CONNECTICUT VOICES FOR CHILDREN

Testimony Regarding Senate Bill No. 1007: An Act Concerning the Governor's Recommendations on Revenue

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Committee on Finance, Revenue and Bonding
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Senator Daily, Representative Widlitz and members of the Finance Committee:

I am testifying today on behalf of Connecticut Voices for Children, an independent child advocacy organization that serves as a member of the State Fiscal Analysis Initiative, a nationwide network of organizations that advocate for responsible state fiscal policy with a particular focus on the needs of middle- and lower-income families. I am a Senior Policy Fellow at Connecticut Voices, concentrating on state fiscal policy.

Today I submit testimony **regarding** Senate Bill 1007 *An Act Concerning the Governor's Recommendations on Revenue*, in particular, regarding components of the act which concern the personal income tax.

Specifically, this testimony makes three broad points:

1) **The Governor's personal income tax proposals generally represent an improvement to Connecticut's current income tax.**
2) **The total elimination of the property tax credit, however, as well as increases to the sales tax make the *middle class* the hardest hit of any income category.**
3) **By scaling back the property tax credit proposal and modestly expanding other elements already included in the package, we can protect the middle class and still meet or exceed revenue-raising targets set by the Governor.**

1) In many ways the personal income tax proposal in this bill should be applauded. Income taxes are one of the few means of raising revenue without placing disproportionate demands on middle- and lower-income residents. Moreover, income taxes can be designed to correct for large tax imbalances that are created by other state and local taxes, such as the sales and property taxes. At present, residents in Connecticut who earn income in the bottom 20% of the income distribution pay, on average, more than twice the amount of their incomes (12%) in state and local taxes than residents in the top 1% (4.9%).[1] The Governor's proposal would strengthen Connecticut's income tax by lowering tax rates on low-income residents through the Earned Income Tax Credit (EITC) and increasing rates on higher incomes through a more progressive rate structure.

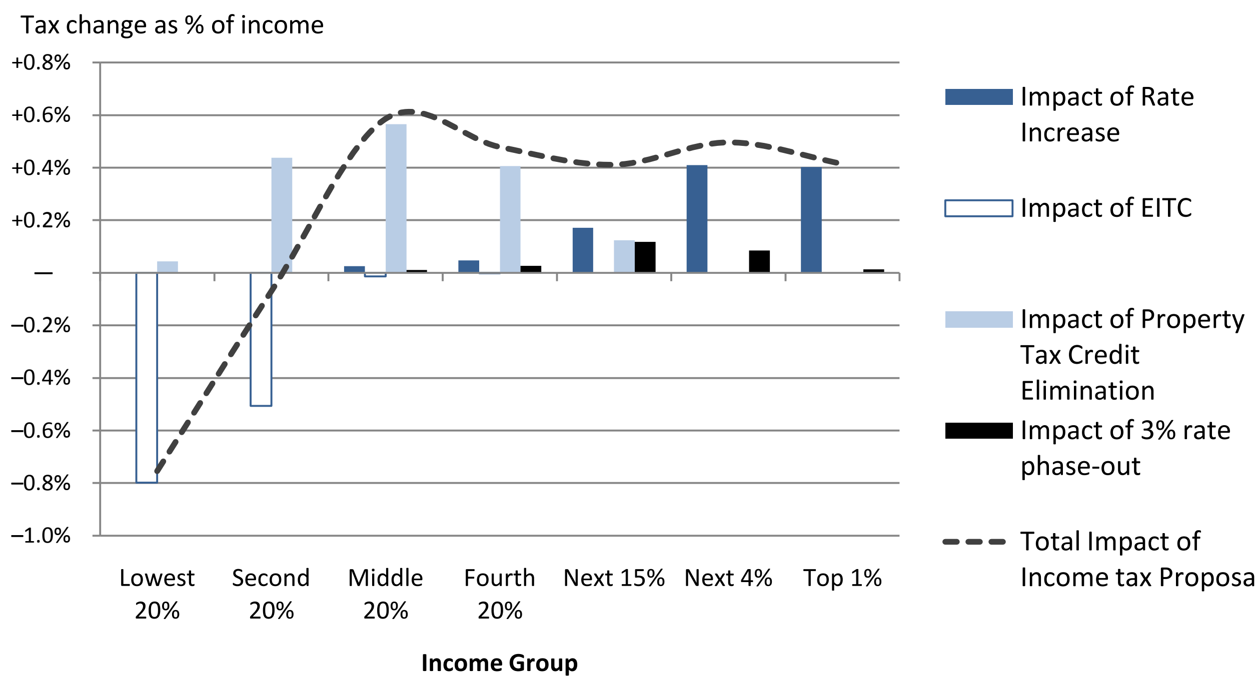
2) However, by totally eliminating the property tax credit, it is moderate and middle-income taxpayers who will be hit harder than any other income group. Figure 1[1], below, shows the impact

[1] All distributional tax modeling in this testimony was done with the assistance of the Institute on Taxation and Economic Policy using their microsimulation tax model. This model is among the most comprehensive and accurate in the country, using actual

by income level of each of the Governor's income tax proposals. It shows that, largely because of the property tax credit elimination, Connecticut residents with incomes in the middle 20% ($44,000 – 75,000) would pay an average of 0.6% more of their incomes in income tax than they currently do—higher than any other group. Additionally, many middle-income families could experience a tax increase on their income taxes of close to twice that amount. For example, a family with a yearly income of $45,000 that currently claims the full $500 property tax credit—an easy feat for a homeowner—would see their income tax rise by the full $500 credit, or 1.1% of their income.[2]

When combined with the other proposed tax changes in the Governor's revenue bill, the net impact over the year on middle-class residents would rise even higher relative to upper income groups. The Institute on Taxation and Economic Policy, using a microsimulation tax model, estimated the combined effects of income and various sales tax changes would result in an average tax increase of 0.9% of income on the middle 20% of residents in Connecticut, compared to an average of 0.5% for the top 1% of residents.

Figure 1. First-year Impact of Proposed Income Tax by Level of Income
(All Returns, 2012)



3) By modifying the proposed elimination of the property tax credit to limit tax increases on moderate and middle-income residents and also expanding upon other components of the Governor's proposal, the General Assembly could protect the middle class and still meet or even exceed current revenue targets. We recommend that the General Assembly:

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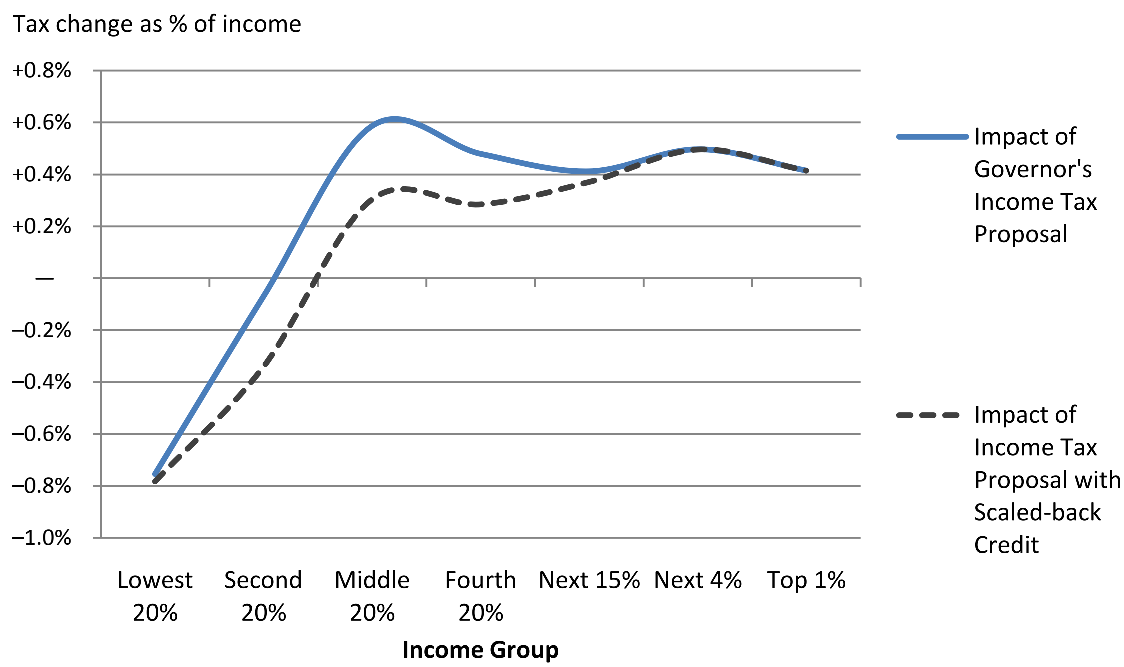
tax records to estimate the impact of proposed changes to state and federal tax law. It models the individual and interaction effects of tax rates, variations in tax base, federal and state adjustments, exemptions, standard and itemized deductions, and credits. For more information on the model, see http://www.itepnet.org/about/ITEP_tax_model_simple.php

- Limit the impact on moderate-income households by scaling back, rather than eliminating the $500 tax credit.
- Make up lost revenue through either (or a combination of):
    a. Raising the top marginal income tax rate.
    b. Extending the rate phase-out to continue beyond the current proposal such that higher income residents pay progressively higher rates on all their income rather than only the portion that falls within a tax bracket.

Limiting the impact on moderate-income households. The governor's proposal would completely eliminate the credit on personal income tax returns for property taxes paid to towns. We propose instead lowering the maximum amount of the credit from $500 to $350 and beginning to phase it out at lower income levels. We propose beginning the phase out at $35,000 for a single filer and $70,000 for a joint return. The reduction in the credit would continue to be 10 percent for every additional $10,000 in income, so, for instance, a couple filing jointly with a combined income of $85,000 would be eligible for a maximum credit of $280. A single filer with income above $125,000 or a married couple with income above $170,000 would be eligible for no credit. Figure 2, below, shows how keeping a reduced version of the property tax credit would mitigate the tax impact on middle and lower incomes. Under this revised plan, we estimate savings to the state of $188 million dollars, $177 million dollars less than the $365 million saved in the Governor's proposal.[3]

Figure 2. Net Impact of Governor's Income Proposal, Without a Property Tax Credit and with a Scaled-Back Property Tax Credit



Making up lost revenue.

a. **The simplest and most equitable way to recoup revenue lost by maintaining the property tax credit would be by raising the top marginal rate of the personal income tax.** By raising the property tax to 6.85%, Connecticut would raise an additional **40 million** in revenue while still not exceeding the top marginal rate in New York, which is currently 8.97% but may decline to 6.85% starting in 2012. Even if marginal income rates were set equal to or even above those in New York, higher sales and property tax rates in New York would likely maintain Connecticut's significant tax advantage. Moreover, concerns that small differences in marginal income tax rates will convince high-income people to leave the state are not substantiated by convincing empirical evidence.[4] People tend to place higher value upon other factors than state taxes, such as social ties, quality of life, quality of public services, and proximity to family.

b**. A second means of raising revenue involves expanding upon an idea included in the Governor's revenue proposal: the "tax table benefit recapture" (Section 40 of Senate Bill 1007.)** A policy first adopted by New York State in 2009, the "tax table benefit recapture" represents an attempt to narrow the revenue gap between marginal and first-dollar taxation. Connecticut Voices supports the basic premise and ultimate effect of the recapture policy, which is to increase the progressivity of average tax rates in Connecticut.

The recapture in the Governor's plan gradually phases out the 3% tax rate for higher incomes until the first $20,000 ($10,000 for single filers) of income is entirely subject to the next lowest marginal rate of 5%. This process could be continued as taxpayers' incomes continue to rise. A recapture plan that includes all brackets incrementally could raise around **$150 million** in additional revenue while maintaining top-line marginal rates where they presently stand. This figure assumes that over the course of the 5.75% bracket, a taxpayer will repay the cumulative tax table benefit accrued up to the 5% rate. Similarly, over the course of the 6.00% bracket, the benefit accrued up to the 5.5% rate would be returned. This would continue until all marginal rate tax table benefits have been repaid by the highest earners in a complete analogy to the New York policy. Implemented correctly, this proposal would have substantial effects on the state's budget while still keeping Connecticut taxpayers in a much less burdensome income tax environment than that evident in New York.

The alternatives presented in this testimony improve upon the Governor's proposals in two principal ways. First, they prevent moderate and middle-income families from shouldering a disproportionate share of new revenues while continuing to meet revenue targets. Second, they represent better economic policy by shifting tax increases away from taxpayers who tend to spend more of their disposable income, most of which flows into local communities.[5]

Thank you for the opportunity to testify today.

Addenda

Improvement of language implementing tax recapture scheme to eliminate tax cliffs:

In Section 40, recapture is effectuated by requiring higher income taxpayers to pay a supplemental tax equal to 10% of the "tax table benefit" for every $10,000, or fraction thereof, in income above a limit that is dependent on their filing status. For example, a joint filer initially gains a tax table benefit of $400 from the difference between the 3% and 5% brackets—calculated as the difference in rate, 2%, multiplied by the income subjected to that difference, $20,000. Once that taxpayer hits $100,500 in AGI, he owes a $40 supplemental tax. At $110,500, the supplemental tax increases to $80. This pattern continues until the full $400 is collected when the taxpayer has reached a Connecticut AGI of $190,500.

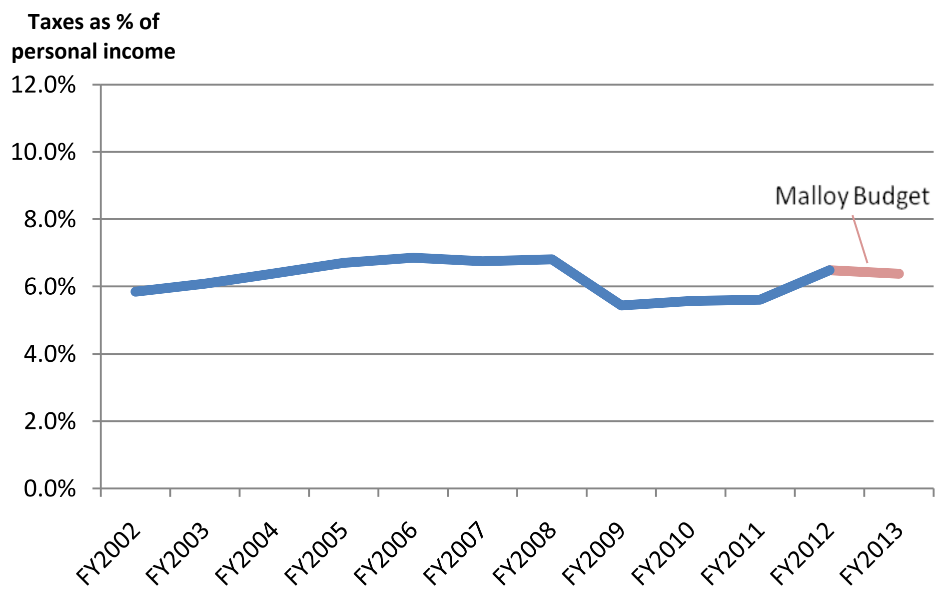
The language of the recapture provisions should be adjusted to address two concerns. First, the current implementation still creates tax cliffs, albeit small ones. With regard to the cliffs, a joint filer with Connecticut AGI of $100,499 would owe $4,628 in state personal income tax, whereas a filer with Connecticut AGI of $100,500 would owe $4,648. By earning an additional $1, the taxpayer would actually lose $19. This could be remedied by smoothing the recapture out, starting at $90,500 and continuing over $100,000, such that the full $400 benefit is recaptured at the same point as under the current proposal, $190,500. A similar adjustment could be made for each other filing status.

The Governor's revenue proposals in context:

As large as $1.5 billion dollars in new revenues may sound, numbers should always be understood in proper context. First, under the Governor's proposal, state taxes would remain a similar proportion of total income in Connecticut than has been seen in recent years. At 6.5% of total income, taxes would in fact be a *lower* proportion of total income than was seen between 2005 and 2008 (Figure 3).

This fact is important in recognizing that the Governor's tax proposals do not represent a large

Figure 3. Under Governor's budget, state tax responsibilities would stay within recent levels



expansion of tax taxation relative to the total level of income in the state. For decades, Connecticut has raised one of the lowest proportions of total personal income in taxes and fees in the country.[6] In 2006, the Federal Reserve Bank of Boston reported that Connecticut was top in the nation in its "revenue capacity" but among the bottom five states in its "revenue effort"—defined as actual revenue raised relative to a state's capacity to raise revenue.[7] These facts point to the conclusion that the Governor's budget could still do more to raise revenue, without departing from the revenue-to-income proportions of other states or even from Connecticut's own historical levels.

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[1] These figures account for state taxes that are offset by the amount that federal tax liability is reduced after deducting local jurisdiction taxes. Institute on Taxation and Economic Policy. Who Pays? A Distributional Analysis of the Tax Systems of All 50 States, 3rd Edition. November, 2009.

[2] For further evidence of this, The Office of Fiscal Analysis' synopsis of the Governor's budget on page 26 includes some finer detail on how sample taxpayers at various income levels might see their tax liability change. Office of Fiscal Analysis, Synopsis of Governor's FY12 & FY13 Budget and Revenue Plan. Presented at Appropriations Committee Hearing. February 17th, 2011.

[3] This estimate was calculated using 2009 tax data from the Department of Revenue Services, which includes the number of credits claimed and the total value of those credits by Connecticut AGI.

[4] The economic literature on this question finds little evidence of a strong relationship between migration and state marginal tax rates, and those studies that do find an association find the effects to be small and do not outweigh the significant fiscal benefits of higher rates. For recent examples, see: Bruce, Fox, and Yang, "Base Mobility and State Personal Income Taxes." National Tax Journal, 63 (4) Part 2, December 2010; Young, Cristobal, Varner, Charles, and Massey, Douglas S. "Trends in New Jersey Migration: Housing, Employment, and Taxation." Policy Research Institute, Princeton University. September 2008.

[5] Peter Orszag and Joseph Stiglitz, Center on Budget & Policy Priorities, Budget Cuts Vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession? (2001), http://www.cbpp.org/10-30-01sfp.pdf

[6] Connecticut Voices for Children. "Reality Check: Connecticut's Public Revenues and Spending Have Remained Lean and Stable for Decades." February 2011, http://www.ctkidslink.org/publications/bud11realitycheck.pdf

[7] Yesim Yilmaz, Sonya Hoo, Matthew Nagowski, Kim Rueben, and Robert Tannenwald. "Measuring Fiscal Disparities Across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002. New England Public Policy Center." Working Paper 06-2. 2006. (Paper is part of the Urban Institute's Assessing the New Federalism project).