Memorandum
Connecticut Tax Study Panel
May 12, 2015

TO: Members of the Connecticut Tax Study Panel
FR: Robert D. Ebel, Executive Director
RE: Guiding Principles and Criteria for Evaluating Changes to the Connecticut State & Local Revenue System

Introductory Comment: Purpose & Scope

An important early action that Connecticut Tax Study Panel will make is to reach agreement on a complementary (i) set of Guiding Principles that frame a high-quality Connecticut state and local revenue system and a (ii) statement on its Criteria for Evaluating Changes to the Connecticut Revenue System.

There are three closely related reasons for taking this action:

The “Why” the Legislature Created the Connecticut Tax Study Panel. A feature typical of the revenue policy process in all state and local governments is that as Legislators convene session after session they often must take ad hoc actions in response to addressing immediate needs. Overtime, such actions can lead to an intricately-constructed patch-work of unwieldy and contradictory collection of rules and regulations that have unintended and harmful results. Accordingly, as the 2014 Legislature concluded, it is important to periodically establish a mechanism such as the Tax Study Panel in order to “step back” from the session-to-session demands and examine whether the state and revenue system conforms to a set of policy goals to guide Connecticut revenue policy-making.

What Makes “Fiscal Sense” for Connecticut as it Approaches the 2020s? Connecticut’s economic structure, demographics, and institutional arrangements undergo continuing change. Moreover, these economic, demographic, institutional trends are largely beyond the control of state and local policymakers. The reality of this changing “fiscal architecture” requires that the Panel address the fundamental question of “what type of revenue system does Connecticut need to be able to capture the fiscal benefits of these trends?” In short, what makes “fiscal sense” given the macro trends? A Panel-agreed upon set of policy objectives can help serve as framework for getting right the answer to “what makes fiscal sense”.

Connecticut Cohesion. By adopting an explicit set of Principles and Criteria that will guide its recommendations, the Panel will be making a statement that the Connecticut state and local revenue system is more than a compendium of dry tax law and arcane economic data, but rather, an expression of community relationships—between individuals and between the people and their government.
One can add a fourth reason, which though less lofty than the preceding three, is that having an early adoption of a set of Principles and Criteria is key to the Panel’s ability to meet its Final Report deadline of January 2016. In order to sort out all the research findings that will be presented to the Panel as it is asked to make a revenue neutral set of policy recommendations, the Panel must initially agree upon a normative framework for the deliberation and recommendation-making process.

ACTION: Review (and discuss, edit, approve) both the set of Guiding Principles for Overall Tax Policy and the Criteria for Evaluating the Connecticut Revenue System.

Principles for Guiding Connecticut Revenue Policy: Statements of the Panel’s Overarching Philosophical Framework

<table>
<thead>
<tr>
<th>Principle</th>
<th>Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoid Fiscal Obsolescence</td>
<td>A state/local revenue system should be designed to make “fiscal sense” over the long term so as to minimize reliance on revenue sources that will become obsolete due to a failure to capture the fiscal benefits (and minimize the fiscal downside) of changes in medium and long term trends in the state’s economic structure, demographic, and institutional arrangements—trends that are largely beyond the control of state and local policymakers.</td>
</tr>
<tr>
<td>Revenue policy understood as a part of an intergovernmental system.</td>
<td>Connecticut revenue policy should be composed of elements that function together as a system of state and local government finance. Although the State is ultimately responsible for determining the functions of local governments and the taxes localities they levy, it should minimize actions that limit local fiscal autonomy. The State should also recognize that because it often has inherent access to more productive revenue sources than its localities, there is a necessary and important role for a well-designed and fiscally certain system of intergovernmental aid.</td>
</tr>
<tr>
<td>Revenue Diversification &amp; Tax Mix</td>
<td>All taxes have inherent structural inefficiencies and inequities, which if relied upon too intensively, will make such defects intolerable. Accordingly, a revenue system should rely on a mix revenue bases so as to not lead to an overreliance on one or a few tax sources. If transparent and coordinated for simplicity, the overlapping of local with state revenues sources need not be competing or contradictory.</td>
</tr>
<tr>
<td>Broad Bases, Low Rates</td>
<td>In order to minimize distortions in economic decision making for individuals and business entities alike, policymakers should begin their tax policy deliberations with a presumption in favor of broad bases and low statutory rates.</td>
</tr>
<tr>
<td>Public values built into the tax law should be explicit.</td>
<td>In adopting a presumption in favor of broad bases and low statutory rates, the Panel also recognizes that giving tax relief to classes of taxpayers is not inherently wrong if such treatment can be shown to satisfy an agreed upon and explicit set of policy goals and there is full disclosure in the granting of such preferential treatment.</td>
</tr>
<tr>
<td>Transparency</td>
<td>Revenue legislation should be based on sound legislative procedures and careful analysis and taxpayers should be informed (and make themselves become informed) regarding how tax assessment, collection, and compliance works.</td>
</tr>
<tr>
<td>Public Accountability</td>
<td>There should be an explicit linking of state and local legislative decisions to the decision makers so that the citizens of Connecticut understand the relationship between the governmental unit that provides public services and the unit of government that levies taxes to pay for those services.</td>
</tr>
<tr>
<td>Uniformity</td>
<td>A revenue system should be administered professionally and uniformly throughout the State.</td>
</tr>
</tbody>
</table>
Criteria for Evaluating Changes in the Connecticut Revenue System

The Panel adopts the following set of criteria of evaluating the quality of the Connecticut state and local revenue system and recommends their use in future revenue policy discussions.

**Certainty and Reliability.** *The Connecticut system should produce revenues with a high degree of reliability and certainty.*

The primary role of a state/local revenue system is to produce revenues in a manner that balances the tradeoff between a mix of sources that allows the system to automatically capture the fiscal benefits of economic growth (an “elastic” revenue) and those that provide a degree of stability (“inelasticity”) in the flow of revenue collections. A relatively elastic revenue system helps one avoid frequent rate and/or tax base changes during periods of economic expansion; but during an economic downturn will tend to cause a drop in revenue collections thereby likely leading to unplanned cutbacks public services, the costs of which tend to be rigid in a downward direction in the short term. In turn, a system that is highly revenue inelastic may require discretionary upward adjustments to revenues as the economy grows in order to maintain the scope and quality of a current expenditure program structure. Even though the Panel has adopted a rule of “revenue neutrality” in making its recommendations, and, thus, will not be making judgments as to the expenditure side of the public budget, the Panel nevertheless recognizes that for any given level of public spending, the Connecticut revenue system must have a mix of elastic (relatively responsive to economic base changes) and inelastic (relatively unresponsive to economic base changes) revenue tools. A system that balances the mix of elastic and inelastic revenue sources meets the tests of reliability and certainty.

**Economic Efficiency (Neutrality).** *Taxes should be designed to avoid unintended interference with private (consumer, worker, producer) decisions.*

Efficiency or “neutrality” in taxation requires that taxes accomplish their intended objectives, but beyond this should minimize interference with the working of the private market system. This criterion applies to individuals/households and businesses alike. In technical terms, “distortions” to the economy are to be avoided. In adopting this criterion, special attention should be placed on the word “intended”. In some circumstances an “efficient” solution will be one whereby a government explicitly uses tax policy to discourage or encourage a specific activity by raising or lowering the “tax price” of an activity. In all such circumstances, the nature of the “intent” should be made explicit and transparent.

**Equity (Fairness).** *The structure of the tax system should treat taxpayers in similar circumstances similarly as well as achieve and an overall (progressive, regressive, proportional) distribution of the tax payment among residents.*

The question of Equity or Fairness in taxation is a proper concern for revenue policy. There are two facets of the fairness (who should pay?) criterion. *Horizontal Equity* requires that taxpayers in similar circumstances be taxed similarly (“equal treatment of equals”). With respect to the taxation of persons, horizontal equity requires that if the accepted tax base standard is income, consumption or wealth, then it follows that those taxpayers with the same amounts of income, consumption, or wealth should be taxed the same. Horizontal equity is also achieved by the application “benefits received” principle (also referred to as the “matching principle”). Here the logic argues that revenue policy should be designed
such that it is the beneficiaries of a flow of services who are required to pay for those services. If well designed, the benefits approach is both horizontally equitable and economically efficient. Moreover, with the benefits standard, it is recognized that some who benefit from public services may not reside in the tax or fee levying jurisdiction. If it is the case that non-residents are benefiting from Connecticut public services, there is a corresponding case for some degree of “tax exporting”. Note that the tests of “similar circumstances” and, thus that of horizontal equity, may be applied to the taxation of business enterprises as well as to persons.

The second facet, *Vertical Equity*, addresses the “fairness” of the distribution of the payments among persons who are not in similar circumstances. Here the most common index of equality is that of income, and thus discussions of vertical equity typically focus on whether the tax system is “progressive” (the effective tax rate increases with income), “regressive” (effective tax rates and income are inversely related), or “proportional” (no change in effective tax rate as income changes). As this criterion applies to only to the tax treatment of people in their role of consumers, factor suppliers and/or earners of income, vertical equity is associated with the fairness concept of “ability to pay”.

**Competitiveness.** The Revenue System should be evaluated for their effects on growth of the economic and employment base and on residential mobility.

“Competitiveness” refers to the interplay between Connecticut’s fiscal structure and decisions that impact income and employment growth and residential location. State fiscal policy can contribute to a growing economy in a number of ways: raising the public sector’s revenues in a manner that is broadly accepted and therefore likely to achieve a high degree of voluntary compliance; a system that implements tax law consistently; and is a revenue regime that is evidence based and transparent. Connecticut’s competitiveness will also take into account the level and quality of services that the State finances through its revenue system.

Within this context, it is often argued that if a state and its localities (a) levy taxes that are “too high” relative to other jurisdictions and/or relative to the level and quality of services that are provided; (b) structure certain taxes or a package of revenues so as to unduly distort private economic transactions in an unintended manner; and/or (c) create a revenue system that is characterized by a high degree of uncertainty, the result is to discourage private investment and job development within the state. If it is determined that for one (or more) of these reasons the Connecticut revenue structure unintentionally hinders or distorts job development that residents care about, then the revenue system would not be competitive.

**Simplicity.** The revenue system should be easy to understand by the taxpayer so as to minimize the costs of both taxpayer compliance and of revenue administration.

As a tax or set of taxes increases in its complexity, the cost borne by taxpayers in keeping records, filing returns, and undergoing audits increases. Another result if complexity is that taxpayer understanding of and trust in, the government decreases, which is a matter of serious concern in a democracy. In a similar manner the more complex a revenue system, the greater is the cost of revenue administration. However, it is also true that while avoiding reliance on a complex maze of taxes, forms and filing requirements is clearly desirable, some level of complexity is inevitable. Thus, the principle of simplicity will sometimes conflict with other principles discussed in this Panel statement and thereby force policymakers to make difficult tradeoffs. However, when the all other things are the same, it makes tax sense to be tax simple.
Recognizing the need to make policy tradeoffs.

It is important to recognize that in selecting or modifying one tax or set of taxes over its alternatives, policy tradeoffs will have to be made—and balanced—among the criteria. There is no single revenue source that will satisfy all of the Panel’s criteria.