

Testimony of Ben Wilterdink
Research Manager, Center for State Fiscal Reform
Connecticut State Tax Panel
September 16, 2015

Chairman Dyson, Chairman Nickerson, members of tax panel, thank you for the opportunity to testify before you today and provide non-partisan research and analysis on the Connecticut state tax code. I currently serve as the Research Manager for the Center for State Fiscal Reform at the American Legislative Exchange Council, the nation's largest, non-partisan, individual membership organization of state legislators that share a common commitment to the principles of limited government, free markets, and federalism.

I understand that the goal of this panel to provide recommendations that preserve revenue neutrality and that time is limited for public comment. With that in mind, I will tailor my remarks to the circumstances, but I am happy to provide additional information upon request. My remarks will focus on the issue of Combined Reporting, improving the economic efficiency of the tax code by broadening the base and lowering the rates for various state taxes, and the benefits of moving away from capital based taxes in favor of consumption taxes.

Unfortunately, the state of Connecticut has firsthand experience with transitioning corporate income taxes from a separate entity system to a combined reporting system. One of the state's largest employers, General Electric, is likely to leave the state as a result of this misguided policy. Beyond driving away specific Connecticut companies by adopting an administratively burdensome income reporting system, there is strong evidence to show that states where combined reporting is adopted costs the state jobs and increases revenue volatility. A 2008 study for the Council on State Taxation, prepared by Ernst and Young, found that from 1982 through 2006, job growth was 6% higher in states without combined reporting than in states with it (after adjusting for changes in population).ⁱ

In addition to being linked with lower rates of job growth, combined reporting may not achieve higher revenues over a longer time period. One academic study from the University of Tennessee found that combined reporting does not increase tax revenues, then later found that combined reporting may or may not increase revenues.ⁱⁱ A commission in Maryland found that combined reporting increased revenue in some years, but decreased it in others. While the exact effect of combined reporting on state revenue may be difficult to determine, it is well-known that corporate income taxes, utilizing any reporting structure, are the most volatile sources of tax revenues for states.ⁱⁱⁱ Relying more on corporate income taxes by implementing combined reporting as a revenue raising measure will only increase Connecticut's revenue volatility.

Setting aside the revenue volatility of corporate income taxes, they are also among the most damaging taxes for economic growth. The vast majority of economic literature finds a strong relationship to lower taxes rates and higher rates of economic growth, with corporate income taxes and personal income taxes being the most harmful to economic growth.^{iv} In a literature review on this topic, William McBride, Chief Economist for the non-partisan Tax Foundation, finds that of 26 peer-reviewed academic studies since 1983, only 3 fail to find a negative effect on economic growth from taxes.^v ALEC's annual economic competitiveness index, *Rich States, Poor States*, rates state economic competitiveness on 15 equally weighted policy variables that affect economic growth. The 2015 edition, ranked Connecticut as 47th out of 50 in economic outlook—Connecticut's worst score in 8 years of doing this report. Connecticut is in competition with the rest of the states and the world to attract capital, investment, and jobs. Sunsetting various deductions and credits in the tax code is a revenue neutral method of reducing the nine percent corporate income tax rate, the 9th highest in the nation. An August, 2014 report from the Center for State Fiscal Reform on state tax preferences notes that in FY 2013 Connecticut

had \$313 million of corporate tax preferences to specific industries or businesses.^{vi} Last year, when Rhode Island adopted combined reporting, some of the increased revenues went to the lowering of their corporate income tax rate, which now stands at seven percent—two percentage points lower than Connecticut's and 27th highest in the nation.

Reducing the corporate income tax rate would help Connecticut in becoming more economically competitive. From 2003 to 2013, the eight states with the lowest corporate income tax rates outperformed the eight states with the highest corporate income tax rates in gross state product growth, employment growth, and population growth.^{vii} For example, the eight states with the lowest corporate income tax rates experienced a 12.1 percent increase in job growth, while the eight states with the higher corporate income tax rates experienced a job growth rate of just 5.1 percent. Furthermore, the eight states with the lowest corporate income tax rates had a population growth rate of 13.6 percent, almost double the population growth in the eight states with the highest corporate income tax rate, which was just more than 7 percent.^{viii}

Another factor that must be considered when discussing corporate income taxes is the distinction between incidence of taxation and burden of taxation. While corporations remit corporate income taxes, the burden of those taxes is distributed between consumers (in higher priced goods and services), shareholders (in less value), and employees (through decreased pay and/or benefits). For example, according to a study from the Department of the Treasury, a 1 percent increase in corporate tax rates is associated with almost a 1 percent drop in wages. The study also estimates at least 40 percent of the corporate income tax is passed on to workers in the form of lower wages.^{ix} While economists have not reached a consensus on exactly what percentage of the economic burden of the corporate income tax falls on whom, policymakers should bear in mind that the tax burdens consumers and workers as well.

In terms of economic growth, along with corporate income taxes, personal income taxes are also among the most harmful for economic growth.^x Here again, revenue rate reductions can be achieved by sunseting some of \$409.8 million in personal income tax preferences reported in FY 2013.^{xi} Reducing the personal income tax rate would help Connecticut become more economically competitive. From 2003 to 2013, the nine states that do not levy a personal income tax outperformed the nine states with the highest personal income taxes in total economic growth, population growth, and employment growth.^{xii} For example, the no income tax states grew their gross state product by 61.9 percent while their high tax counterparts only grew by 47 percent. The nine no income tax states grew employment by 9.9 percent, more than double the 4.3 percent growth rate experienced by the nine highest income tax states.^{xiii}

In addition to being one of the most damaging taxes to economic growth, there are several reasons why Connecticut should decrease its reliance on personal income taxes in favor of consumption taxes. First, Connecticut relies on personal income taxes to collect 42 percent of its total revenue, among the highest in the nation. This means that 42 percent of the state's revenue comes from a very volatile source, making budget planning much more difficult than it has to be. Consumption taxes on the other hand, as noted this morning by the Connecticut OPM's presentation, are far more stable—making budgeting much easier and predictable. Additionally, as confirmed in this morning's presentations from OPM, the leading post-recession employment sectors that are adding jobs and economic output are generally lower wage jobs. This represents a base erosion for the personal income tax that could mean that Connecticut may have to raise income tax rates even higher to maintain the same amount of revenue.

It has been argued that relying on multiple sources for tax revenue (personal income taxes, corporate income taxes, and sales taxes) is a good strategy to help with revenue stability. Relying on all three is certainly better than relying on personal income taxes or corporate income taxes alone, but relying on the stable consumption tax base would be more stable than including a mixture of other highly volatile taxes. Broadening the sales tax base would also make this already stable tax base even less volatile. And, broadening the sales tax base by including more services (services make up more than half of Connecticut's economy) is a great mechanism to find revenue savings that can be put towards reducing the personal and corporate income tax rates.

Overall, the tax source that Connecticut gets 42 percent of its total revenue from is the personal income tax. A tax that is far more volatile than consumption taxes, post-recession employment trends suggest that it has a shrinking base, and most importantly, is one of the most damaging to economic growth.

In conclusion, people and capital are increasingly mobile in our modern era. People vote with their feet and take their incomes with them. Connecticut has experienced this firsthand; according to IRS income migration data, from 1992 to 2013, Connecticut has lost more than \$11 billion of wealth to other states in the form of domestic migration.^{xiv} Nearly half of that amount has gone to no-income-tax Florida. From 2004 to 2013, Connecticut lost more than 140,000 people to other states on net. The 2015 edition of *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index* ranked Connecticut's economic outlook at 47th out of 50—the lowest economic outlook score for Connecticut in the eight years of producing the report. By rejecting combined reporting and utilizing tax preferences as “base broadeners” to reduce top marginal rates while decreasing the reliance on personal income taxes, Connecticut can become much more economically competitive while its tax structure remains revenue neutral.

ⁱ Cline, Robert. “Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting,” Ernst & Young, May 30, 2008.

ⁱⁱ Cline, Robert. “Comparison of State Economic and Fiscal Performance During the Recession,” Ernst & Young, January 12, 2010.

ⁱⁱⁱ Laffer, Arthur, Moore, Stephen, and Williams, Jonathan. *Rich States, Poor States* 7th Ed. American Legislative Exchange Council. 2014.

^{iv} Arnold, Jens, Brys, Bert, Heady, Christopher, Johansson, Åsa, Schwellnus, Cyrille, & Vartia, Laura. Tax Policy For Economic Recovery and Growth, 121 *Economic Journal* F59-F80 (2011).

^v McBride, William. “What is Evidence on Taxes and Growth?” Tax Foundation. December 18, 2012.
<http://taxfoundation.org/article/what-evidence-taxes-and-growth>

^{vi} Freeland, William, Wilterdink, Ben, and Williams, Jonathan. “Tax Cronyism: Favoritism and Foregone Growth.” American Legislative Exchange Council. August, 2014.

^{vii} Laffer, Arthur, Moore, Stephen, and Williams, Jonathan. *Rich States, Poor States* 7th Ed. American Legislative Exchange Council. 2014.

^{viii} *Ibid*

^{ix} Gentry, William. “A Review of the Evidence on the Incidence of the Corporate Income Tax.” Department of the Treasury. December 2007. <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota101.pdf>

^x Arnold, Jens, Brys, Bert, Heady, Christopher, Johansson, Åsa, Schwellnus, Cyrille, & Vartia, Laura. Tax Policy For Economic Recovery and Growth, 121 *Economic Journal* F59-F80 (2011).

^{xi} Freeland, William, Wilterdink, Ben, and Williams, Jonathan. “Tax Cronyism: Favoritism and Foregone Growth.” American Legislative Exchange Council. August, 2014.

^{xii} Laffer, Arthur, Moore, Stephen, and Williams, Jonathan. *Rich States, Poor States* 7th Ed. American Legislative Exchange Council. 2014.

^{xiii} *Ibid*.

^{xiv} IRS Domestic Migration Data and U.S. Census Data via <http://www.howmoneymoneywalks.com/irs-tax-migration/>