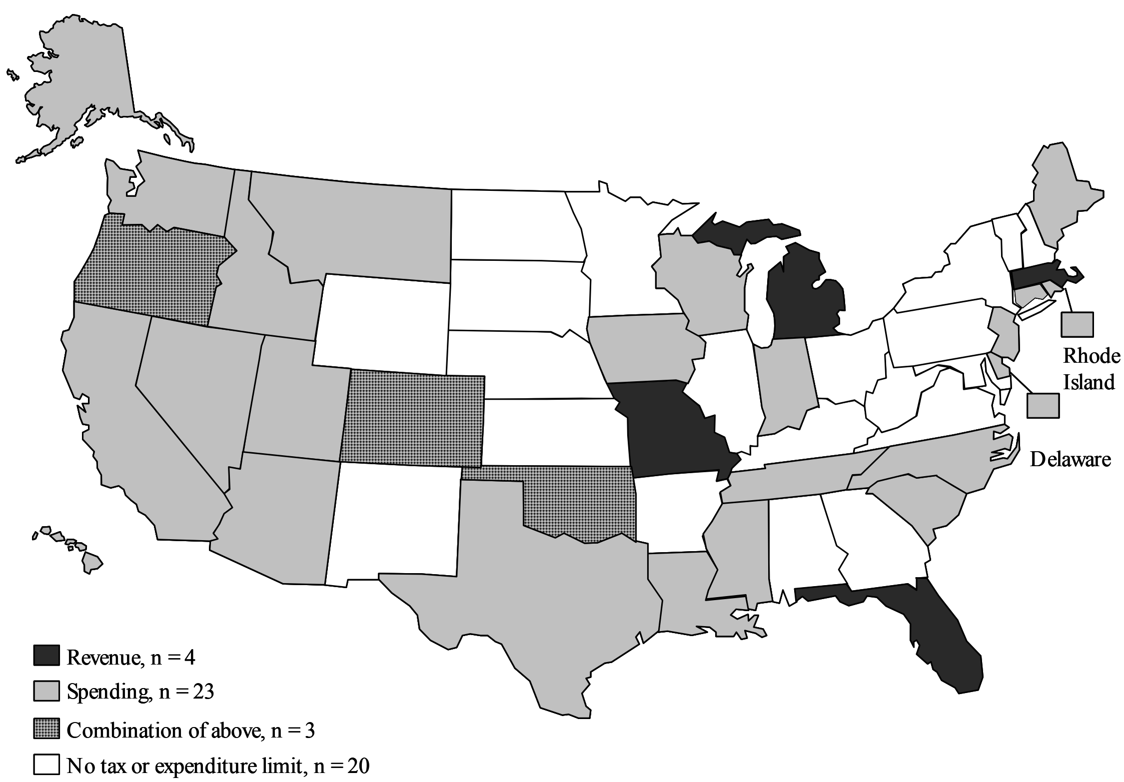
Section 3

Other States' Experiences

The program review committee has expressed interest in what other states have done to modify their tax structures to better align their revenue sources with the state's economic framework or delivery of services, and to respond to voter/taxpayer sentiment. Presented below is a general discussion regarding the use of tax and expenditures limits followed by case studies of states that have changed their tax systems in a fundamental way.

One of the mechanisms states have used is to place restraints on the growth of government budgets either by limiting the taxing or spending side or both. The National Conference of State Legislatures released a report in June 2005 on the states' use of these tax and expenditure limitations (TELs), and the report illustrated their use in the following map.

Figure III-1. Tax and Expenditure Limits Use Among the States



Source: National Conference of State Legislatures, State Tax and Expenditure Limits Report, June 2005

The NCSL report, which limited its scope to TELS at the state level, and therefore does not include any limits states may place on revenues or spending through local property taxes, found that 30 states used TELs. Several states had considered imposing new TELS during the past three legislative sessions, but Maine is the only state to have adopted such an initiative in 2005.

Tax and Expenditure Limitations

While NCSL found there was no one method used to restrict spending or taxes, the report concluded that TELs fall into one of the following categories:

- **Revenue limits** – tie allowable yearly increases in revenue to personal income or some other type of index like inflation or population. Typically, amounts that exceed the limit are refunded to taxpayers.

- **Expenditure limits** – typically tie growth to increases in personal income or some other index. The impact depends on the limit parameters – ones that are less restrictive are those tied to growth in the economy, while TELs with tighter controls often require refunds if revenues exceed expenditure level thresholds.

  Connecticut is one of 23 states that impose an expenditure limit. The "spending cap" limits increases in budget expenditures to the greater of either: 1) the five-year average in growth of Connecticut's personal income; or 2) the 12-month rate of inflation as measured by the consumer price index.

- **Appropriations limited to a percentage of revenue estimates** – ties appropriations to a portion (e.g., 90 percent - 95 percent) of forecasted revenues. This TEL does not establish an absolute limit or tie growth to a measurable index.

- **Hybrids** – a combination of components that set limits. For example, Oregon has a spending limit tied to personal income growth, and a provision requiring refunds if revenues are more than 2 percent above the revenue forecast. In a way, this type of TEL restricts spending and also limits revenues by tying them to forecasted amounts.

Voting Requirements

In addition to the TELs, states also may have in place required voter approval mechanisms that also can limit revenue and spending actions. These voter-approval requirements typically either: 1) call for outright voter approval of all tax increases or those over a certain amount; or 2) require a supermajority vote in both chambers of the legislature in order to pass a new tax or increase an already existing tax. Three states use the first method, and 16 states use the latter. Often these measures are even more restrictive than technical tax and expenditure limitations.

Impact of TELs

The NCSL report states that a number of academic studies have been conducted to examine how well TELs work and what ramifications their use may have had for state fiscal policy. Drawing on the results of several studies of TELs, it can be concluded that:

- the impacts of TELs vary depending on such factors as formula of limits, method for approval of limits, requirements for passing increases, and treatment of surpluses;
- limits on government growth through fiscal caps are more prevalent than placing limits on property taxes;
- Colorado has the most restrictive TEL structure and Rhode Island the least;
- states with strict spending limits faced lowering borrowing costs, while states with strict taxing limits incurred higher than average borrowing costs;
- TEL states did not show a strong link to limiting the size of governments, but states with slow income growth did have more size limitation effects, while states had greater increases in government if they had high income growth.

The table below lists other pros and cons of TELs that may not be proven in studies, but are widely cited by supporters or detractors.

Pros	Cons
• Makes government more accountable • Forces more discipline to budget and tax practices • Controls growth of government/makes it more efficient • Enables citizens to vote directly on tax increases, and thus the level of government services • Helps diffuse the power of special interests • Forces government to evaluate and prioritize • Raises questions about the advisability of providing some government services • Helps citizens feel empowered • Makes government think of other ways to raise revenue	• Shifts fiscal decision making away from elected officials • Causes disproportional cuts for non-mandated or General Fund supported programs • Does not account for disproportional growth in populations that use government services (e.g., children and the elderly) • May result in extra costs for rebates and refunds • Fails to provide revenues to meet continuing services during tough economic times, and results in declining services over time • Shifts tax base away from the income tax to the more popular (but more regressive) sales tax if voter approval required • Shifts tax base away from broad taxes to narrowly defined sources from gaming or user fees
Source: NCSL, State Tax and Expenditure Limits, 2005	

CASE STUDIES OF SPECIFIC STATES

Program review staff selected, based on committee interest and suggestions, several states that have changed their tax structures in some manner over the past couple of decades. The case studies summarize each state's experience including: the problem or issue each state was addressing that necessitated the policy change; the strategy or initiative developed and its features; and what the impacts have been since the strategy was implemented. It is important to note the analysis and conclusions in these case studies are based on committee staff's review of the literature, and not the result of independent analysis. Case studies are presented for California, Massachusetts, New Jersey, New Hampshire, Colorado, and Michigan.

California: Proposition 13 and Its Impact

Problem: Perceived runaway local property taxes

- During the 1970s, home values in California increased dramatically
- As property values soared, local governments did not adjust rates adequately, creating very high property tax bills
- California residents, angry about their high property taxes and about what they perceived as unresponsive local government, voted a ballot initiative known as *Proposition 13*
- ***Proposition 13*** was enacted in June 1978 – voters passed the measure by a vote of 65 percent to 35 percent
- California tax revolt continued into 1979 with the passage of *Proposition 4,* which limited state spending to previous year's with allowances for increases in population and inflation

Strategy: Proposition 13

- Proposition 13 cut local property taxes in California by about $6 billion (53 percent)
- It set property values at 1975-76 levels
- The measure limits property taxes to 1 percent of assessed value
- Proposition 13 limits annual increases in assessments to 2 percent
- Allows reassessment of property only when the property is sold
- The measure also made raising taxes more difficult by requiring approval by two-thirds of the legislature to increase state taxes, and prohibits local governments from imposing new taxes without a two-thirds vote of the electorate

Impact: 25 Years of Direct and Indirect Consequences

On the property tax:

- Property tax becomes very unfair -- owners of similar houses in the same neighborhood paying hugely different tax bills because one house was bought more recently than another

- Homeowners have assumed a greater share of local property tax than business, largely because commercial property turns over much less frequently than residences, and business have been able to change hands while circumventing a sale and thus a new assessment

On school funding and education:

- California legislature passed Assembly bill 8 in 1978 increasing the state's responsibility for school district funding
- Because resources are equalized across districts, local voters have less incentive to spend as much on schools, leading to larger class sizes
- By 1982-83, California per-pupil spending dips below the national average
- School district funding becomes more prone to fluctuations in the state's economy
- By 1988, California voters, unhappy with state spending on local education, pass Proposition 98, which provides a formula-driven guarantee of state funding for local schools
- During the 1980s -- a period of relative prosperity in California -- the state met its obligations for school funding
- The funding impact of Proposition 13 is acutely apparent during the recession of the early 1990s – a series of state budget shortfalls prompts the state legislature to shift responsibility for funding services back to local levels
- Some local jurisdictions – especially counties -- experience fiscal crisis
- California legislature in 1996 passes a class-size reduction measure providing an additional $650 (later $800) for each K-3 student in classes of 20 or less. This incentive unintentionally hurts lower income and predominately minority schools and increases the gap between rich and poor districts and educational results
- In 1998, California voters pass Proposition 1A, a state bond measure earmarking $6.7 billion for school construction and repairs, and in 2002, another $11.4 billion in local bonds is approved through Proposition 47. Despite these measures, per-pupil spending in California is still below the national average and a recent Rand study showed California students scored 3rd from the bottom in achievement tests taken between 1990 and 2003.

***On other funding*:**

- Both Proposition 13 and Proposition 4 have had a ripple effect on funding for other services, leading to passage of a number of propositions (in addition to those above) that established dedicated funding. These initiatives allowed revenues from a particular tax (or rate increase) to fund a particular service. For example, Proposition 111 funds transportation from the gas tax; Proposition 172 earmarks some of the sales tax revenues for local public safety; and Proposition 99 funds some public health programs with tobacco taxes.
- Recent state financial woes have also had other impacts – the state has had to seek additional sources of revenue to fund public services. For example, in November 2004 California voters approved Proposition 63, which imposes a 1 percent surcharge on

incomes over $1 million to fund mental health services. While an increase in the top rate for California's income tax rate was also considered it was not enacted.

- A proliferation of initiatives (potentially 61) will be on the ballot for a November 2005 special election. Those measures up for vote include repealing Proposition 63 and enacting a "Live Within our Means Act," which would impose new state spending limits (including on those revenues guaranteed under other propositions) and would allow the governor broad authority to cut spending if revenues fall below forecasted levels.

Massachusetts: Proposition 2½ and Its Impact

Problem: Perceived High Tax Burden as Evidence of Government Inefficiency

- Massachusetts residents have voiced their discontent with the property tax since the 1960s. In 1967, per capita property taxes were almost 50 percent above the national average; by 1977, property taxes were the highest in the country. A tax revolt in Massachusetts led to the adoption of Proposition 2½ in 1980.
- Supporters of Proposition 2½ believed it would reduce taxes without cutting services.
- Proposition 2½ was enacted in November 1980 - passing by a vote of 59 percent to 41 percent; 81 percent of communities voted in favor.
- The original legislation was amended in December 1980 to exclude from the limit new growth from construction and to provide communities with mechanisms to raise additional revenue when necessary via overrides and exclusions.
- The legislation implemented five changes:
    1. Limited state agency assessments on cities and towns;
    2. Prohibited unfunded mandates;
    3. Repealed binding arbitration for certain public employees;
    4. Reduced the motor vehicle excise tax rate; and
    5. Allowed renters a deduction on their state income tax.
- The limits went into effect in 1982**.**

The strategy: Proposition 2½

- Proposition 2½ established two types of levy limits on property taxes:
    - *Levy Ceiling*: a community cannot levy more than 2.5 percent of the total full and fair cash value of all taxable real and personal property. It is calculated as follows:

      (full and fair cash value) x (2.5 percent) = Levy Ceiling
    - *Levy Limit*: is a constraint on the amount a community can increase a levy from year to year. It includes new growth to account for increased service costs associated with new development. This is calculated as follows for each city/town annually by the Department of Revenue:

(Prior year's levy limit) + (prior year's levy limit x 2.5 percent) + (additions to the tax base from new growth during the year) + (any approved overrides or exclusions) = *Levy Limit*

- This amount is then compared to the levy ceiling; the lesser amount becomes the *levy limit* for that year.
- Exceptions can be made through overrides and exclusions that must be approved by a referendum.
  - An override is a permanent increase in the tax limit; it becomes a part of the base for calculating future years' levy limits. It allows residents to reduce the levy and raise additional revenues to put funds in local operating budgets. It must be for a specific amount, approved by a two-thirds vote of the local legislative body, and placed on the ballot for voter approval. It cannot exceed the levy ceiling.
  - An exclusion is an allowable tax increase for debts, bonds, or local project funding (e.g., new school, acquire land, etc.). Exclusions are not permanent. Instead, they remain in place for the duration of the expenditure and do not add to the base for calculating future years' levy limits. Like overrides, they must be approved by a two-thirds vote of the local legislative body before it can appear on the ballot.

Impact:

- In 1980, 54 percent of Massachusetts cities and towns had effective tax rates that exceeded 2.5 percent. Those communities had to reduce their tax burden by 15 percent annually until they were in compliance with the law. Over one-third of the communities needed only one year of reductions, and another 9 percent needed two to three years to reach the limits.
- During the first few years, 1981-1988, the effects on the local budgets were mitigated by significant increases (64 percent) in state aid provided to assist municipalities in avoiding budget shortfalls. In addition, the real estate boom in the 1980s increased new growth and added to levy limits causing a decline in effective property tax rates.
- Property tax reductions in the first three years of the limit reached over $500 million.
- The late 1980s experienced a recession, a decrease in property values and new construction, and a reduction in state local aid (over 30 percent between 1989-1992). In addition, the need for school funding grew as baby-boomers' children reached school age and increased enrollment.
- During the late 1980s and early 1990s, many communities passed overrides to deal with their limited revenues. Some communities experienced increases in property values with voter-approved overrides that increased spending. This indicates that Proposition 2½ resulted in lower levels of spending than what was preferred by some towns.
- From 1990-1994, changes in house values ranged from an increase of 7 percent to a decrease of more than 20 percent. Despite the constraints, communities that

experienced gains in property values were able to increase school funding. School spending increased more substantially in areas where the number of pupils quickly increased.

- During the late 1990s and into the early 2000s, state aid was generous to the towns. Therefore, Proposition 2½ did not have an impact on local revenues or services. However, between 2002 and 2004, state aid to municipalities dropped 8 percent; in 163 of the 311 towns, aid was cut by 15 percent.
- Thus, more recently, local property taxes have increased substantially. Between 2001 and 2004, local property growth averaged 6.2 percent per year. This growth was largely fueled by new construction, which over the three-year period added $650 million to local property tax rolls. Also contributing to the growth, however, is that towns are increasingly making decisions on exemptions and overrides of Proposition 2½. Those shot up by 60 percent in 2003 alone.
- In addition to raising taxes to deal with the reduction in state funding, towns also cut their own spending. According to the Bureau of Labor Statistics, Massachusetts dropped almost 8,500 jobs from municipal payrolls in 2003, the largest drop in the nation. Almost two-thirds of the job cuts were teachers and front-line public safety personnel.

Summary: Key Findings

- Voters' views of local government are strongly influenced by their individual property tax burden.
- The constraints imposed by Proposition 2½ had a considerable impact on both school and non-school spending adjustments. Studies found school-spending changes to be significantly correlated to changes in house values. The theory is that Proposition 2½ may have contributed to the demand for housing in communities that prioritized school spending. The state system for financing local schools has since been reformed by earmarking a portion of the state sales tax.
- Overall property tax burden in Massachusetts (3.5 percent of personal income) and its reliance on the property tax (36.5 percent of all state and local taxes) are somewhat lower than the rest of New England, but both are higher than the national average despite Proposition 2½.
- According to the Government Performance Project, Massachusetts has one of the highest debt burdens in the country. Factors cited include the lack of county government and local government reliance on the state due to limitations on local borrowing imposed by Proposition 2½.
- Imposition of a cap on property tax makes towns more reliant on the state to provide needed financial aid to provide local services. When that aid is forthcoming, the cap causes little pain. When the state aid drops, towns are forced to cut essential services, implement cap waivers, or both, and still face deterioration of their financial condition.

New Jersey: Finance Education and Lower Property Taxes

Problem: Local school funding found unconstitutional

- In 1973, the New Jersey Supreme Court ruled the practice of relying solely on local property tax to finance education was unconstitutional
- In response, then-governor Brendan Byrne proposed a state income tax, which New Jersey did not have at the time. The New Jersey legislature initially failed to approve the tax, but the state Supreme Court closed the schools, and the legislature approved the tax in 1976.

Strategy: Income Tax With All Revenues Going to Local Towns

- When the income tax was approved in 1976, a provision was included to constitutionally guarantee that all money raised from the income tax would go into the Property Tax Relief Fund, and that money can be used in very limited ways, like funding schools, municipalities, and counties, and financing actual property tax reduction programs like the *Homestead Rebate Program* (which was passed in concert with the income tax).
- For almost two decades, legislative and judicial branches wrangled over school finance. Large state tax increases and aid restructuring came in response to a Supreme Court decision.
- Former Governor (then a gubernatorial candidate) Christine Todd Whitman ran on a platform to cut state taxes. In 1994, after Whitman was elected, she successfully spearheaded enactment of cuts in the state income tax totaling 30 percent during her first term in office.
- Resulting cuts in state aid to towns were estimated at about $250 million, prompting municipalities to increase property taxes about the same amount (although experts argue some of that increase would have occurred without cuts in aid).
- The extraordinary boom in the New Jersey economy (as with the nation) during the late 1990s and early 2000s provided generous funding from the state, even with the cut in the income tax.
- Also, during these good economic times New Jersey passed another property tax reduction program for individuals called NJ SAVER (School Assessed Value Exemption Rebate), authorizing an exemption of a portion of a home's value from the school property tax. The value of the exemption – beginning at $9,000 to a maximum of $45,000--was to be phased in over five years from 1999 through 2004.

Impact: Attempts to Provide Property Tax Relief Only Partially Successful

- When New Jersey's economy slumped (like most other states), the funding for local services, like education, declined, and so did the funding for local property tax relief programs. Funding for the NJ Saver program and other property tax relief programs was severely curtailed, and the Senior Property Tax Freeze Program was suspended in 2003. The NJ Saver Rebate and Homestead Rebates were combined into the FAIR rebate program, with more limited rebates of up to $1,200 for seniors or disabled persons, but only $300 for other residents.

- To fill the gap, some state taxes were raised. For example, in 2002, then-Governor McGreevey proposed and the legislature enacted significant changes in New Jersey's corporate business taxes, which brought in over $1 billion more in revenue in FY 03, but that went to fund state expenses and not for property tax relief. In 2004, the top rate of the personal income tax was raised to 8.97 percent for incomes of $500,000 or more.
- The increase in income tax revenue helped pay for property tax relief, including the resumption of the Senior Freeze program.
- However, even with the rebate programs and exemptions from taxable income, New Jersey residents have one of the highest property tax burdens in the country. The 2002 census data indicates that 46.5 percent of state and local revenues come from the property tax; the second highest in the country and the highest of any state with a broad-based income tax.
- Further, even with all revenues from the income tax distributed to the towns in aid and property tax relief, increases in the local property tax was 7.2 percent in 2004 and 52 percent over the last 10 years.
- The continuing dependence on the local property tax to fund education perpetuates the inequities among income levels and among poor and rich towns. But the financial input from the state has reduced the disparities in local school tax rates among districts somewhat by redistributing school aid to the more needy towns.

New Hampshire: Statewide Property Tax and School Finance

Problem: System of school financing declared unconstitutional

- From 1984 through 1999, the State of New Hampshire provided about 5 percent of the total cost of education for public schools through a "foundation aid" program.
- In two cases, Claremont I (1993) and Claremont II (1997), the New Hampshire Supreme Court ruled that the state constitution requires the state to provide an adequate education to public school children and tax rates levied to fund education must be "proportional and reasonable."

Strategy: Statewide property tax and a new education funding formula

- The 1997 court decision gave the legislature until April 1999 to develop a new education finance formula. The legislature developed a plan in October 1999.
- In FY 00, the state's required financial contribution to ensure the provision of an adequate education, under the new plan, was estimated at $825 million.
- The state created a new aid formula and established a statewide property tax set at $6.60 per $1,000 of equalized property value, administered by each municipality, to fund about half of the new program. The other portion is funded by sweepstakes revenue and business taxes. The tax rate has been adjusted through the years, and for FY 06, it is 2.84 per $1,000.

- The idea behind the plan was to have wealthier towns donate a portion of what they raise to poorer towns.
- The statewide property tax, for the most part, represents a conversion of existing local property tax. For many towns, a portion of local property taxes was essentially renamed as a state property tax. Only certain "donor towns" contributed some portion of the statewide tax to the new state fund.
- "State" property taxes retained locally must be subtracted from the $825 million to calculate the real amount of state education aid. In 1999, real state education aid increased from $97 million to just over $400 million, and is scheduled to increase to over $470 million in FY 06. It has been estimated that, up to FY 06, 95 percent of the statewide property tax is raised locally and kept locally, meaning donor towns contributed about $25 million to the state's $400 million contribution.
- Many political leaders, including Governor Lynch and the speaker of the house, have made statements calling for the elimination of the statewide property tax and the donor town concept.
- The general aid formula was changed in FYs 03, 05 and 06. The current law is supposed to better target aid and nearly eliminates all donor towns. The new law is currently being challenged in court.

Impact: Some improvements, but reforms are not working entirely as intended

- A study completed in June 2003, compared education finance data in the year prior to reform with the three years after reform. This assessment examined what progress had been made in raising expenditure levels and lowering tax rates in New Hampshire's less wealthy communities relative to communities with greater property wealth. It found:
  - Reform has done little to change the overall per pupil expenditure patterns. Although towns with less property wealth received larger grants, spending increases were nearly the same across property wealth quintiles regardless of size.
  - Tax rates declined, but decreases in local property taxes since reform were greater in communities with higher median household incomes than in communities with lower median incomes. With the exception of donor towns, upper, middle, and low property wealth towns saw reductions in tax rates. Rates declined in poor communities by 16 percent, but the middle quintile communities experienced reductions of 21 to 26 percent.
  - The system had defined rich and poor towns solely on the basis of property valuations. Consequently, the town with the lowest median household income in the state was classified as rich, as were 21 other towns with below average incomes, while the four highest income towns received $10 million in state aid.

- Another study, published in March 2005, examined how new state education aid affected local budgets and which towns benefited from the increase in state education aid between FYs 00 and 04. It found:
  - Less than 40 percent of new state education aid was used to educate New Hampshire students. The remainder of the additional aid spurred additional municipal or county spending or tax relief.
  - Before the Claremont decision, education aid was highly targeted to low-income towns, and after the decision middle- and high-income towns received the largest percentage increases in state education aid.
  - In FY 04, low-income towns received only 22 percent of the total state general education aid, compared with 37 percent before Claremont.

- The new aid formula for 2005/06 apparently allows poorer communities to receive more education aid, while more prosperous communities receive lesser amounts compared to last year. Communities that are losing aid, under the revised formula, would be guaranteed at least 85 percent of what they receive now in state aid for two years, but drop another 15 percent for the next two years.
  - Overall, the total real state aid to towns for FY 06 of $473 million is seven times the aid in FY 98 of $70.8 million (pre-Claremont).
  - The wealthiest towns will receive 17 times what they did in 1998; in FY 05, they received 19 times what they had in 1998.
  - The poorest towns will receive five times as much as they did in 1998; in FY 05, they received four times what they had in 1998.
  - The poorest communities have and continue to receive the greatest *amount* of state aid; however, relative to other towns on a proportional basis, they receive less. For example, towns in the two *poorest* quintiles received 68 percent of state aid in FY 98 and will receive 50 percent in FY 06, while towns in the *wealthiest* quintile received 5 percent of state aid in FY 98 and will receive 14 percent in FY 06.

Colorado: TABOR and its impact

Problem: Perceived lack of accountability and unrestrained government growth

- Colorado has a long tradition of direct democracy, and over the years has adopted a number of voter-initiated fiscal policies ranging from a ceiling on the state's operating budget (annual increases are limited to 6 percent) to restrictions on local property tax assessments.

- Beginning in the 1970s, concerns over excessive growth in state and local government led to a number of proposals to limit taxes. By the 1990s, anti-tax groups concerned about government's ability to control spending on its own, especially during exceptionally strong economic times, had gained wide public support for adding a "taxpayer bill of rights" (TABOR) amendment to the state constitution as a way of limiting government growth and preventing tax increases.

Strategy: The TABOR ("Taxpayer Bill of Rights") amendment, a constitutional limit on state and local revenue growth

- In 1992, Colorado voters approved a ballot initiative known as TABOR that amended the state constitution to require:
  - voter approval of any state or local tax increase;
  - growth in state and local revenues be limited to the inflation rate plus population growth ("allowed tax collections"); and
  - any revenues received in excess of allowed collections be refunded to taxpayers.
  - However, the amendment also allows voters to exempt governments from these limits for a set number of years and at certain times vote to allow governments to retain excess revenues.

Impact: Limited spending growth, state government is actually shrinking relative to the economy at present, and conflicts between tax and spending mandates

- TABOR, generally viewed as the most restrictive tax limitation in the country, kept government spending levels in check in Colorado throughout the economic boom of the 1990s. During the subsequent economic recession, when tax receipts dropped sharply, the TABOR limits were also rebased to a lower level. Despite the recent improvement in its fiscal conditions and healthy revenues, spending levels are still limited to inflation plus population growth and will take years to return to pre-recession levels.
  - In fact, state government growth has fallen below growth in the economy. Because the largest items in the budget (i.e., Medicaid and K-12 education) grow at rates faster than those allowed under TABOR and offer limited opportunities for significant cuts, Colorado is experiencing serious budget shortfalls at the same time the state is required to provide taxpayer refunds.
  - TABOR's provision that all excess revenues be returned to taxpayers also prevents creation of an effective "rainy day fund."

- Critics claim TABOR has significantly reduced the quality of many Colorado services. Some comparative statistics cited as evidence of this decline include the following: the state ranks 48th in higher education per capita spending; it ranks 49th in K-12 expenditures as a percent of personal income; it has the 6th lowest rate for Medicaid enrollment; and the percent of uninsured low-income children jumped from 15 to 27 percent between 1991 and 2003.

- Supporters point out TABOR has been successful in limiting government growth and preventing tax increases, which contributes to a favorable tax climate. Among the comparative statistics cited as evidence of this success are the following: Colorado currently has the 10th lowest per capita state/local tax burden; Colorado state and local taxes account for 9.5 percent of state personal income, ranking 37th among all states; and its business climate according to Tax Foundation rankings is the 8th "friendliest" in the country.
- TABOR tax limits conflict with a mandatory spending initiative. In 2002, Colorado voters approved another constitutional provision, Amendment 23, that requires per pupil K-12 education funding be increased at the rate of inflation plus 1 percent each year through 2010 and at the annual inflation rate each year after. Many believe the restrictions TABOR places on revenue growth will not permit compliance with the spending requirements of Amendment 23 and they also expect additional constitutional funding mandates will be pursued by various interest groups in the future.
- Another unintended consequence of TABOR is a more complicated state and local tax structure. A voter-initiated tax limit enacted in 1982, the Gallagher amendment, established restrictions on property taxes. Specifically, it requires 55 percent of revenues to come from commercial properties and 45 percent from residential properties. It also sets the commercial assessment rate at 29 percent of value, while residential rates are variable.
    - Over time, as the value of residential properties has increased in relative terms, residential rates have had to drop to maintain the required tax ratio. In some cases, residential rates are so low they cannot produce adequate revenues for local budgets but, under TABOR, any property tax increase requires voter approval.
    - Without approved property tax increases, towns must further cut spending or find other sources of revenue, usually from changes to local option sale taxes. As each of Colorado's approximately 2,500 local governments can set its own rates and exemptions, the result is an extremely complicated and confusing tax structure for businesses and individual taxpayers.

Status: Changes to TABOR provisions under consideration

- Legislation to relax the TABOR restrictions and allow the state to retain more revenue over the next five years was approved by the legislature and the governor earlier this year.
- Implementation of these provisions, however, requires voter approval. A vote on this proposal is scheduled for sometime in November 2005.

Michigan: Local Property Tax and State Business Tax Reforms

Problem: Property tax reforms from the 1990s limit local revenue-raising options; a declining state economy is raising questions about revenue adequacy and the business climate

- At the beginning of the 1990s, the local property tax burden in Michigan was among the highest in the country (34 percent above the national average in 1992). In addition, state support for education costs was among the nation's lowest, and spending disparities among local school districts were great.
- Property tax reforms enacted in the mid-1990s have helped to address local tax burden and school finance issues, but have had an unintended consequence of severely limiting local revenue-raising authority. If state revenue sharing is not adequate, local officials are concerned they will be unable to meet necessary expenses.
- Michigan's weak economy in recent years is consistently producing revenues below anticipated levels. At the same time, a major state revenue source, the Single Business Tax (SBT), is being phased out, and there is no agreement about how it will be replaced.

Strategy: Enactment of Proposal A and elimination of the Single Business Tax

- To provide local property tax relief and reduce school funding inequities, Michigan restructured its tax system in 1994 in accordance with voter-approved ballot Proposal A, which:
  - increased state tobacco taxes, increased the sales tax rate, established a new state education tax (6 mills on all property), and created a new real estate transfer tax to replace about two-thirds of local school property taxes;
  - earmarked all resulting new revenues to a new state School Aid Fund;
  - placed a per parcel cap on annual increases in the taxable rate for property of 5 percent or the inflation rate, whichever is less;[33] and
  - required legislative approval by a three-quarter vote of any increase in local property taxes for school operating expenses.

- Michigan enacted its unique Single Business Tax in 1975 as a means of insulating state revenues from dramatic fluctuations related to its volatile business cycles. The SBT, the only value-added type tax on business gross receipts in the country, replaced Michigan's corporate income tax and six other businesses taxes including the local property tax on business property. In addition to being more stable and transparent, the SBT was intended to be a more neutral business tax, treating all entities (incorporated and unincorporated) the same, encouraging investment, and not penalizing businesses for being profitable.

[33] This cap is in addition to a 1978 constitutional limit on property tax increases that requires unit-wide property taxes adjusted for new construction not to increase more than the rate of inflation without a taxpayer vote.

- Since its enactment, the SBT has been amended over 60 times to add exemptions and exclusions, which has significantly reduced its original broad base.
- Its low 2.3 percent tax rate remained unchanged, however, until 1998. That year a proposal was put in place to phase the tax out over a 20-year period by annually reducing the rate (unless the state rainy day fund balance drops below a set level, which temporarily halts the phase-out).
- Prompted by business concerns about competitiveness given the state's poor economy, the SBT phase-out was accelerated in 2002. The tax is now scheduled for elimination by 2010.

Impact: Several reform goals achieved but with some unintended consequences

- Michigan's Proposal A reforms have resulted in lower property taxes, substantially improved state support of education, and less disparity in district spending. According to a recent university study:
  - Michigan ranked 18th in property tax burden in 2002 compared to 5th in 1992;
  - the state now supports almost 80 percent of K-12 general education funding versus 29 percent in FY 93; and
  - the difference in per pupil spending between the highest and lowest spending local districts was reduced from three times to two times between the 1993-1994 and 2002-2003 school years.[34]
- At the same time, with the restrictions Proposal A placed on local tax options, some towns report they may be unable to raise sufficient revenues to meet expenses. Given Michigan's current economic conditions, increases in state aid levels seem unlikely.
- According to most reports, the SBT has been a significant, stable, and countercyclical revenue source for the state.
  - Despite rate reductions as it is being phased out, the SBT produced nearly $2 billion in revenues for FY 05, almost one-quarter of the state's general fund revenues and about 6 percent of all state revenues.
  - The SBT base, however, has been eroded over time reducing its neutrality and fairness. As a result of the numerous exemptions and exclusions, it is estimated at least half the businesses in the state are no longer required to file a return.
- An unintended consequence of the SBT is it can provide generous incentives for investments multi-state corporations make in other states, while measures to limit such

[34] Douglas B. Roberts, PhD., Michigan State University, *Property Tax Reform/School Finance Reform: Michigan's Experience*, October 1, 2004.

tax benefits to Michigan firms have been found to violate interstate commerce provisions of the federal constitution.

Status: The direction of tax reform is uncertain and still under debate

- In September 2005, Michigan legislators and the governor reached agreement on a state spending plan that appears to preserve present levels of state education aid to municipalities. It is not clear if state revenues will be sufficient to meet both state and local spending needs.
- A tax plan including business tax reforms is not expected to be taken up until sometime in October 2005. At present, there is no agreement among legislative leaders and the governor on how to make up the state revenues that are lost from the continuing phase-out of the SBT.

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Section 4

Administration of Connecticut Taxes

Any tax policies a state adopts need sound administration to ensure:

- fair implementation;
- prompt and clear communication to the public;
- efficient revenue collection;
- administrative opportunities for taxpayers to appeal a tax bill; and
- enforcement against those who attempt to avoid paying taxes owed.

In Connecticut, administrative functions for all state taxes are carried out by the Department of Revenue Services. While this study is not intended to be an in-depth performance audit of DRS, the study scope calls for an assessment of administrative simplicity, efficiency, and compliance within the state tax system. To complete this task, committee staff are developing information to describe and analyze how taxes are collected, what levels of compliance are achieved, and the general cost-effectiveness of the state's major tax administration functions.

This section describes the organization and structure of the Department of Revenue Services, outlining major functions and profiling primary resources over time. As the following discussion notes, the department has experienced staff reductions and essentially flat funding throughout the last decade. While limited staff and funding may be less of an issue when offset by state-of-the-art automation, this has not been the case at DRS.

As discussed below, until this year the agency has been reliant on an assortment of antiquated and incompatible computer systems to carry out all major functions. The impact of available resources on department efficiency and effectiveness is being examined by program review staff. Analysis of department workload and outcome measures, where available, along with an assessment of agency performance in terms of efficient administration and promoting compliance, will be provided in the final report.

DEPARTMENT OF REVENUE SERVICES: ORGANIZATION AND STRUCTURE

The Department of Revenue Services is the state agency responsible for tax administration, collection, and enforcement in Connecticut. The department processes all tax returns for major state taxes (personal income, corporation and other business taxes, general and selected sales taxes, and the estate tax) and ensures the accuracy of amounts paid. DRS also ensures compliance with state tax laws and regulations. To carry out this mission, the agency currently is organized into four major program areas and eight divisions, which are described briefly below.

Major Programs and Functions

The organizational structure of the Department of Revenue Services is shown in Figure IV-1. The department is organized along management reporting lines rather than by the programs and functions described in the state budget document. The description of the department summarized below is presented by major program and function.

Management Services

Executive Office -- includes the commissioner and deputy commissioner. The office establishes the policy and direction for the department, oversees legislative activities and programs, handles all public and government relations, planning and organizational development, taxpayer advocate functions, and implements the agency's affirmative action plan.

Legal Division -- is responsible for drafting regulations and legislation, issuing rulings and legal opinions, and reviewing issues regarding tax policy. This division also represents the commissioner in all succession tax litigation.

Taxpayer Services -- focus is to promote voluntary taxpayer compliance. To accomplish this, the division maintains five field offices and a call center through which it provides public education and information, responds to taxpayer inquiries, assists with applications and returns, and offers speakers for organizations and businesses. In addition, the division administers the exemption programs for farmers, fishermen, and nonprofit organizations.

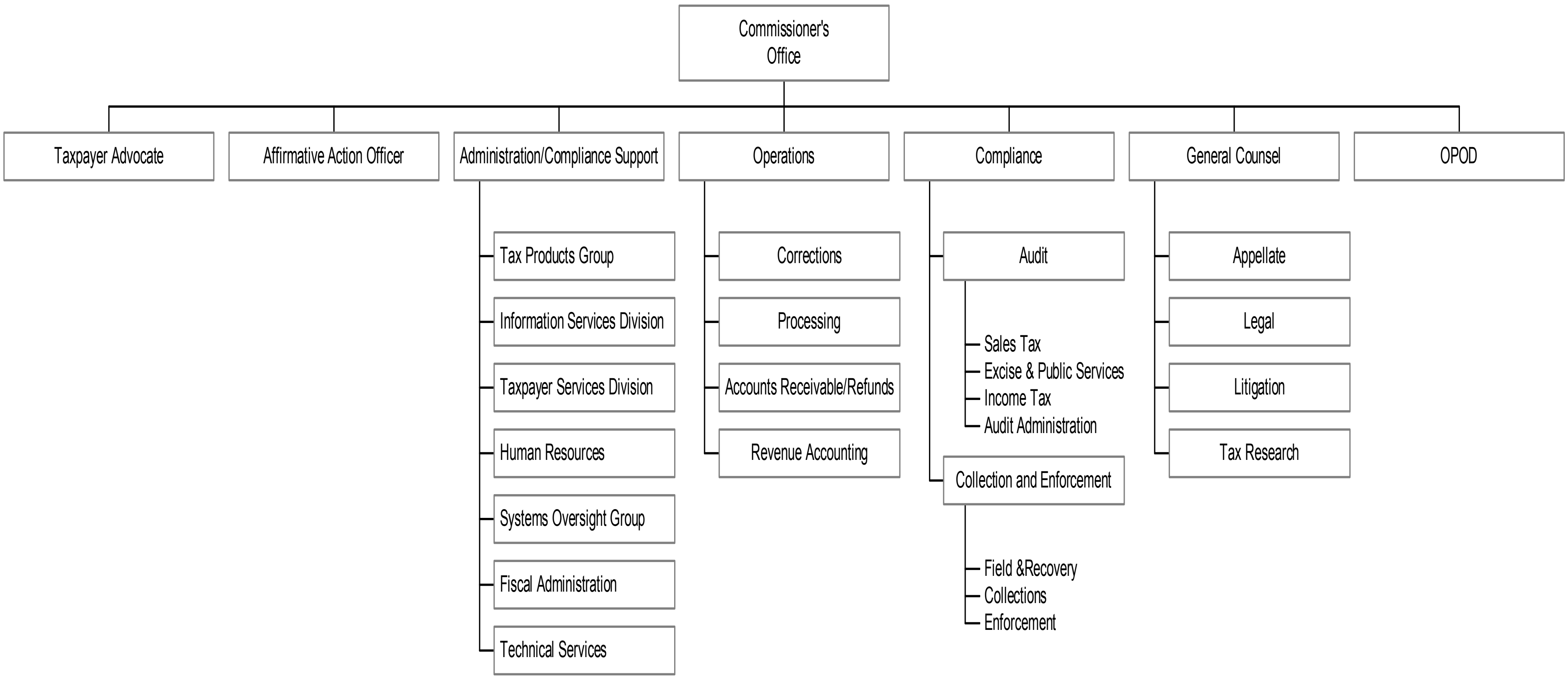
Tax Research Unit -- analyzes, prepares and disseminates statistics generated by DRS as well as preparing the annual report and statistical overview of the income tax. The unit researches and estimates the effects of various taxing options proposed by policy makers, performs legislative liaison work, and responds to requests from other states and agencies.

Appellate Division -- receives and reviews all taxpayer protests of audit assessments, liability impositions, disallowance of refund claims, and penalty waivers. The division conducts hearings of appeals and issues final administrative adjudications.

Administrative Services -- is responsible for preparing and administering the agency budget, monitoring expenses, and providing training opportunities for DRS staff. Administrative Services also act as the personnel and payroll units administering the rules and regulations regarding state employment and recruitment.

Litigation Division -- represents DRS in litigated appeals and all court-ordered pretrial/settlement conferences held by and before the Tax Session of the Connecticut Superior Court. In addition, the division acts as a liaison for the Office of the Attorney General in preparing and arguing appeals decisions of the Tax Session.

Figure IV-1. Department Of Revenue Services



Operations

Operations Division -- processes and deposits the revenue from taxpayer returns, verifies timely issuance of refunds, creates bills for delinquencies, and develops reports based on tax collection revenues. The division also develops tax forms and publications, enters data, and issues permits, licenses, motor carrier decals, and tax registration numbers.

Information Services Division -- is responsible for system design and implementation for all agency functions as well as providing technical support and technological training. Staff is in charge of the department's equipment including acquisition and maintenance.

Audit/Compliance

Audit Division -- determines the accuracy of tax reporting through field and office audits of targeted accounts. The program consists of seven field audit units. The units conduct approximately 3,400 field audits and 60,000 office audits annually. Staff develops both computerized and manual audit selection programs and maintains a centralized automated program to develop pertinent audit and statistical information. In addition, they direct a discovery program, which investigates new areas of tax compliance, assists taxpayers with preparing returns and advises them on maintenance of records, and monitors internal activities for compliance with established policies, procedures, and performance standards. The audit division also develops and administers the electronic data processing audit program and all aspects of inheritance taxation.

Collection and Enforcement

The Collection and Enforcement Division encompasses three major functions:

Outreach -- agents mail overdue tax notices, work with taxpayers to establish repayment schedules, initiate telephone contact to resolve overdue accounts, and refer chronic debtors or high-risk cases for enforcement.

Enforcement -- agents obtain tax warrants to garnish wages, schedule permit suspension hearings, file tax liens, and obtain evidence of bankruptcy claims. Agents conduct on-site investigations of complaints regarding tax violations, regularly inspect problematic vendors, and follow-up on leads from audit examinations.

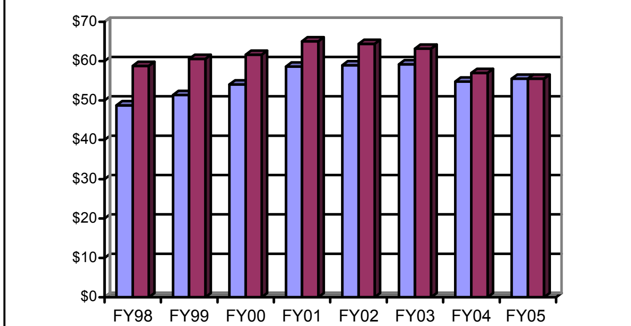
Criminal investigations -- agents of the Special Investigation Section have police powers and may make arrests in cases involving operating without valid permits, bad checks, refusal to file/pay or filing fraudulent returns, and smuggling of contraband fuel, cigarettes, and alcohol.

Agency Resources

Adequate resources are critical to efficient and effective tax system administration. Both the quantity of staff and quality, in terms of training and experience, contribute to how well a tax agency performs its key administrative and compliance functions. Automated information systems that incorporate up-to-date, high quality software and hardware and integrate major functions are also critical for successful tax system administration. Information that program review committee staff has gathered to date on DRS budget, staffing, and automation resources is highlighted below.

Operating budget. The trend in funding for the Department of Revenue Services over the past eight years is presented in Figure IV-2. The figure shows the agency's operating budget has grown very little over this period. Current funding is still below a peak of about $59 million in FY 03 and only 14 percent more than the budget for FY 98. When adjusted for inflation, DRS expenditures during the just completed fiscal year (almost $56 million) were actually less than FY 98 expenditures (almost $59 million). It is important to note, the operating budget does not include most expenses related to agency computer systems and equipment, which are covered, like nearly all automation costs, in the state's capital budget.

Figure IV-2. DRS Operating Budget: FY98-FY05
(Dollars in Millions)

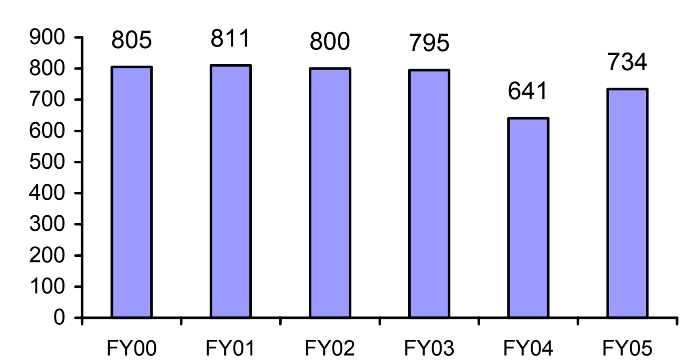


Source of Data: OFA and DRS

Staffing. Staffing levels within the Department of Revenue Services since FY 00, in terms of filled positions on July 1 of each year, are shown in Figure IV-3. This period includes the two years of staffing reductions through employee layoffs and early retirements put into effect across all agencies to help reduce state budget deficits. The impact of these personnel reductions at DRS was a sharp drop in filled positions, about 21 percent, to a low of 641 in FY 04.

As the figure indicates, a little over half of the lost positions (93) were recovered by FY 05. In addition, funding for 20 new positions was included in the agency's budget for the current fiscal year. Department managers point out, however, that many of the employees who retired early were among the most experienced staff in the agency. Frequently, the individuals replacing them are new to DRS and to state tax administration duties in general.

Figure IV-3. DRS Staffing Levels: FY00-FY05



Source of Data: DRS

Automated systems. At present, the Department of Revenue Services is in the midst of implementing an entirely new, agency-wide automated information system called ITAS (Integrated Tax Administration System). ITAS is replacing what has been long recognized as an inadequate collection of antiquated and incompatible computerized operations. These include the agency's more than 30-year-old mainframe-based primary information system, which requires extensive programming for all data retrieval and reporting, and a totally separate computerized system developed to handle just the personal income tax when it was enacted in 1991.

ITAS has been in development since 1994 and is expected to have a final cost of about $70 million. Progress has been slow, and costs have increased for a number of reasons including: funding issues; personnel changes; restructuring the state information technology function; and implementation of other statewide computer projects (e.g., Y2K conversion and the CORE-CT system). The new system is being phased in. At this time, all businesses taxes have been converted to ITAS, and the personal income tax will be incorporated during 2006.

The goal is to integrate all taxes and all taxpayers in one automated system, a "best practice" recommended by tax administration experts and professional organizations. Once it is fully in place, ITAS is expected to:

- promote compliance and enforcement (e.g., through automated "cross referencing" internally and externally);
- permit automated case management and taxpayer assistance (e.g., on-line access to all data by case/taxpayer, allowing quicker updating and correction); and
- allow extensive research and analysis (e.g., automated historic data retrieval, statistical reporting across all taxes, tracking of trends and patterns, and preparation of projections and impact evaluation of proposed changes).

DRS staff have explained the capabilities of ITAS, but to date committee staff has not received any reports produced by the new system. Over the last few months, the agency has focused almost exclusively on getting the system operational, and report production has been a lower priority. In addition, ITAS is not maintaining data in the same way or even capturing some of the same information as the old systems, and thus may not generate the same types of reports.

In preparation for ITAS conversion, DRS has upgraded a number of its business systems and made electronic improvements in agency operations. For example, the agency has improved its centralized call center capabilities for handling taxpayer inquiries, and DRS has also made great strides in providing for electronic filing of returns. During the 2005 tax season, Connecticut's rate for non-paper filings for the income tax was 67 percent. This was third highest in the country and considerably higher than the national average of 54 percent. If ITAS operates as intended, further expansion of automated public education, research, and management information activities will be possible.

Appendices

APPENDIX A
Sales & Use Taxable and Tax-Exempt Items

Taxable	Tax-Exempt
Consumer Goods	
▪ Food for take-out or restaurant consumption ▪ Miscellaneous retail: movies, electronics, appliances ▪ Automotive products ▪ Household products: paper products, soap, shampoo, detergent ▪ Apparel & accessories over $50 ▪ Home furniture/furnishings ▪ Construction and hardware ▪ Lodging ▪ Magazines sold over-the-counter	▪ Groceries ▪ Vending machine sales under $0.50 ▪ Blood & life support equipment ▪ Prescription drugs, syringes and needles, disposable pads used for incontinency, and smoking cessation products ▪ Non-prescription drugs and medicines ▪ U.S. and CT flags ▪ Newspapers and magazine subscriptions ▪ Utilities for residential use and certain manufacturing or agricultural production ▪ Apparel under $50 ▪ Bicycle helmets and child car seats ▪ College textbooks ▪ Hybrid cars (prior to 10/1/08) ▪ Items purchased with federal food stamps
Business Purchases	
▪ Furniture ▪ Computers, computer software and equipment ▪ Office supplies ▪ Natural gas, electricity, and oil for non-residential use.	▪ Livestock and feed ▪ Machinery used in agricultural production ▪ Machinery and equipment used in manufacturing production ▪ Commercial fishing ▪ Commercial printing ▪ Material used in industrial waste treatment ▪ Certain containers ▪ Ambulances and commercial trucks, truck tractors and semitrailers ▪ Aviation fuel, aircraft replacement parts, materials etc. used in an aircraft manufacturing facility ▪ Sales to units of government ▪ Sales to UConn Ed. Properties, Inc. ▪ Interstate commerce including mail order and internet purchases

<table>
<tr><th>Taxable</th><th>Tax-Exempt</th></tr>
<tr><th colspan="2">Services (Personal & Business)</th></tr>
<tr><td>

- Labor: motor vehicle repair, maintenance, locksmith, extermination, painting and lettering, photographic studio services, telephone answering services, pool cleaning and landscaping
- Professional: computer and data processing (including internet access), management consulting, business analysis, health and athletic club, credit information and reporting, employment agency services, lobbying, and private investigation
- Lease or rental (non-residential), storage or mooring of a noncommercial vessel from Nov.1st – Apr.30th
- Cable/satellite television and telephone services

</td><td>

- Drug testing services
- Barber and beauty services
- Laundry, dry-cleaning and shoe repair
- Up to $2,500 of the cost of services for a funeral
- Services related to human health
- Utility services
- Leasing and renting of movies by theaters
- Aircraft repair services
- Property tax on leased motor vehicles
- Sales of services between parent companies and wholly owned subsidiaries
- Personnel services (e.g. marketing, development, testing or research services, business services in joint ventures)
- Computer and data processing
- Massage therapist and electrology services
- Marine vessel brokerage services (effective 10/1/05)

</td></tr>
<tr><th colspan="2">Use Tax Exemptions</th></tr>
<tr><td colspan="2">

- Property subject to sales tax
- Property purchased from the US government
- Purchases brought into the state by nonresidents
- Property donated to the government or to tax exempt organizations
- Vessels brought into the state exclusively for storage, maintenance or repair
- Capital resources provided to institutions of higher education for electronic commerce studies or work force development programs

</td></tr>
<tr><td colspan="2">Source: C.G.S. Chapter 219 § 12-406 through § 12-432b</td></tr>
</table>

APPENDIX B

[not available currently in electronic format]

Appendix C. Property Tax Exemptions	
Category	**Description**
Agricultural	Various exemptions (some limited) are available relating to farm structures, tools and machinery, livestock, produce, commercial fishing vessels and apparatus. Municipalities may adopt a number of optional additional exemptions in this category.
Charitable Organizations	Real and personal property owned by or held in trust for corporations organized exclusively for scientific, educational, literary, or a charitable purpose is exempt. The statutes also specifically exempt improvements to open-space land held by federally exempt organizations, religious institutions, hospitals, colleges, agricultural societies, veterans' organizations, and camps and recreation facilities owned by charitable institutions. Municipalities may provide an exemption to businesses offering day care services.
Disabled Persons and Senior Citizens	Property of totally disabled persons is exempt to the value of $1,000. Municipalities may provide property tax relief to disabled persons and senior citizens not to exceed 10 percent of the total real property tax assessed. Property of blind residents is exempt in the amount of $3,000. Municipalities may provide additional exemptions for blind persons. In addition, permanently and totally disabled persons and senior citizens are eligible for a homeowner's tax reduction or a renter's direct grant.
Property Tax Abatements based on Inability to Pay	Municipalities may abate the property taxes due to an owner-occupied residential dwelling to the extent the taxes exceed 8 percent of the taxpayer's income. The owner must agree to reimburse the municipality for the amount of the taxes abated with 6 percent interest or a rate set by the municipality. In the year of a general revaluation, municipalities in which the effective tax rate on residential property exceeds 1.5 percent of market value may adopt a surcharge against all property classified as industrial, commercial, or public utility. The proceeds from the surcharge are to be used to fund the residential property tax credit. Municipalities may abate the taxes and interest on delinquent taxes that are assessed "upon such persons as are poor and unable to pay." Municipalities may also grant whole or partial abatements of taxes to corporations that are unable to pay

Appendix C. Property Tax Exemptions	
Category	**Description**
	the tax and have applied for a working capital loan from the federal government, if the taxes due constitute a bar to granting the loan.
Governmental and Public Property	Property belonging to the federal government, the state of Connecticut, Native American reservations, municipalities, and cemeteries are exempt.
Manufacturing and Industrial Property, and Inventories	The monthly average quantity of goods of any manufacturing business is exempt. Manufacturer's machinery and equipment is exempt for the first five full assessment years following the assessment year. The monthly average quantity of goods of wholesale and retail businesses are exempt.
Fixed Assessments	Certain real and personal property may be subject to a fixed assessment for a period of time (i.e., delayed increase in assessment) negotiated by a taxpayer and a local legislative body, within statutory parameters.
Veterans and Military Personnel	Various property tax exemptions are available to veterans and active duty personnel. Additional exemptions are available to disabled veterans, and some exemptions are available to surviving family members of a deceased veteran. Various local option exemptions are also allowed.
Miscellaneous	Other abatements include household goods, certain commercial vehicles, nonmotorized vehicles, pollution control facilities, historic property, and partial exemption for businesses in an enterprise zone. Other municipal options include the abatement of: a portion of taxes for certain municipal volunteers; taxes on communications establishments and information technology, and sites subject to remediation.
Sources: Connecticut General Statutes; *Handbook for Connecticut Assessors*, The Connecticut Association of Assessing Officers, Inc, 2004.	

APPENDIX D. Fiscal Year 05 and 06 Major State Grants to Municipalities							
		Fiscal Year 05			Fiscal Year 06		
Program	Statutory Reimbursement Rate	Amount Required by Statutory Formula (millions)	Estimated Expenditure (millions)	Actual Percent of Statutory Amount Reimbursed	Amount Required by Statutory Formula (millions)	Approp. (millions)	Estimated Percent Reimburse. Rate
State Owned Property	100% for correctional facilities;100% for towns with more than 50% of all property is state owned;65% for Connecticut Valley Hospital;45% for all other property	$ 93.10	$ 72.50	77.9%	$ 100.20	$ 72.54	72.4%
Private Colleges and Free Standing Chronic Disease Hospitals	77% of tax losses due to real property exemptions for eligible private colleges and general and free standing chronic disease hospitals	134.80	105.90	78.6%	141.00	111.00	78.7%
Electric Generation Facilities	100% 1st year and 10% less each year	11.30	11.30	100.0%	9.30	9.30	100.0%
Distressed Municipalities	50% of revenue loss due to certain exemptions granted to qualified businesses	7.80	7.80	100.0%	7.80	7.80	100.0%
Manufacturing Machinery and Equipment and Commercial Vehicles	100% to 80% of revenue loss as a result of state mandated exemptions	59.70	50.70	84.9%	55.30	55.30	100.0%
Vessels	Each municipality receives an amount equal to property tax	2.30	2.30	100.0%	2.30	2.30	100.0%

APPENDIX D. Fiscal Year 05 and 06 Major State Grants to Municipalities							
		Fiscal Year 05			Fiscal Year 06		
Program	**Statutory Reimbursement Rate**	**Amount Required by Statutory Formula (millions)**	**Estimated Expenditure (millions)**	**Actual Percent of Statutory Amount Reimbursed**	**Amount Required by Statutory Formula (millions)**	**Approp. (millions)**	**Estimated Percent Reimburse. Rate**
	receipts for boats on its 1978 Grand List						
Elderly/Disabled Freeze Program (Closed in 1978 to new applicants)	100% of revenue loss due to program	1.90	1.90	100.0%	1.40	1.40	100.0%
Elderly/ Disabled Circuit Breaker Program	100% of revenue loss due to program	20.50	20.50	100.0%	20.50	20.50	100.0%
Disabled Tax Relief Program	100% of revenue due to program	0.25	0.25	100.0%	0.53	0.53	100.0%
Veteran's Additional Exemption	100% of revenue loss due to program	2.90	2.90	100.0%	2.90	2.90	100.0%
Sub-total PILOT		*$ 334.55*	*$ 276.05*	*82.5%*	*$ 341.23*	*$ 283.57*	*83.1%*
Other Grant Programs							
Mashantucket Pequot /Mohegan Fund	Grant calculations depend on various statutory formulas	$ 135.00	$ 85.00	63.0%	$ 135.00	$ 91.10	67.5%
Education	Various	1,996.70	1,902.80	95.0%	2,090.90	2,014.90	96.4%
Other (estimated)	Various	41.65	41.65	100.0%	58.73	58.73	100.0%
Sub-total Other Grants		*$2,173.35*	*$ 2,029.45*	*93.4%*	*$2,284.63*	*$2,164.73*	94.8%
GRAND TOTAL		**$2,507.90**	**$ 2,305.50**	**91.9%**	**$2,625.86**	**$2,448.30**	**93.2%**
Source: Office of Policy and Management, Office of Fiscal Analysis, and LPRIC calculations							