CONNECTICUT VOICES FOR CHILDREN

How Can Connecticut *Still* Be Facing a General Fund Deficit in SFY 06?

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New Haven Office
33 Whitney Ave.
New Haven CT 06510
Phone: 203.498.4240
Fax: 203.498.4242

Hartford Office
60 Gillett St. Suite 204
Hartford CT 06105
Phone: 860.548.1661
Fax: 860.548.1783

Web Site: www.ctkidslink.org
E-mail: voices@ctkidslink.org

Summary

Connecticut's FY 05 General Fund budget is projected to have a surplus of more than $300 million, yet its FY 06 General Fund budget is expected to have a current services deficit between $800 million and $1.3 billion, despite the improving economy.

Many ask, "How can this be?"

This report reviews *why* Connecticut's budget remains in trouble. It focuses on state revenues, the predominant factor in Connecticut's structural deficit. A subsequent and complementary report will examine in some greater detail trends in state investments in health, mental health, education, and other programs and services essential to the long-term prosperity of Connecticut's families and its economy and other state spending.

The story in brief. Like a family whose parents decide to quit full-time work and work part-time when a strong stock market starts to bring hefty dividend checks into the household, Connecticut made $2 billion of permanent cuts to its tax base during the late 1990s when state coffers were flush with taxes on surging capital gains and dividend income. Then, when the economy went into recession and the stock market fell, Connecticut found it hard to pay its bills even though growth in state spending was just slightly above inflation.

Like a family who first deals with a crisis like this by cutting back its spending, emptying all its savings accounts, and borrowing, Connecticut too addressed its deficits by cutting spending, borrowing, and transferring cash from various other funds and quasi-public agencies to the General Fund.

But this strategy can only work for so long. At some point, the parents must return to full-time work lest the family be unable to meet its essential needs and make the investments it must in its future – in its children's health and education, for example.

So too it is in Connecticut.

For the last three years, rather than addressing the budget problem in a permanent way by restoring *more of* the $2 billion Connecticut cut from its tax base and modernizing its outdated tax code, Connecticut has relied primarily on one-time and temporary revenues – and deep spending cuts -- to address its deficits.

And while Connecticut also *restored* on-going taxes by $962 million since the deficits began, it *concurrently* made on-going General Fund tax *cuts* of $242 million. So the *net increase* in on-going General Fund tax revenues in FY 05 is only $720 million, *or less than 40% of the taxes cut in the late 1990s.*

Were Connecticut simply to restore the *remaining* tax revenues that it cut in the late 1990s, the projected FY 06 Current Services deficit would evaporate.

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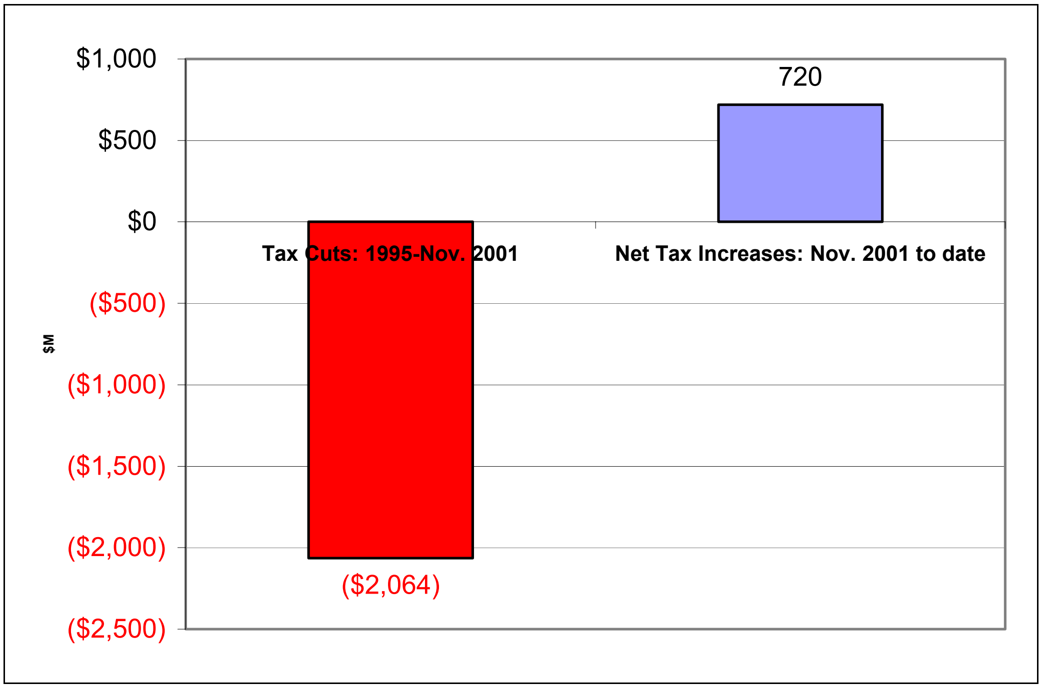
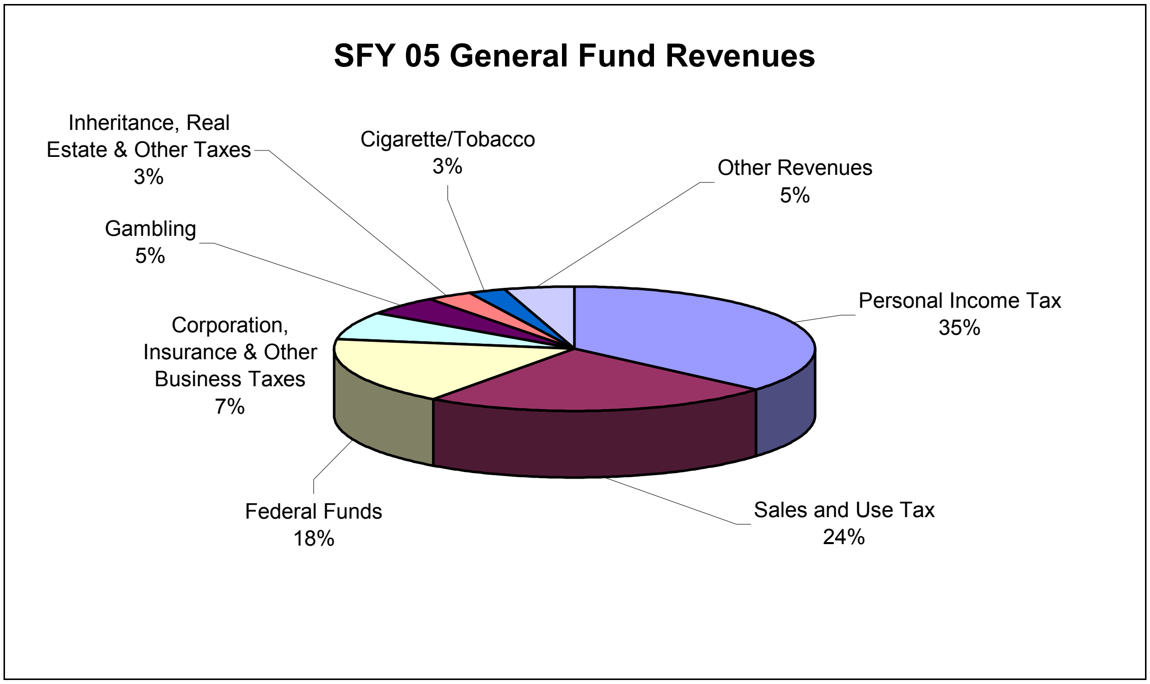


In short, we've been bailing Connecticut's fiscal boat, but haven't yet permanently fixed its holes.

1. The FY 05 Budget Includes Millions of Dollars of Tax Cuts and One-Time and Temporary Revenues, Perpetuating a Revenue "Hole" in The FY 06 Budget

The SFY 05 General Fund budget is based on $13.31 billion in expected *net* revenues ($14.11 billion in gross revenues less $800 million in tax refunds and various other adjustments).[1] The gross revenues are projected to come from the following sources:

[1] Specifically, the SFY 05 budget projects $5.13 billion in personal income taxes, $3.32 billion in sales and use taxes, $2.47 billion in federal funds, $1.02 billion from combined business taxes (e.g., corporation business tax, insurance premiums tax, public service companies tax), $713 million from gambling, $422 million from various other taxes (e.g., inheritance, real estate conveyance, gift), $379 million from cigarette/tobacco taxes, and a total of $659 million in "other revenues" (that include revenues from fees, permits, licenses, as well as the many other one-time sources discussed below).



Appendix A provides detail about the revenue changes included in the revised SFY 05 budget. Three general points about this $13 billion General Fund budget, adopted in the 2004 General Assembly Session, merit special mention:

1) *Only $8 million in new on-going revenues.* Only one change was made in the 2004 session that will result in an *on-going* increase in tax revenues – the provision that enhances the *collection of* personal income tax currently due to Connecticut by out-of-state owners of pass-through corporations.[2] It is projected to result in $8 million in additional revenues on an on-going basis.

2) *Nearly $500 million in "quick fixes."* The revised FY 05 budget relies on a total of $499.9 million[3] in *one-time* revenues (including temporary taxes and delays in scheduled phase-outs of tax), and pre-funded expenditures. Of this, $287.0 million were adopted in the 2004 Session and the remaining $212.9 million in the prior 2003 Session. While these one-time revenues and pre-funded expenditures account

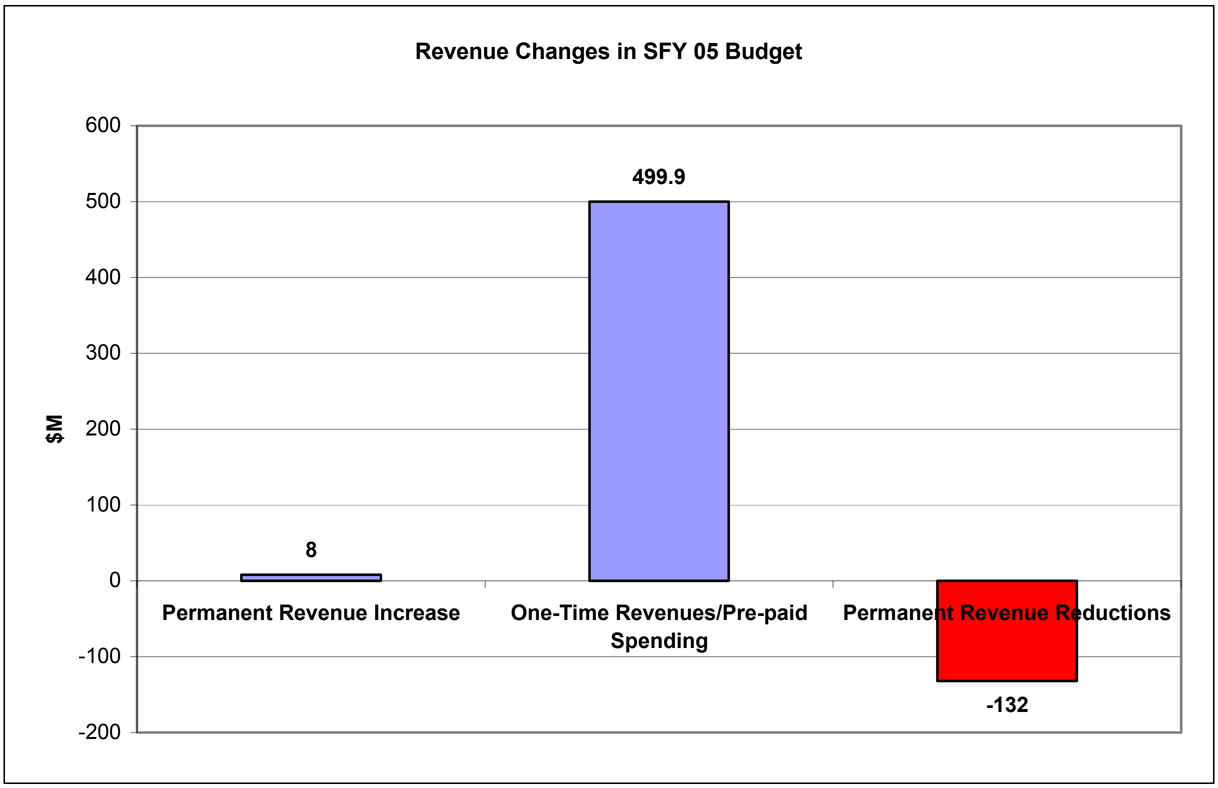
[2] The change tightens the personal income tax filing requirements for people who live out of state but who receive income from pass-through entities (S corporations, LLPs, LLCs) that do business in or derive income from Connecticut sources. This is not a *new* tax, but merely a mechanism to increase the payment of taxes owed to Connecticut from persons living out of state. While OFA projected a revenue gain of $8 million/year from this greater enforcement, the experience in New Jersey, which adopted similar changes two years ago, suggests that this estimate of new revenue may be low.

[3] OFA's estimate of the one-time revenues in the FY 05 budget is $382.7 million. See, CT General Assembly, Office of Fiscal Analysis, *Where Does the Money Come From? Where Does the Money Go?* (January 25, 2005). OFA's estimate *does not include* the following "one-time" items included in this report's table and the Governor's estimate of one-time revenues/pre-paid expenses in the FY 05 budget: a) FY 05 expenses pre-paid in FY 04 ($78.7 million); b) tax revenues kept in the General Fund rather than transferred, as scheduled, to the Special Transportation Fund ($8 million); c) revenue gains from delays in the scheduled reductions in the personal income tax for single filers ($3.5 million), in the phase-out of the succession tax ($26.0 million), and in the phase-out of the gift tax ($1.0 million).

for just 4% of the total SFY 05 revenues, they *will not exist at all* in SFY 06, creating an immediate budget hole in the SFY 06 budget.

3) *$132 million in <u>new permanent tax cuts</u>.* The revised FY 05 budget also includes $132 million in *permanent tax cuts* and an additional $1.7 million in *temporary tax cuts*. These will reduce FY 06 General Fund revenues by $133.7 million. Already-scheduled tax cuts will further reduce General Fund revenues by $15.7 million (the increase in the income tax exemption for single filers, $4.7 million; the succession tax phase-out, $11.0 million).

In short, the revised FY 05 budget did not ensure that Connecticut's General Fund revenues in future years are adequate and stable. Indeed, the budget did the opposite.



2. The Revised FY 05 Budget Is Consistent With Recent Past Practice Of Relying On "Quick Fixes," Rather Than Permanent Solutions, To Address Connecticut's Structural Budget Problems

For more than three years, Connecticut has been struggling to balance its budget. In addition to significant spending cuts and reductions in state personnel (to be discussed in a forthcoming report), Connecticut increased its revenues. However, as in the FY 05 budget, many of the "new" revenues in the prior three years were one-time or temporary. *Permanent* tax increases have been a relatively small part of Connecticut's deficit-mitigation solution since deficits began in November 2001, and – during this period – some tax *cuts* also were enacted. This section puts the FY 05 changes in the context of previous deficit-mitigation.

Short-term revenues. Many of the new revenues used to help balance the FY 02, FY 03, FY 04 *and* FY 05 budgets came from short-term solutions that provided quick infusions of cash into the General Fund, not permanent revenue increases. Over this period, these temporary revenue solutions have included:

- *Rainy Day Fund.* Depleting the Budget Reserve ("Rainy Day") Fund ($594.7 million in 2002)

- *Borrowing.* Issuing 5 year Economic Recovery Notes (total of $345.3 million--$222.4 million in 2002, $122.9 million in 2003)

- *One-time revenues.* Including liquidation of stock from Anthem demutualization ($127.2 million), a tax amnesty program ($109 million), "Wall Street" litigation settlement proceeds ($4.2 million)

- *Fund transfers.* Transfers of money to the General Fund (or maintaining tax revenues in the General Fund that should have been transferred to other Funds). Fund transfers included those from: the tobacco settlement (Tobacco Health Trust Fund, total of $84.8 million; the Biomedical Research Trust Fund, total of $12 million), the Connecticut Housing Finance Authority (total of $90 million), the Connecticut Development Authority (total of $27.5 million), Connecticut Innovations, Inc. (total of $17.5 million), Mashantucket/Pequot grant (total of $64.5 million), Special Transportation Fund (total of $128 million), Energy Conservation and Load Management Fund ($144 million), Clean Energy Fund (total of $50 million), Probate Administration Fund (total of $15 million), Banking Fund (total of $10-13 million), Private Occupational Student Protection Fund ($1 million), Home Construction Guarantee Fund ($1.2 million), and Commercial Recording Account (total of $5.5 million)

- *Escheats.* Increased revenues from the sale of abandoned property that resulted from reducing the time necessary for property to be considered abandoned ($38.6 million) and by allowing the Treasurer to liquidate all types of unclaimed property when received ($50 million)

- *Other timing gimmicks.* These included allowing the Comptroller to count certain taxes received in July in the preceding fiscal year, transferring $125.3 million of FY 04 surplus funds into the FY 05 budget and pre-paying $78.7 million of FY 05 expenditures in the FY 04 budget.

- *Delays in scheduled tax reductions.* Delays in scheduled phase-outs or phase-downs of various taxes, including the increase in single filer exemptions on the personal income tax, the elimination of the gift tax, and the elimination of the inheritance tax.

- *Temporary tax increases.* Including a 20% surtax in the 2003 income year and a 25% surtax in the 2004 income year on the corporation business tax (projected to yield $32.4 million in FY 03, $82.4 million in FY 04 and $33.6 million in FY 05) and the temporary tax on estates of more than $1 million of persons who die between July 1, 2004 and January 1, 2005 ($55 million in FY 05).

In total, these short-term revenue "fixes" provided a total of about $2.486 *billion* of *one-time* "new"[4] revenues over this period. Of this, less than $119 million came from delays in scheduled tax reductions and $205 million from temporary tax increases.

Structural tax changes. By comparison, the net gain in *on-going* General Fund revenues (permanent tax increases less permanent tax cuts) resulting from changes enacted since November 2001 is about $720 million[5] -- about $962 million in General Fund tax *increases* offset by about $242 million in General Fund tax cuts.

As shown in the table below, the on-going General Fund[6] tax *increases* enacted since the start of budget deficits in November 2001 are expected to generate a little more than $962 million in new revenues in FY 05, as follows:

General Fund FY 05 Revenue Gains from Permanent Tax Increases Enacted Since 2002 ($M)	
	Projected FY 05 Revenue ($M)
Personal Income Tax	
-Increase 4.5% rate to 5%[7]	$445.5
-Reduce maximum property tax credit from $500 to $350	$112.2
-Capture tax due from out-of-state owners of LLPs, LLCs, S corps	$ 8.0
Corporation Business Tax	
-Surcharge of $250 on LLCs, LLPs, and S corporations	$ 28.0
-Limit use of tax credits to offset no more than 70% of pre-credit tax liability	$ 30.0
-Prohibit use of tax credits to eliminate $250 Alternative Minimum Tax	$ 0.5
-Set a maximum per company for refundable research & development tax credit	$ 8.5
-Require company to add back to income certain interest expenses w/ related company	$ 10.0
-Increase from $25,000 to $250,000 the "preference" tax for a corporation that *elects* to file using unified reporting	$ 30.0

4 While, for example, the transfer of FY 04 "surplus" funds to the FY 05 budget provides "new" revenue in FY 05, it creates a budget hole in FY 06.

5 Notably, a number of permanent tax changes were enacted that would have generated about $66 million in additional General Fund revenues, only to be repealed soon thereafter. These included: a) requiring a type of mandatory unified reporting for the corporation business tax (projected to have resulted in income gain of $40 million); b) repeal of the sales tax exemption for newspapers and magazines (projected revenue gain of $15 million); d) imposition of a 3% sales tax rate on advertising and public relations services for direct mail (projected revenue gain of $7.8 million); and d) repeal and then restoration of the "sales tax free" week in August (providing an exemption for clothing costing from $50 to $300/item)(projected revenue gain of $3.3 million).

6 In addition, an increase in the diesel fuel tax from 18 to 26 cents per gallon was projected to generate an additional $25 million per year in revenues, but these are credited to the Special Transportation Fund.

7 Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was less ($393.0 million).

Sales & Use Tax	
-Reduce exemption from $75/item of clothing to $50/item[8]	$ 35.2
-Repeal exemption for health & athletic clubs[9]	$ 7.9
-Impose 3% rental surtax on rental trucks	$ 0.1
-Impose tax on self-storage units	$ 1.5
-Repeal final step of phase-out of 1% tax on computer/data processing services	$ 10.8
-Require vendors with state contracts to collect sales/use tax from customers	$ 5.0
Cigarette Tax	
-Increase tax from $0.50 per pack to $1.51 per pack	$201.0
Insurance Companies Tax	
-Eliminate tax credit for Managed Care Organizations providing HUSKY coverage[10]	$ 15.6
-Limit use of tax credits to offset no more than 70% of pre-credit tax liability	$ 2.5
Public Service Companies Tax	
-Extend 5% tax on cable TV to satellite TV	$ 3.0
Other	
-Apply controlling interest transfer tax to additional real property transfers	$ 5.0
-Allow alcohol sales until 9 p.m. on weekdays and Saturday	$ 2.1
TOTAL	**$962.4**

Fee increases. In addition to these tax increases, Connecticut increased a variety of fees over this period. Fee increases generating General Fund revenue (projected to be about $19.3 million in FY 05) include: a) increases in a variety of court fees; b) a new $205 "program" fee for the Community Service Labor Program;[11] c) increasing the surcharge for various infractions (e.g., not carrying motor vehicle registration) from $20 to $35; d) a new "health and welfare" fee on insurers to help subsidize the state Department of Public Health's immunization program; e) a new $0.50/report fee on towns that make certain reports to the Department of Motor Vehicles (e.g., delinquent property taxes); and f) increases in various environmental quality permit and land use application fees.[12]

Over this same period, however, the General Assembly also enacted nearly $242 million in *permanent General Fund tax reductions:*[13]

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[8] Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was less ($32 million).

[9] Revenue estimate for FY 05 is from *Governor's Presentation on Connecticut's Budget Situation* (December 14, 2005). OFA estimate was more ($8.5 million).

[10] The managed care organizations concurrently received a fee increase, so there was no net savings to the General Fund.

[11] Certain people charged with violating drug laws may participate in the Community Service Labor Program, which is within the Court Support Services Division. Program activities include performing unpaid labor for government agencies and nonprofit charitable organizations. The court must dismiss the charges against anyone who successfully completes the program. There were 3,700 people who participated in the program in FY 02.

[12] In addition, many Department of Motor Vehicle fees were increased (e.g., for permits, licenses, exams, for copies, duplicates and replacements of various legal papers, for the Connecticut River ferry) and are projected to generate about $27.6 million in revenue for the Special Transportation Fund in FY 05, of which about $5 million is earmarked for the Transportation Strategy Board Projects account.

[13] In addition, there were a number of *temporary* tax reductions enacted over this period. Most were targeted to exempt sales of alternative fuels and fuel efficient cars (total revenue loss of about $3 million). One provided a special exemption for the sale of certain items sold to a for-profit, acute care hospital ($0.8 million one-time revenue loss).

General Fund Annual Revenue Losses from Permanent Tax Reductions Enacted Since 2002 ($M)	
Personal Income Tax	Annual Revenue Loss ($M)
-Increase maximum property tax credit back to $500 from $350 (eff. 1/1/05)	**($105.0)**
Corporation Business Tax	
-Extend refundable research & development tax credit to capital base taxpayers with no net income	**($ 12.5)**
Sales & Use Tax	
-Exempt certain services provided by specified aircraft companies, retroactive to 1994	**($ 0.2)**
-Exempt non-cable communications services bought by cable company	**($ 0.1)**
-Repeal 5.75% tax on patient care services	**($116.4)**
Public Service Companies Tax	
-Exempt portion of co. revenues used for debt service on energy securitization bonds	**($ 1.7)**
-Exempt sales of natural gas to existing, specified plant	**($ 5.0)**
-Exempt sales of natural gas for fuel in co-generation plant co-sited with manufacturing plant though not co-owned	**($ 0.8)**
TOTAL	**($241.7)**

3. To Date, Connecticut Has Restored Less Than Half of the $2 Billion In Tax Revenues Eliminated In The Late 1990s

As shown in the table below, net *total* tax and fee increases enacted since the November 2001 Special Session remain *less than half* of the total tax cuts made between the time Governor Rowland was first elected and deficits began in 2001.[14]

	Tax Cuts in Rowland Tenure, Pre-Nov. 2001 Special Session[15]	Total Net On-Going Tax & Fee Increases since Nov. 2001[16] (FY 05 revenue)	*Net* Change in Taxes & Fees
Income Tax	-711.5	565.7	-145.8
Sales Tax	-193.3	-55.4	-248.7
Corporation Tax	-496.6	94.5	-402.1
Hospital Tax	-190.4	0	-190.4
Cigarette Tax	0	201.0	201.0

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[14] NOTE: Revenue losses are as reported in *Governor Rowland's Budget Proposal FY 2003-2005 Biennium* (March 4, 2003 PowerPoint), not as of FY 05.

[15] *Governor Rowland's Budget Proposal FY 2003-2005 Biennium* (March 4, 2003 PowerPoint), p. 46.

[16] The table does not include revenues from temporary surtaxes nor revenues resulting from delays in implementation of tax cuts since they fail to address the structural deficit in a permanent way. Because OFA reduces General Fund revenues whenever funds are earmarked, this table assumes the same. Numbers shown in the second column represent *net* changes in FY 05 revenues. The current estimates of FY 05 General Fund revenues resulting from tax *increases* since 2002 are taken from *Governor's Budget Presentation on Connecticut's Budget Situation* (December 14, 2004). The Governor's PowerPoint notes that the property tax credit has been reinstated at the $500 level beginning January 1, 2005 for an annual personal income tax revenue loss of $105 million. This loss is *not* shown on this table as it begins in FY 06.

Inheritance Tax	-158.1	0	-158.0
Gasoline/Diesel/Petroleum Tax	-190.2	24.7	-165.5
Local Business Property Tax	-66.1	0	-66.1
Other Taxes & Fees	-57.8	55.3	-2.5
TOTAL	**-2,064.0**	**885.8**[17]	**-1,178.2**

4. Overall State Taxes and Fees Remain Less in Connecticut Than They Were in The Mid-1990s, But *Who* Is Paying Them Has Shifted

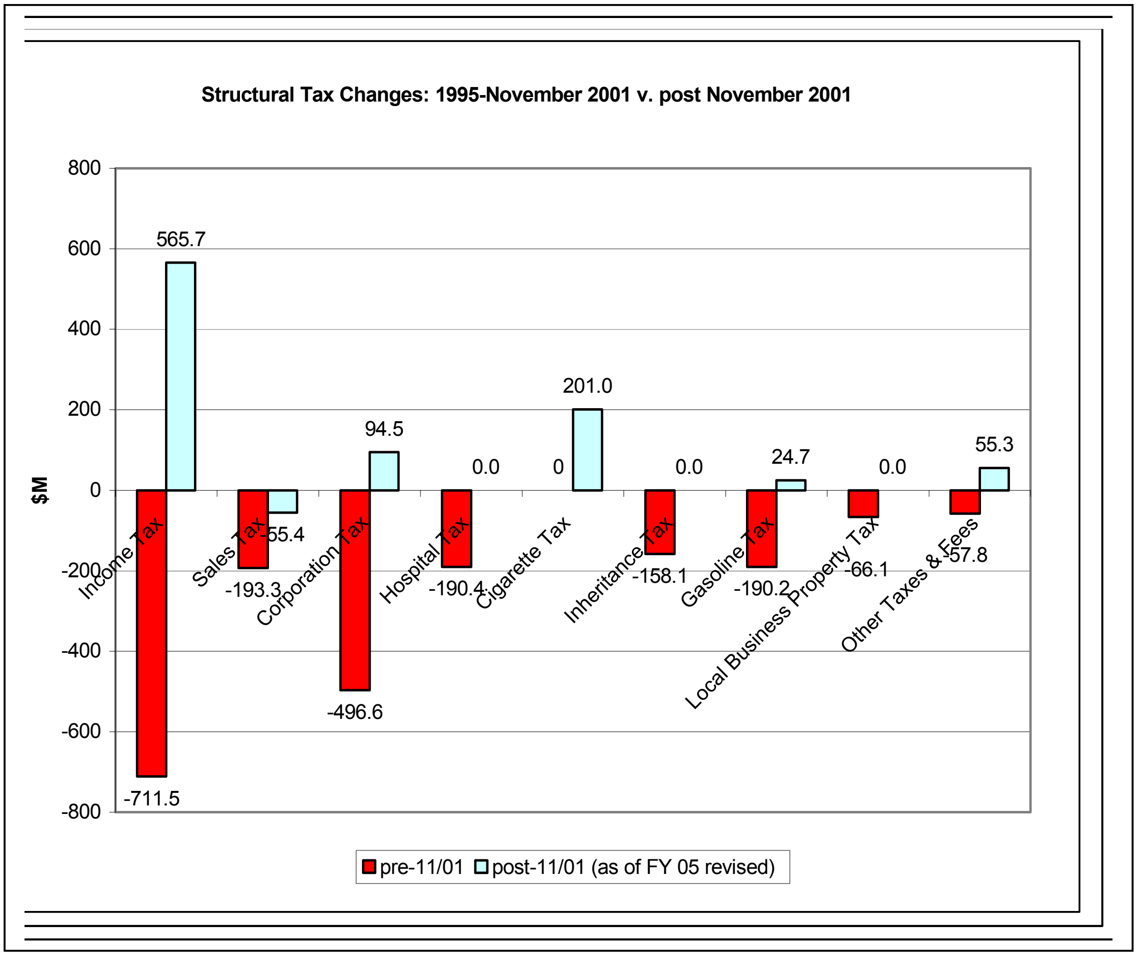
When the deficit began in FY 02 and Connecticut began to increase on-going revenues, it did not simply repeal the tax cuts enacted in the late 1990s. Rather, it enacted a variety of *new* tax and fee increases, allowing many of the tax cuts of the late 1990s to remain in effect.

As a result, there has been a shift in how much responsibility different types of taxpayers now bear for financing state government. In general, more responsibility is now placed on individuals and families and less on businesses.

The following chart shows graphically how the *net* state tax and fee *increases* enacted through, and including, the revised FY 05 budget compare to the state tax *cuts* from the time Governor Rowland took office and the time that deficits emerged, by type of tax.[18]

[17] This number differs from the $720 million *net change* number discussed in the preceding section of the report as it takes into account *all* revenue changes (fee increases, as well as tax increases) and also revenue changes for *all* funds (not just General Fund). Also, for consistency, it uses the Governor's revenue estimates rather than OFA's. OFA projected *less* revenue than did the Governor from the income tax rate increase ($393 million compared to $445.5 million) and from the reduction in the sales tax exemption for clothing ($32 million compared to $35.2 million). The following graph, like the table above, also does *not* take into account the restoration of the property tax credit to $500 (projected revenue loss of $105 million beginning in FY *06*).

[18] The chart includes only the net state tax and fee increases (and reductions) that are *not temporary*. Excluded as tax cuts, for example, are Connecticut's two tax rebates in the late 1990s (a total of $219.2 million for an income tax rebate in FY 99 and a sales tax rebate in FY 00). Similarly excluded are temporary tax increases, such as the 20% surcharge on the corporation tax for income year 2003 (in PA 03-2) and the 25% surtax for income year 2004 (in the FY 03-05 budget bill). *Included* are revenues from *delays* in the implementation of already-scheduled tax cuts (such as the delay in the phase-out of Connecticut's inheritance tax).



As shown in the chart above, in the late 1990s the personal income tax was reduced by $711.5 million (largely through enactment of property tax credit). To date, deficit-mitigation efforts have *increased* the personal income tax by about $566 million, primarily from the rate increase from 4.5% to 5% (resulting in $445.5 million in projected additional FY 05 revenue) and the reduction in the maximum property tax credit from $500 to $350 and elimination of the residual $100 credit for high-income taxpayers (resulting in $112.2 million in additional FY 05 revenue). That is, as of FY 05, a little more than ¾ of the personal income tax cuts made in the late 1990s have been rolled-back since deficits began.[19]

By comparison,[20] new permanent corporate business taxes are less than *one-fifth* of the corporation business tax cuts enacted in the late 1990s.[21] While the decline in

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19 Not shown in the chart (because it first impacts revenues in FY 06, not FY 05) is the 2004 Session's increase in the property tax credit to $500 again (reducing the gain in income tax revenues by an estimated $105 million, to $460.7 million). If this change were included, the personal income tax cuts of the late 1990s would be rolled back by about two-thirds rather than three-quarters.

20 A closer look at other revenue changes over this period shows that many of the *other* taxes and fees that were increased (e.g., cigarette tax, sales tax on clothing costing between $50 and $75/item, sales tax on athletic clubs) will be borne primarily by individuals and families, while certain other changes (e.g., expansion

Connecticut's corporation business tax revenues does not necessarily mean there has been a decline in *total* business taxes (since corporations, like families, pay other taxes), at least two independent analyses of Connecticut's *total* business tax burden find it to be relatively low *and declining* compared to the majority of other states.

A January 2004 report prepared by Ernst & Young for the Council on State Taxation (a non-profit trade organization with a membership of 550 major businesses engaged in interstate and international trade) found that Connecticut was one of only three states to reduce overall state and local business taxes[22] between FY 2000 and FY 2003. It reported that, nationally, total state and local business taxes *increased* by 8.3% over this period, while Connecticut's state and local business taxes *declined* by 1%. The COST report also found that Connecticut ranked in the bottom 10 of all states on three of four measures of business tax burden: 43rd (8th lowest) in the share of all taxes paid by business; 40th in business taxes per dollar of private sector economic activity; and 40th in business taxes per dollar of capital income. While it also found that Connecticut ranked 12th highest in business taxes per private sector employee, this reflected – in part – the continuing decline in private sector employment in Connecticut in what had become the state's longest recession since 1939.[23]

Also, Robert Tannenwald of the Federal Reserve Bank of Boston recently released a report that sought to "clarify recent debate about the fairness, adequacy, and competitiveness" of business taxes. It found that in FY 2000 Connecticut ranked 40th (11th lowest) in business share of state and local taxes, 28th in business taxes as a percent of business profits, and 28th in business taxes as a percent of statewide personal income (business tax burden).[24]

5. Conclusion

Connecticut was one of just six states[25] that enacted tax cuts between the mid-1990s and 2001 that were so large that they reduced state revenue by *more than 10%*. In retrospect, these deep tax cuts overshot what was affordable (given the unsustainable levels of capital

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of refundable research and development credit, natural gas exemptions) will benefit businesses. Some (e.g., increases in court and DMV fees) will affect both.

21 A portion of the decline in the corporation business tax is attributable to a gradual reduction in the tax rate to around the national median, a change that was important to keep Connecticut economically competitive. The balance of the decline, however, results from new tax credits, exemptions, deductions, and apportionment formulas that are not assessed periodically to see if they provide appropriate economic return to the state and whether they provide disproportionate and unwarranted benefit to particular corporations.

22 COST included within its 50-state comparison of "total state and local business taxes:" property tax (on real, personal, and utility property), sales and use taxes, excise taxes, gross receipts taxes, corporate income taxes, employer payroll contributions (including unemployment insurance, workers' compensation insurance, and disability insurance taxes) and license and other business taxes. The other states with a decline in these total taxes were Oregon (less than 1% decline) and Alaska (10% decline).

23 Connecticut Department of Labor, "Employment Declines for Third Year," *The Connecticut Economic Digest,* 9(3) (March 2004, p. 1).

24 R. Tannenwald, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?* (Federal Reserve Bank of Boston, *Public Policy Discussion Papers,* No. 04-4, August 20, 2004).

25 The other states were Colorado, Delaware, Massachusetts, New Jersey and New York. R. Zahradnik, *Tax Cuts and Consequences: The States That Cut Taxes the Most During the 1990s Have Suffered Lately* (Center on Budget and Policy Priorities, January 12, 2005), available at www.cbpp.org.

gains and dividend income on which they relied) and have had severe fiscal and economic impact.

Compared to states that cut taxes by less (or did not cut taxes at all), these top six tax-cutting states had smaller budget reserves at the start of the state budget crises in 2001, larger deficits between 2001-2003, and had to cut spending and raise taxes more to close their deficits. Equally troubling, the economic performance of these states has lagged national averages. For example, between 2001 and 2003, Connecticut's 2.3% job loss was nearly three times the national average (a 0.8% loss). Connecticut's growth in *un*employment was second only to Colorado's and double the national average. Connecticut's personal income increased just 2.0%, compared to 5.3% nationally.[26]

Moreover, as discussed in this report, Connecticut's deep tax cuts of the late 1990s continue to have an impact. Connecticut's projected SFY 06 deficit is directly linked to its failure to restore a greater share of the General Fund revenues depleted through these tax cuts.

With the baby boomer generation at the peak of its earnings but on the verge of retirement, and federal budget cuts likely (to address the ballooning federal deficit), Connecticut has little time to waste in addressing its structural budget deficit.

Now is the time to *restore* the remaining taxes cut in the late 1990s. By doing so, Connecticut can avoid further deep spending cuts that threaten Connecticut's high quality of life, and can assure adequate revenue for the investments in education, transportation, housing and health care that are necessary to keep Connecticut economically competitive.

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[26] R. Zahradnik, *Tax Cuts and Consequences: The States That Cut Taxes the Most During the 1990s Have Suffered Lately* (Center on Budget and Policy Priorities, January 12, 2005), available at www.cbpp.org.

APPENDIX A

General Fund Revenue Changes in Revised FY 05 Budget[27]	
	FY 06
TAX CHANGES	**($M)**
Personal Income Tax	
Increase in the maximum property tax credit against the personal income tax, from $350 to $500, effective for tax years after 1/1/05 [PA 04-216][28]	**($105.0)**
Enhance collection of personal income tax from out-of-state owners of pass-through entities (S corporations, LLCs, LLPs) [PA 04-216]	$8.0
Corporation Business Tax	
Permanently extend the refundable research & development tax credit against the corporation business tax to capital base taxpayers with no net income [PA 04-235]	**($15.0)**
Extend from 1/1/04 to 1/1/08 the clean alternative fuels tax credit [PA 04-235]	**($0.5)**
Sales and Use Tax	
Permanently restore the sales tax free week (for clothing items costing between $50 and $300/item) [PA 04-216]	**($3.3)**
Exempt certain items sold to a for-profit, acute care hospital [PA 04-2, MSS]	**($0.8)**
Exempt purchase of hybrid cars between 10/1/04 and 10/1/08 if EPA-rated mileage exceeds 40 mpg [PA 04-231]	**($0.1)**
Petroleum Gross Earnings Tax	
Extend from 7/1/04 to 7/1/08 the exemption for sales of propane used as a motor vehicle fuel [PA 04-231]	**($0.1)**
Extend from 7/1/04 to 7/1/08 the exemption for petroleum products used as a fuel in fuel cells [PA 04-231]	**($0.1)**
Public Service Companies Tax	

27 Estimated revenue gains and losses are taken from two sources: CT General Assembly, Office of Fiscal Analysis, *Where Does the Money Come From? Where Does the Money Go?* (January 25, 2005) and *Governor's Presentation on Connecticut's Budget Situation* (PowerPoint presentation, December 14, 2004). Where estimates differ, OFA's estimates are used (and the Governor's estimates specified in a footnote).

28 The Act *restores* the maximum property tax credit against the personal income tax from $350 to $500 for tax years starting on or after January 1, 2005. The maximum credit had been *reduced* from $500 to $350 by PA 03-1 (June Special Session). This credit increase will reduce General Fund revenues by $105 million in FY 06 and each year thereafter.

Permanently exempt from tax the portion of public service company revenues that are used for debt service on energy securitization bonds [PA 04-180]	**($ 1.7)**
Permanently exempt sales of natural gas to a plant with "three gas turbines with total capacity of 775 megawatts" [PA 04-180]	**($ 5.0)**
Permanently exempt sales of natural gas for fuel in a co-generation facility that provides "electricity or steam to a company engaged in a manufacturing process" and extends the exemption to a facility located on the premises of a manufacturing plant although operated by a third party [PA 04-180]	**($0.8)**
Extend from 7/1/04 to 7/1/08 the exemption for natural gas/propane when used as a motor vehicle fuel [PA 04-231]	**($0.1)**
Real Estate Conveyance Tax	
Permanently exempt from the tax all employer/relocation company re-sales of residential property relating to employee relocations [PA 04-154]	**($ 1.2)**
Eliminate earmarking of lodging tax revenues[29]	$20
ONE-TIME REVENUE CHANGES IN REVISED FY 05 BUDGET[30]	
Treasurer's sale of unclaimed property [PA 04-216] [31]	$83.0

[29] Elimination of the earmarking of tax revenues is considered by OFA to be a General Fund revenue gain, while the earmarking of taxes is treated as a General Fund revenue loss. There is no additional tax being imposed here nor is there net revenue gain to the *state*.

[30] Included as "one-time" revenues are revenues that are not on-going, either because they are arise from a source that is depleted after use in SFY 05 (e.g., proceeds from the sale of unclaimed property), or arise from a tax change that is temporary in nature (delay in phase-out of a tax).

[31] PA 04-216 included a $90 million one-time General Fund revenue gain in FY 05 from changes pertaining to abandoned/unclaimed property. $50 million of the $90 million was to have come from the State Treasurer's sale of her current unclaimed property portfolio and the remaining $40 million from the issuance of special obligation abandoned property fund bonds. *However,* because the Treasurer's actual sale of her unclaimed property portfolio resulted in $38 million more in revenues than the $50 million OFA had projected, it eliminated the need to issue these bonds.

Prior law had required the Treasurer to wait at least one year after she received most types of unclaimed property before selling it and, unless she found it to be in the state's best interest to sell sooner, to wait at least three years before selling any abandoned ownership interests in a business. This Act allowed the Treasurer to liquidate all types of unclaimed property as soon as received and expressly permitted her to immediately liquidate all unclaimed securities she is currently holding. It also eliminated the right of a person who claims an abandoned business ownership interest before the end of the 3-year waiting period to receive the greater of the sale proceeds or the market value of the securities at the time of the claim. Instead, the claimant can either get the securities themselves (if still in the Treasurer's possession) or the sale proceeds (but not the market value of the securities on the date of the claim).

In addition, the Act also had authorized the State Bond Commission, by June 30, 2005, to allocate up to $60 million in special obligation abandoned property fund bonds (plus the costs of financing and issuing the bonds). The bond proceeds were to go to the General Fund. Before issuing the bonds, the State Treasurer and Office of Policy and Management Secretary had to find that issuance was necessary to support state General Fund programs. The bonds had to have a maximum term of seven years. The bill established a Special Abandoned Property Fund to secure the bonds and required the Treasurer to deposit in this fund the cash proceeds realized from abandoned property to which the Treasurer took custody under the law. Investment earnings were to become part of fund assets and the fund balance remaining at the end of the fiscal year had to be carried forward to the next fiscal year. Debt service on these "abandoned property"

Transfer of FY 04 surplus funds to FY 05[32]	$125.3
Pay for certain 2005 General Fund expenses in FY 04 (nursing home rate increases, Department of Higher Education, Reserve for Salary Adjustments)	$78.7
ONE-TIME REVENUES ALREADY INCLUDED IN FY 05 BUDGET	
Transfer funds to the General Fund from: Energy Conservation and Load Management Fund ($12), Transportation Fund ($8), quasi-public agencies ($17.5), Tobacco and Health Trust fund ($12), Biomedical Research Trust Fund ($2), Clean Energy Fund ($25)	$76.5
Sell additional unclaimed property by reducing from 5 to 3 years the time unclaimed property must be held before it can be sold by the Treasurer	$17.3[33]
TEMPORARY REVENUES ALREADY INCLUDED IN FY 05 BUDGET	
Delay scheduled personal income tax reductions for single filers, effective for tax years on and after 1/1/04	$3.5
Impose 25% corporate business tax surtax for income year 2004	$33.6[34]
Delay each remaining step of phase-out of succession tax by two years (to 1/1/06 for Class B heirs and to 1/1/08 for Class C heirs; roll-back of rate reduction of 1/1/03	$26.0
De-couple estate tax from federal tax for six months by establishing a tax on estates over $1M for persons who die between 7/1/04 and 1/1/05. Tax is equal to 1.3 times the maximum credit allowable against the federal estate tax for state tax payments (excluding the 75% reduction in that credit applicable under federal law in 2004)	$55.0
Delay by two years the remaining steps of the phase-out of the tax on gifts between $250,000 and $1 million (phase-out to resume with gifts given on or after 1/1/06 and will be completed with gifts given on or after 1/1/10)	$1.0

bonds was to be repaid from future abandoned (unclaimed) property revenue, and was to have first claim to the revenues. The bonds were not subject to statutory limits on the state's bond debt. OFA stated that this would have resulted in an annual General Fund revenue loss of $10 million from FY 06 through FY 10 (for a total revenue loss of $50 million over these five years). As noted, this sale was not necessary.

[32] The revised FY 05 budget required the State Comptroller to transfer $125.3 million of FY 04 revenues ("surplus") to the FY 05 General Fund budget prior to June 30, 2004 (the end of FY 04), thereby providing additional FY 05 revenues. If the Comptroller anticipated a FY 04 deficit prior to certifying the final FY 04 General Fund balance, the amount appropriated for the Higher Education Matching grant was to be reduced correspondingly to prevent a FY 04 deficit. Because there was no FY 04 deficit, this did not occur.

[33] The Governor's revenue estimate is $10.3 million. *Governor's Presentation on Connecticut's Budget Situation* (PowerPoint presentation, December 14, 2004).

[34] The Governor's revenue estimate is $28.0 million. *Governor's Presentation on Connecticut's Budget Situation* (PowerPoint presentation, December 14, 2004).