Executive Summary

Connecticut's Tax System

The Legislative Program Review and Investigations Committee initiated a study of Connecticut's state and local tax system, incorporating an examination of all major state taxes as well as the local property tax, in March 2005. The study's main purpose was to assess the overall performance of Connecticut's system 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 selected as the committee's primary evaluation framework.

NCSL identified nine guiding principles for state tax systems: Complementary; Balanced; Reliable; Equitable; Economically Competitive; Neutral; Promotes Compliance; Accountable; and Fairly and Efficiently Administered. The first phase of the program review committee study focused on identifying measures and analytical techniques for applying all nine principles to Connecticut's state and local tax system as a whole, and to each major component tax. None of the principles was easy to define, as each involved qualitative as well as quantitative concepts. In addition, there was considerable overlap among the principles and, in some cases, conflicting purposes.

The committee's tax system study also encountered a number of data challenges. The best comparative information on state and local finances, which is compiled by the U.S. Census, was from 2002. Detailed data on Connecticut local government budgets were not centrally collected, and local property tax collection figures lag state level revenue data by at least two fiscal years. Problems with state information systems, both at the Office of the State Comptroller and within the Connecticut Department of Revenue Services (DRS), complicated data collection efforts throughout the study. Confidentiality issues related to tax information additionally impeded program review research efforts and prevented several key areas of analysis. One area particularly hampered by data limitations was analysis of equity issues including the distribution of tax burden among individual taxpayers.

In the end, the program review committee was able to complete a broad assessment of the state and local tax system based on currently available information. The research presented in this report shows Connecticut's tax structure seems to perform fairly well in terms of most of the criteria encompassed by the NCSL principles and in comparison to other states.

Connecticut's system employs a relatively simple yet complementary structure with few layers, and no overlap or duplication. There is no county taxation, the state imposes a single state sales tax and a single state income tax, and local tax revenues are limited to the tax on real and personal property. For the most part, the state and local tax system has provided a reliable revenue stream, with growth outpacing measures of inflation and the economy. State government revenue collections, however, are volatile and do not always meet state expenditure levels.

The local property tax provides a great measure of stability to the overall revenue system, but heavy reliance on that tax raises concerns about the balance of Connecticut's state and local tax structure. Connecticut relies more on the property tax than 42 other states, and three of the states that are more reliant do not have a broad-based personal income tax.

Connecticut's personal income tax is relatively simple, with only two rates, high filing thresholds, and few credits and exemptions. At the same time, it is only slightly progressive, and does not appear to offset the regressivity of the other taxes on lower- and middle-income groups. Since the program review committee had only limited access to Connecticut-specific data, no original analysis could be done of how the state tax structure impacts individuals, households, or businesses at different income levels. Instead, the committee had to rely on tax incidence work conducted by a national research organization, the Institute on Taxation and Economic Policy, using samples of data from each state.

The committee found problems with the corporate income tax, including questionable compliance and overall declines in revenues. Further, legislative efforts at spurring economic development through tax credits and incentives appear to have little positive effect on job growth or in enhancing the state's competitive position. However, only very narrow aspects of corporate and other business tax credits, and their impact on the state's economic growth, could be examined, again, because of DRS data access issues.

At the committee's direction, program review staff also looked into the experiences of specific states that had implemented major tax reforms including tax and expenditure limitations (TELs). The study's review of reform results in California, Colorado, Massachusetts, Michigan, New Hampshire, and New Jersey shows it is difficult to determine whether TELs succeed or fail as state tax policies. The impact of such measures varies, depending on many factors -- how limits are calculated, methods for applying them, requirements for approving tax or spending increases, and the ways budget surpluses are treated. While imposing strict limitations (caps on annual property tax increases, for example) may be viable policy options, the experiences of other states show policymakers should recognize they can have unintended negative consequences.

After completing its performance assessment of the state and local tax structure, the committee undertook the study's second phase, which was aimed at exploring revenue-neutral alternatives for addressing identified system shortcomings. This report contains a number of broad policy options the legislature could consider as ways to improve the performance of Connecticut's tax system, in terms of one or more of the principles. In response to its findings, the program review committee also proposed some specific statutory and administrative changes intended mainly to strengthen tax administration, taxpayer compliance, and future legislative oversight and public accountability.

Committee findings, recommendations, and policy options, organized by each of the nine revenue system principles, are summarized in the following table. A concise definition of each principle is also included in the table.

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<tr><th colspan="2">CONNECTICUT'S TAX SYSTEM
SUMMARY OF PROGRAM REVIEW COMMITTEE FINDINGS,
RECOMMENDATIONS, AND POLICY OPTIONS BY REVENUE SYSTEM PRINCIPLE</th></tr>
<tr><td colspan="2">I. Complementary</td></tr>
<tr><td>Objectives of tax system should be consistent and system must recognize limitations and responsibilities of local government</td><td><u>Finding:</u>

Connecticut has a complementary system, with no overlap in taxing authority, but policymakers do not have an accounting of the cost impact of state mandates on towns, and the state does not fully fund its obligations to municipalities.

<u>Recommendation:</u>

1. Amend C.G.S. Section 2-79a to require the Connecticut Advisory Commission on Intergovernmental Relations to identify and describe each unfunded and partially funded state mandate affecting municipalities, quantify the actual cost of major mandates, and determine the effect of eliminating or reducing any such mandates. ACIR shall submit a report to the legislature every four years.

<u>Policy Options:</u>
A. Increase State Grant Funding
B. Remove Barriers to Increased State Grants
C. Review Nonprofit Tax Exemptions</td></tr>
<tr><td colspan="2">II. Balanced</td></tr>
<tr><td>The major taxes (personal income, sales, and property) should be contributing a nearly equal proportion to total revenues</td><td><u>Finding</u>:

By most measures, Connecticut is heavily reliant on the property tax and, therefore, the state's revenue structure does not meet the principle of a balanced tax system.

<u>Policy Options</u>
A. Reduce Property Tax Proportion of State and Local Revenues
B. Increase Local Taxing Authority
C. Redistribution of the Sales Tax
D. Enact Local Tax and Expenditure Limitation (TEL)
E. See Policy Option A under Complementary Principle</td></tr>
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III. Reliable	
Revenues produced by a tax system should be stable, certain, and sufficient. Revenues should be relatively constant and predictable over time and at levels adequate for balancing the budget each year and adapting to desired spending changes.	Findings: *Connecticut's state tax revenues are volatile and some state taxes are prone to frequent revision. Local property tax growth is relatively slow but steady and adds stability to Connecticut's overall revenue structure.* *In total, state and local tax revenue growth is well above the rate of inflation and generally keeps pace with growth in the economy. State revenue collections, however, do not always match state spending levels, large General Fund budget shortfalls have occurred during severe economic downturns, and deficits are forecast within the next five years.* Policy Options: A. Maintain Stronger Reserves B. Improve Sales Tax Reliability C. Increase Participation in the Streamline Sales Tax Project
IV. Equitable	
The overall tax system should minimize regressivity and not place an unfair burden on people with lower incomes.	Findings: *Connecticut's tax system is similar to the rest of the nation in terms of the state's overall tax burden. However, Connecticut places less burden on the top income group than the U.S. average. Property taxes in Connecticut take a larger share of the incomes of the lower and moderate income taxpayers than most other states.* Policy Options: A. Earned Income Tax Credit B. Modify Personal Income Tax Structure C. Property Tax Refund Program D. State Sponsored Property Tax Deferral Program E. Single Motor Vehicle Tax Rate
V. Economically Competitive	
Tax burden in a state should not be very different from other states, especially burdens in neighboring states.	Findings: *Taxes on businesses in Connecticut have been reduced significantly, and by most measures, are not considered more burdensome than other states. However, in Connecticut businesses pay a greater share of the sales tax than in most states. The effective property tax rates on industrial and commercial property in Connecticut's cities are not competitive.*

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<tr><td></td><td><u>Policy Options:</u>
A. See Policy Options for Corporate Income Tax Presented under the Neutral Principle
B. Tax Final Consumption Not Business Inputs
C. Reduce or Eliminate the Tax on Manufacturer’s Equipment and Machinery
D. See all Policy Options under Balanced Principle to reduce property tax reliance overall.</td></tr>
<tr><td colspan="2">VI. Neutral</td></tr>
<tr><td>A tax system should not be used to influence economic decisions on spending or investments.</td><td><u>Findings:</u>

Connecticut has been more restrained than most states in using tax policy to influence economic behavior or in creating dedicated funds. The major exception is that Connecticut has used the corporate income tax to attempt to promote economic development. Connecticut also has an estate tax, which can influence taxpayers’ investment and location decisions.

<u>Policy Options:</u>
A. Reduce the Corporate Income Tax Rate and Eliminate Credits
B. Replace the Corporate Income Tax with a Broad-Based Tax on Gross Receipts and Eliminate Credits
C. Modify Corporate Tax by Changing Certain Factors
D. Eliminate the Connecticut Estate Tax
E. Replace Current Estate Tax Threshold with an Exemption</td></tr>
<tr><td colspan="2">VII. Promotes Compliance</td></tr>
<tr><td>A tax system should be easy to understand and comply with and minimize compliance costs for taxpayers and tax program administrators.</td><td><u>Findings:</u>

The vast majority of state tax revenue in Connecticut is collected through voluntary compliance. However, DRS does not have the capability to measure the difference between tax liability (what is owed under full compliance with all tax laws) and taxes voluntarily paid, and the results of the department’s special compliance projects are not formally tracked, compiled, or reported. In addition, DRS does not use all the enforcement tools it should to deter non-compliance.

<u>Recommendations:</u>

2. Once ITAS is fully in place, DRS should make estimating and reporting of tax gap information a priority of future agency research. A more precise picture of the extent and areas of non-compliance should assist DRS in developing an overall strategy to</td></tr>
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promote compliance and deter tax avoidance.

3. **DRS should conduct a cost benefit analysis of each major tax compliance initiative, including amnesty programs, and report the results to the appropriations committee.**

4. **DRS should publicly report the results of tax compliance efforts on its website. Such efforts assure the taxpaying public that non-payers are being detected and promote overall compliance.**

5. **The Department of Revenue Services shall study the impact of amending the statutes to require that any person or entity doing business with the state must be in compliance with state tax laws. The study should assess the methods that might be employed by DRS to provide verification of tax compliance to state agencies before issuing a contract or grant, as well as any anticipated legal issues that might arise including definitions of compliance and confidentiality, any anticipated delays in awarding of contracts, and an estimate of resources necessary for implementation.**

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<tr><td colspan="2">VIII. Accountable</td></tr>
<tr><td>A tax system should be explicit in how revenues are raised, changes should be well publicized, and the costs and benefits of tax policies should be examined</td><td>

Findings:

Accountability is strongest for local property tax; state taxes are less transparent. The state has minimal capacity for tax policy research, and little is known about the distribution of tax liability within Connecticut's revenue system or its component taxes.

Recommendations:

6. **DRS should take immediate steps to formally establish an agenda for its research office. It should begin this task by identifying, assessing, and prioritizing both currently required reports and projects and internal and external requests for new or expanded research products. Based on this assessment, DRS should also determine the types and sources of data required and how ITAS will be used to support these research efforts.**

7. **Amend the statutes to require the Department of Revenue Services to include information on total local**

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property tax collections each year for the most current five-year period available in its annual statistical report.

8. The Office of Policy and Management should include in the municipal fiscal indicators report it publishes each year information on trends in local property values and taxes such as: the average and median single-family home tax bills and percent change in those amounts over time; town-by-town information on the availability and use of local option property tax exemptions; and measures that indicate the accuracy and uniformity of local revaluations (e.g., sales assessment ratios, coefficient of dispersion, price related differentials).

<u>Policy Options:</u>
A. Conduct Regular Tax Incidence Analysis
B. Provide Legislature with Tax Change Impact Notes
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<td colspan="2">IX. Fairly and Efficiently Administered</td>
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<td>The provisions of a tax system should be easy to understand and implement and be uniformly applied. The proportion of revenues used to assess and collect taxes, enforce laws, and audit compliance should be minimized.</td>
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<u>Findings:</u>

Connecticut's personal income and sales tax provisions are relatively simple, making them less prone to errors and avoidance and easier to manage than the complicated state corporate income tax. The Department of Revenue Services operating budget accounts for a very small portion of total state tax collections, but the lack of good quality performance data make it difficult to assess the agency's administrative efficiency or effectiveness.

<u>Recommendations:</u>

9. DRS should formally establish an internal working group to: i) identify agency-wide management information needed from ITAS; and ii) coordinate and oversee development of the system's ability to track and report performance measures. The group should ensure ITAS will collect and produce data that allow monitoring of key activity trends and outcomes and consider including a capacity to track selected benchmarks developed by the Federation of Tax Administrators.

10. DRS should assign agency resources to develop and maintain a current strategic plan for accomplishing its mission and goals.
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	11. The statutes should be amended to lower the current interest rate, or at least the rate charged on cases under appeal, to the same rate the IRS uses, which is the federal short term interest rate plus 3 percent. DRS should update the rate quarterly based on changes in the IRS rate. **12. The homepage of the DRS website should prominently display a link to the agency's description of the Connecticut's "Taxpayer Bill of Rights."**