Revenue Options are Crucial to Maintaining Public Investments that Promote Prosperity

Derek Thomas, M.P.A.

March 2016

In confronting the financial crisis looming over state budget decisions, the common-sense choice for Connecticut should be a balanced approach that includes revenue, rather than a cuts-only approach that threatens an already fragile economic recovery.

The difficult choices facing the state result from two significant challenges: post-recession revenues coming in short of expectations and past budgeting decisions that have left us with significant debt. The Governor's budget, proposed last month, includes $200 million in deep cuts to programs that support families and children to close a projected deficit in the fiscal year that begins July 1 – these cuts were proposed even before the projected deficit ballooned to nearly a billion dollars. A balanced approach to addressing the deficit would not rely strictly on cutting services for struggling families and their children. On the revenue side, there are opportunities to invest in Connecticut's future by closing tax loopholes, modernizing outdated tax laws, and calling upon the wealthiest to pay their fair share. Here is a look at the options available to Connecticut lawmakers:

Collect a Larger Share of Taxes Due on Internet Sales: Implement a version of Colorado's reporting law that requires Internet, catalog, and other out-of-state sellers either to charge state sales tax or to provide information about the tax due on those purchases to the buyer and the state revenue department. Due to U.S. Supreme Court rulings, Connecticut cannot require out-of-state companies with no employees or facilities in the state to charge sales tax to in-state buyers. Enactment of a law similar to Colorado's – recently upheld by a federal circuit court – however, provides a path for the state to chip away at the estimated $65 to $70 million lost annually in uncollected sales taxes on Internet sales.[1] The law will require out-of-state retailers to remind buyers that they are legally obligated to pay the tax even if the seller doesn't charge it, and provide information to the state that will enable it to seek payment of the tax from people who purchase big-ticket items upon which significant sums of tax are due.

Increase Rates on Capital Gains or Personal Income: Leading the nation in income inequality, Connecticut's lawmakers should consider increases that fall largely on the wealthiest one percent of households – whose income, as of 2012, is 51 times greater than the average income of everyone else in Connecticut.[2]

As it stands now, Connecticut's overall tax system (including income, property, and sales and excise taxes, minus federal deductions) allows the wealthy to pay a much lower percentage of their income than middle-class or low-income taxpayers. For example, a family making less than $25,000 a year pays 11 percent in state and local taxes, a family making between $46,000 and $76,000 pays 10.9 percent, and a family making over $1,331,000 – the top 1 percent – pays 5.5 percent.[3] Property taxes and sales taxes are the main culprits of the state's unfair tax system.[4] An adjustment (see option C below) that combines an increase in the tax on personal income and capital gains – 84 percent of which would fall on the top 1 percent of taxpayers – would result in an estimated $283.1 million in new state revenue. Over a third of this tax increase on the wealthy would be offset by the larger deductions they would be able to take on their federal income taxes. This increase could raise over $100 million more than what taxpayers would end up paying after accounting for the federal deductions. As a matter of perspective, the total increase is equal to asking an income group that has experienced 63 percent of all income growth from 2009 to 2012 (and 81 percent of all growth from 1979 to 2012) to share in addressing just under one-third of the budget shortfall.[5]

84% of Revenue from Capital Gains & Income Tax Change Would Fall on the Top 1% of Taxpayers

(A) Higher Capital Gains Rate on Top 3 Income Tax Brackets						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
Tax Change, % of Income	0.03%	0.19%	**$112 million**	34%	$37.7 million	$74.3 million
Average Tax Change	$174	$7,202				
Share of Total Change	11%	89%				
% Facing Tax Increase	27%	90%				
(B) Higher PIT Rate on Top 2 Income Tax Brackets: 6.9% to 7.4%; 6.99% to 7.49%						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
Tax Change, % of Income	0.097%	0.350%	**$226.6 million**	37%	$83.5 million	$143.1 million
Average Tax Change	+552	+13,565				
Share of Total Change	17%	83%				
% Facing Tax Increase	31%	100%				
(C) Higher PIT Rate on Top 2 Income Groups *and* Higher Capital Gains Rate on Top 3 Income Tax Brackets						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
Tax Change, % of Income	0.11%	0.44%	**$283.1 million**	36%	$102.3 million	$180.8 million
Average Tax Change	+642	+17,183				
Share of Total Change	16%	84%				
% Facing Tax Increase	38%	100%				

Source: Institute on Taxation and Economic Policy

Institute a Low-Wage Workers Fee: Impose a fee on large corporations that pay employees less than $15 an hour to recoup state costs attributable to low-wage employers. The rise in low-wage work is a double whammy to the state fiscal's health. First, as low-wage jobs grow faster than high-wage jobs, state revenue streams are hurt by decreased income tax revenue.[6] Second, some of the largest and most profitable employers in industries that have seen the strongest growth during the recovery are relying on public assistance programs to subsidize the low wages they pay their employees. A low-wage worker fee will help support programs that meet the needs of the low-income families and/or encourage such companies to raise employee wages. According to the state Office of Fiscal Analysis, last year's proposal to recoup state costs attributable to low-wage employers was estimated to generate $305 million in revenue in the coming fiscal year. Changes in this year's legislation, which would phase in the fee and the size of the affected company, will result in less revenue; updated estimates from state analysts are forthcoming.[7]

Create a Soda Tax: The American Heart Association cites research that finds that increasing the price of soda reduces consumption and the associated adverse health impacts, especially for low-income individuals.[8] According to the Office of Fiscal Analysis, an increase of one cent on each fluid ounce of soda would raise more than $85 million in the coming fiscal year. Legislation drafted last year would have required the state Department of Public Health to levy a soda tax for "education and outreach regarding obesity, heart disease and diabetes."[9]

Apply the Sales Tax to Digital Downloads: Update the state sales tax law and regulations to apply the sales and use tax to digital goods and services, such as downloaded computer software and online books and movies. Currently, an in-store purchase of a movie is taxed at a 6.35 percent rate while its digital equivalent is assessed a one-percent "computer services tax."[10] Applying the sales tax to digital downloads would have generated $7 million to $11 million in revenue in 2011.[11] This adjustment would also slightly reduce the extent to which the sales tax falls on lower-income households, since digital goods are disproportionately purchased by upper-income households that are more likely to have Internet access, as well as credit cards with which to make online purchases.

Close the Expedia Loophole:[12] Require online travel companies to pay state hotel or lodging taxes on the amount they charge the customer rather than the wholesale rates they pay to hotels – a scheme known as the "Expedia loophole." This step would ensure that companies such as Expedia, Orbitz, and Priceline are taxed identically to the hotels themselves. The existence of the Expedia loophole is estimated to have resulted in a loss of $3 million to $4 million in 2010. The revenue gain in the coming fiscal year would likely be much higher, given that online travel purchases are growing.[13,14]

[1] Mazerov, Michael. CBPP. *States Get New Tool to Collect Taxes Due on Internet Sales*. February 2016. Retrieved from: http://www.cbpp.org/blog/states-get-new-tool-to-collect-taxes-due-on-internet-sales

[2] Sommeiller, Estelle and Price, Mark. *The Increasingly Unequal States of America.* Economic Policy Institute. January 2015. Retrieved from: http://www.epi.org/publication/income-inequality-by-state-1917-to-2012/

[3] Davis, Carl et al. Institute for Taxation and Economic Policy. *Who Pays? 5th Edition.* January 2015. Retrieved from: http://www.itep.org/whopays/full_report.php

[4] See our Policy Tax Primer to learn more about a property tax circuit-breaker to promote tax equity: http://www.ctvoices.org/publications/policy-primer-reforming-our-property-tax-system

[5] Sommeiller, Estelle and Price, Mark. *The Increasingly Unequal States of America.* Economic Policy Institute. January 2015. Retrieved from: http://www.epi.org/publication/income-inequality-by-state-1917-to-2012/

[6] See our State of Working Connecticut Report for more on the rise of low-wage work and other economic trends: http://www.ctvoices.org/stateofwork

[7] Office of Fiscal Analysis. *HB-5461 - An act concerning the recoupment of state costs attributable to low wage employers*. January Session, 2015. Retrieved from: https://www.cga.ct.gov/2015/TOB/S/2015SB-01044-R00-SB.htm

[8] American Heart Association. *Decreasing Sugar-Sweetened Beverage Consumption*. 2015. Retrieved from: https://www.heart.org/idc/groups/heart-public/@wcm/@adv/documents/downloadable/ucm_474846.pdf

[9] Office of Fiscal Analysis. *HB-5461 - An act imposing a tax on sugary soft drinks*. January Session, 2015. Retrieved from: https://www.cga.ct.gov/2015/FN/2015HB-05461-R000104-FN.htm

[10] Fox, William. Presentation before Connecticut Tax Study Panel. University of Tennessee. *Sales Taxation in Connecticut.* October 2015. Retrieved from: https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929_State%20Tax%20Panel

[11] Mazerov, Michael. CBPP. *States Should Embrace 21st Century Economy by Extending Sales Taxes to Digital Goods and Services*. December 2012. Retrieved from: http://www.cbpp.org/sites/default/files/atoms/files/12-13-12sfp.pdf

[12] See Model Statutes from Multistate Tax Commission: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Collection-and-Remittance-of-Lodging-Taxes-by-Acco/Accommodations-Intermediaries-as-Adopted-8112.pdf.aspx

[13] Mazerov, Michael. CBPP. *State and Local Governments Should Close Online Hotel Tax Loophole and Collect Taxes Owed*. April 2011. Retrieved from: http://www.cbpp.org/sites/default/files/atoms/files/4-12-11sfp.pdf

[14] Market Realist. Schmidt, Ally. *Priceline's Stock Hits a New All-Time High on Strong 2Q15.* August 2015. Retrieved from: http://marketrealist.com/2015/08/online-travel-agencies-future-industry-outlook/