CONNECTICUT VOICES FOR CHILDREN

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Testimony Supporting
H.B. No. 6498, An Act Concerning the Sales and Use Tax Rate
Testimony of Jeffrey M. Tebbs*
To the Committee on Finance, Revenue, and Bonding
February 23, 2009

Senator Daily, Representative Staples, and distinguished Members of the Finance, Revenue, and Bonding Committee,

I am testifying today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families. I submit this testimony because the manner in which Connecticut raises and spends its revenues is of great importance to the state's children and families.

Connecticut Voices for Children partially supports H.B. 6498, An Act Concerning the Sales and Use Tax Rate.

H.B. 6498 provides for an increase in Connecticut's sales and use tax rate from six to seven percent. In ordinary times, Connecticut Voices for Children would oppose an increase in the sales tax rate. Indeed, **Connecticut Voices strongly believes that the Finance, Revenue, and Bonding Committee should consider progressive reforms of the personal income tax before turning to increases in the sales and use tax.**

Nevertheless, the magnitude of the current fiscal crisis necessitates action on multiple fronts. On February 2, 2009, the Office of Fiscal Analysis projected that the deficit will approach $4.0 billion in Fiscal Year 2010 and rise to $4.7 billion in Fiscal Year 2011. Given the immense size of these deficits, it would be difficult to restore balance to the state budget without modification to each of the major components of the current revenue system, including the sales tax.

1. The fiscal crisis is actually a "revenue crisis" that requires a revenue solution. In September 2008, the Office of Fiscal Analysis projected the Fiscal Year 2011 deficit at $1.2 billion. Since September, the projected deficit has increased by $3.5 billion. Nearly 89 percent of the deterioration in the budget outlook during these five months is due to declines in projected revenues. Figure 1 depicts the deterioration in the revenue outlook

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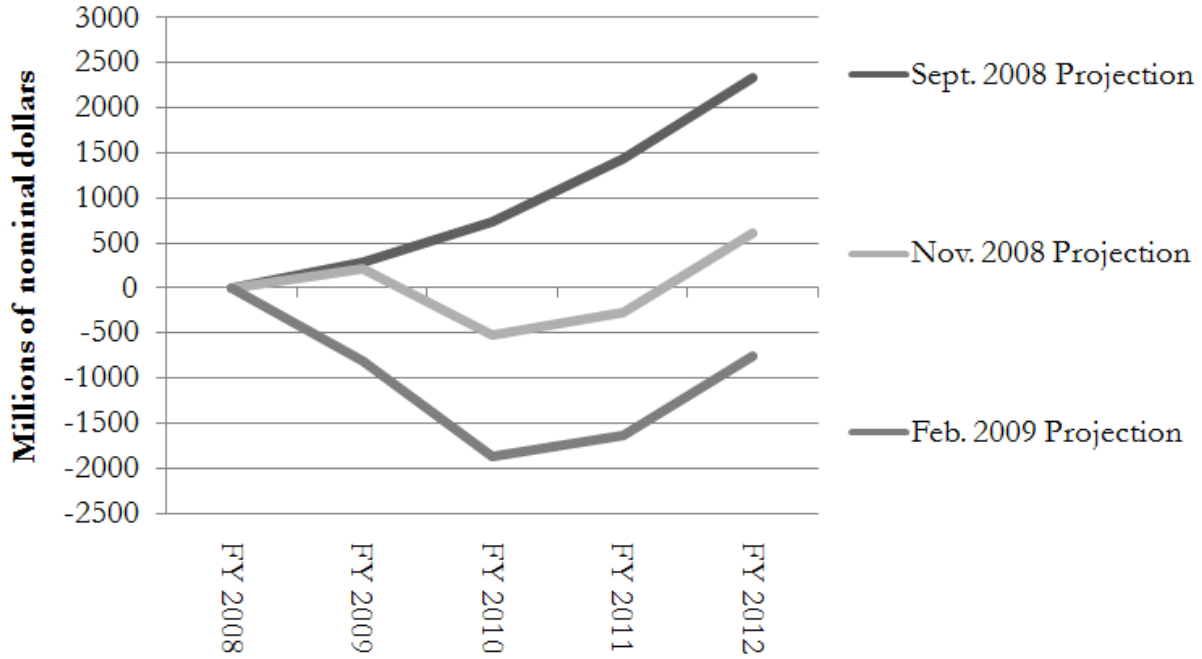
since September 2008. This illustration lucidly demonstrates that our current fiscal crisis is in fact a revenue crisis.

Figure 1. Projected Growth in Tax Revenue (FY 2008-FY 2012).[1]



At this juncture, the projected deficit for Fiscal Year 2011 represents the confluence of three factors:

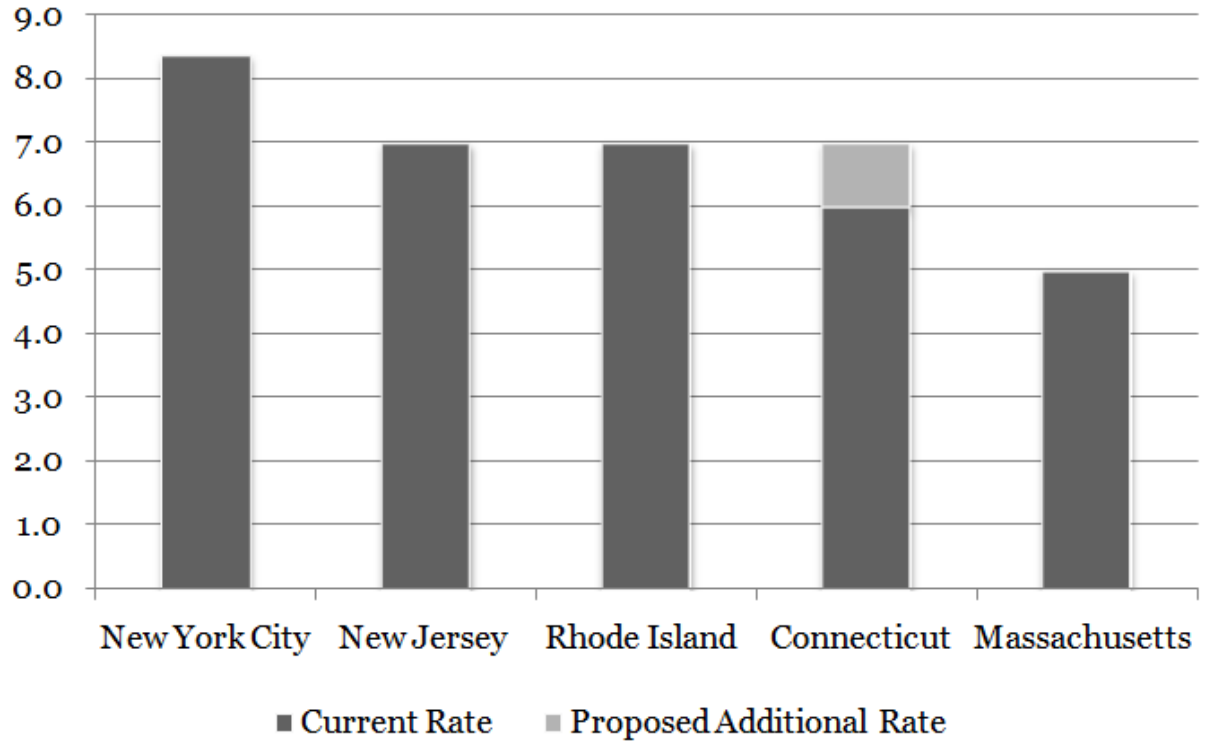
> **(a) A long-term structural imbalance between revenues and expenditures** (26 percent of the deficit projected in February was already expected back in September);
> **(b) A dramatic decline in revenues in the immediate term** (65 percent of the projected deficit for Fiscal Year 2011 is due to a diminished revenue outlook); and
> **(c) A modest increase in the cost of maintaining current services as a result of the recession** (increases in projected expenditures are responsible for 8 percent of the projected deficit for Fiscal Year 2011).

Thus, more than 92 percent of the expected deficit is attributable to a failure to raise adequate revenue to fund existing commitments and priorities. While responsible and targeted cuts in expenditures will be necessary to restore budgetary balance during this recession, drastically slashing spending in response to fluctuations in the business cycle would risk exacerbating the economic downturn. Moreover, Connecticut residents should be able to rely on government services during a recession. Connecticut must remain committed to investing in primary, secondary, and higher education; adequately funding transportation and related infrastructure; providing health insurance for low-income and unemployed

families; and maintaining financial support of our cities and towns. In short, a revenue problem requires a revenue solution rather than an abandonment of core commitments.

2. While an increase in the sales tax rate is undesirable, Connecticut's sales tax rate would remain competitive with neighboring states. Figure 2 provides the sales tax rates for Connecticut's neighboring jurisdictions as of January 1, 2009.[2] A single percentage point increase in the sales tax would place Connecticut at or below the current sales tax rate of most neighboring localities.[3]

Figure 2. Sales Tax Rates by State or Locality (2009).*

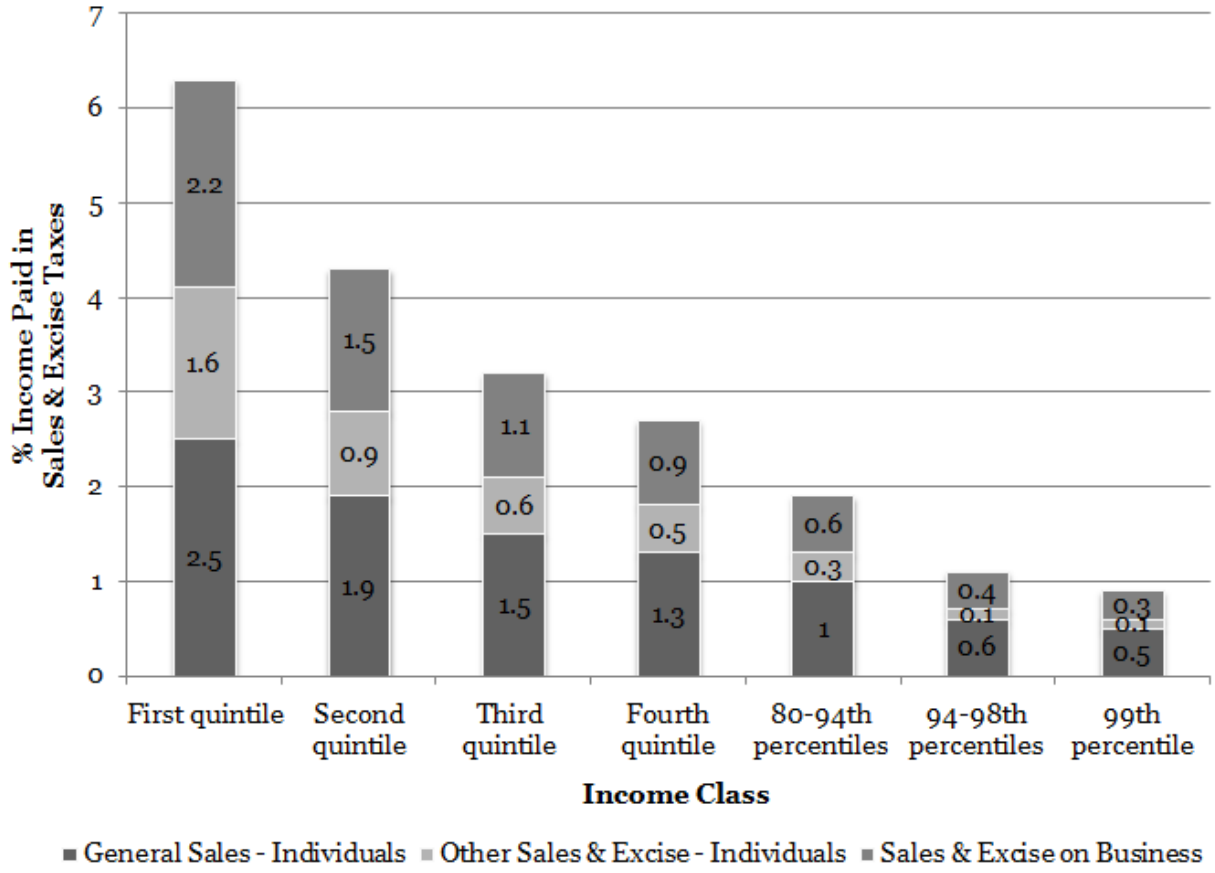


* Sales tax for New York State residents are a combination of state and local sales taxes. There is no uniform statewide rate. Local rates range from 7.00% to 8.75%.

3. Since an increase in the sales tax would impose a heavier burden on low-income households, it should be coupled with the creation of an Earned Income Tax Credit. Lower income families pay a higher share of their income in sales taxes than higher income households who are able to save more of their income. Recent analysis conducted by the Institute on Taxation and Economic Policy reveals that the poorest fifth of Connecticut's population pay an average of 6.4 percent of their income in sales and excise taxes, whereas the highest-income fifth spend only 0.9 to 1.9 percent of their income on sales and excise taxes. Figure 3 outlines the impact of the sales tax on different income groups. Since increasing the amount of revenue raised from the sales tax has a greater impact on lower-

income residents, Connecticut Voices supports the creation of a refundable state Earned Income Tax Credit (EITC). A state EITC program rewards work and has proven to be one of the single most effective anti-poverty programs.[4]

Figure 3. Sales and Excise Tax Burdens by Income Group (2006).[5]



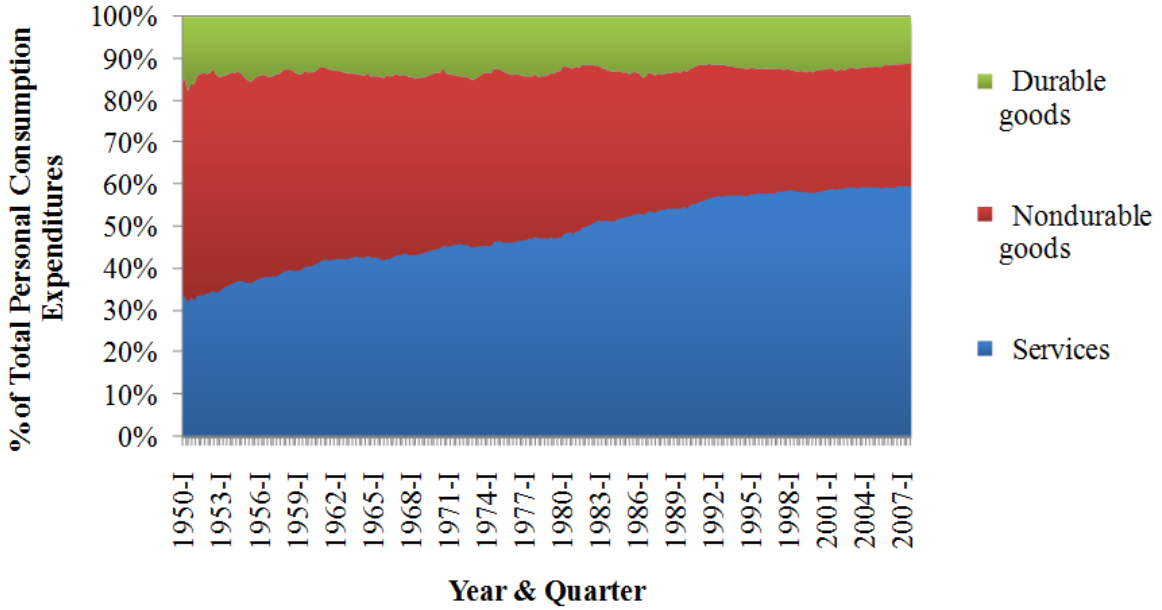
Twenty-four states have already successfully enacted EITC programs. Connecticut should join its neighbors: New York, New Jersey, Rhode Island, and Massachusetts already operate refundable EITC programs.[6] This state EITC could be calibrated as a simple fraction of the federal EITC.

4. Broadening the base of the sales tax would be a fairer, more economically efficient manner in which to raise revenue. Connecticut could avoid raising the sales tax rate by instead taxing certain services and eliminating ill-advised exemptions.

(a) Expanding the Sales Tax to Certain Services. Over the past several decades, consumers have shifted their spending away from goods and toward services. Figure 4 illustrates the long run trends in the composition of consumer spending. In 1950, only 33.1 percent of personal consumption expenditures (PCE) were on services, while 15.1 percent of PCE were on durable goods and 51.8 percent were on non-durable goods. At the close of

2007, consumer spending on services had risen to 59.7 percent of total PCE, while spending on durable goods fell to 10.9 percent and spending on non-durable goods fell to 29.4 percent.

Figure 4. Trends in Personal Consumption Expenditures (1950-2007).[7]



These substantial shifts in the composition of consumer spending reflect increased spending on medical care, financial services, recreation services, and education and research services.[8] The decline in the share of personal consumption expenditures on goods also reflects the relative price declines of household appliances, furniture, and automobiles. As consumers shift their spending patterns toward services, Connecticut should modernize its conception of what purchases should be taxed to include services like dry cleaning, pet grooming, limousine services, investment advice, and storage services. Table 1 provides a list of personal services that are not currently subject to the sales tax, an indication of how many states already tax these services, and a preliminary projection of the revenue that would have been collected in 2007 if these services had been included. Tables 2 provides a list of sales tax expenditures related to services (personal and otherwise) accompanied by an estimate by the Office of Fiscal Analysis of the revenue loss from these provisions.

H.B. No. 6349 would subject professional, insurance, occupational, and personal service transactions to the sales tax. Connecticut Voices believes that personal service transactions should generally be brought under the umbrella of the sales tax. Including personal service transactions will cohere with our evolving conception of consumer spending. However, the treatment of professional, insurance, and occupational services is significantly more complicated. The General Assembly should consider taxing these services under either:

> (a) The corporation business tax, which could be expanded to apply to S-Corporations, LLCs, LPs, and LLPs; [9] or

(b) The sales and use tax, but not necessarily at the same six or seven percent rate.

To the extent that accounting, engineering, and legal services are provided to clients in markets outside of Connecticut, then the potential cost of a sales tax may not be borne by the consumer but instead absorbed by the Connecticut-based producer. For certain services, it may be more appropriate to treat the providers of occupational and professional services in the same fashion as manufacturers organized as C-Corporations. Regardless of one's position with regard to rate and structure of Connecticut's corporation business tax, it is inequitable to apply that tax to C-Corporations while subjecting businesses organized as "pass-through" entities to a mere $250 per year business entity tax.

(b) Elimination of certain exemptions to the sales tax. Finally, Connecticut must revisit its tax expenditure budget to remove unnecessary exemptions. In January 2008, the Office of Fiscal Analysis released estimates of the revenue loss in Fiscal Year 2009 from exemptions to the sales tax.[10] OFA estimated that the revenue loss from consumer goods exemptions equaled $1,385.1 million; from business and agricultural exemptions equaled $188.4 million; and from exemptions from the services already taxed equaled $154.2 million. The total revenue loss from all of the exemptions to the sales tax was $2,568.4 million or nearly 70 percent of the revenue actually expected to be raised (as of February 2008).[11] While certain exemptions (e.g., food) are meritorious, other exemptions are dubious and impose unnecessary distortions in consumer spending.

In conclusion, increased revenue from the sales tax may be necessary to shore up Connecticut's finances. The preferable route for increasing revenue from the sales tax is the elimination of certain exemptions and the addition of certain services. If the General Assembly instead elects to increase the rate from six to seven percentage points, Connecticut Voices urges that an Earned Income Tax Credit be instituted to protect low-wage workers from the impact of the increase.

Table 1. Projected Revenue from Taxing Selected Personal Services. (millions of dollars)

Service	# of States Currently Taxing this Service	Estimated Revenue Gain in CY 2007
Bowling alleys	27	2.9
Laundry and dry cleaning services, non-coin op	22	12.1
Warehousing and storage (automotive, food, fur, household goods, cold storage)	19[12]	15.0
Pet grooming (excludes veterinary services)	18	4.7
Limousine service (with driver)	16	9.3
Interior design and decorating	10	9.8
Barber shops, beauty parlors/salons, and nail salons	7[13]	35.0
Investment advice	6[14]	41.7
Property sales agents (real estate or personal)	5	110.7
Real estate title abstract services	5	4.6
Travel agent services	4	10.9
Loan broker fees	3	11.0
Total		**267.7**

Methodology: We extracted a list of services in Connecticut that are currently exempt from taxation from a Federation of Tax Administrators (FTA) survey of sales tax practices in all 50 states.[15] This FTA list contained the North American Industry Classification System (NAICS) codes associated with each industry. The NAICS codes were then matched with state-level data from the U.S. Census Bureau's most recently available Economic Census.[16] Specifically, gross receipts/revenue totals were extracted for the applicable industry codes for 2002. We extracted data from both the employer and non-employer (sole proprietor) datasets. We then "grew" this gross receipts data to calendar year 2007 using state GDP data from the Bureau of Economic Analysis.[17] When industry-specific growth figures were available, we inflated the gross receipts data accordingly. Where a percentage growth figure for the particular industry was not found, we inflated the gross receipts data by the overall growth in Connecticut GDP from 2002 to 2007, which was 30.2 percent. Finally, we estimated that sales tax revenue would equal six percent of gross revenue for each industry under analysis.

Table 2. OFA Estimates of Certain Tax Expenditures Related to Services.[18]
(millions of dollars)

Service	Revenue Gain in FY 2009
Personnel Services; Marketing, Development, Testing or Research Services; Business Services in Joint Ventures	4.0
Computer and Data Processing	64.0
Certain Sales of Computer and Data Processing Services	0.3
Calibration and ISO Services	0.2
Sale of Repair or Maintenance on Vessels	3.8
Renovation & Repair for Residential Property	21.0
Motor Vehicle Parking	2.5
Massage Therapist and Electrology Services	0.3
Sales Agent Services	2.0
Advertising	20.0
Winter Boat Storage	0.3
Non-Cable Communication Services	0.1
Marine Vessel Brokerage Services	0.2
Media Payroll Services	1.5
Total	**120.2**

[1] Office of Fiscal Analysis, Budget Briefing Information Session, http://www.cga.ct.gov/OFA/Documents/Statements/2009/pp%20presentation%209-08%20for%20web.pptSeptember 25, 2008; Office of Fiscal Analysis, Fiscal Forecast Presentation to the Appropriations & Finance Committees, November 18, 2008, http://www.cga.ct.gov/OFA/Documents/FiscalForecast/FiscalForecast2008.pdf; Office of Fiscal Analysis, FY 09 - FY 12 General Fund and Transportation Fund Budget Projections, February 2, 2009, http://www.cga.ct.gov/OFA/Documents/Statements/2009/Feb_2_2009_Statement.pdf.

[2] TAX FOUNDATION, STATE SALES, GASOLINE, CIGARETTE, AND ALCOHOL TAX RATES BY STATE, 2000-2009, January 28, 2009, *available at*: http://www.taxfoundation.org/publications/show/245.html; NYC Finance, Business and Excise Taxes, http://www.nyc.gov/html/dof/html/business/business_tax_nys_sales.shtml#rates (accessed February 22, 2009); FEDERATION OF TAX ADMINISTRATORS, STATE SALES TAX RATES (2008), *available at* http://www.taxadmin.org/fta/rate/sales.html.

[3] Neighboring jurisdictions face similarly daunting deficits and may also increase their sales tax rates. For instance, the Governor of Massachusetts has proposed: increasing the state tax on meals by one percentage point; increasing the state rooms tax by one percentage point; and eliminating the sales tax exemption on alcohol , soda, and candy. *See* MASSACHUSETTS BUDGET & POL'Y CTR., BUDGET MONITOR: THE GOVERNOR'S FY 2010 BUDGET PROPOSAL (2009), http://www.massbudget.org/file_storage/documents/FY10HOUSE1.pdf.

[4] *See generally* ISABEL SAWHILL AND ADAM THOMAS, BROOKINGS INSTIT., A HAND UP FOR THE BOTTOM THIRD: TOWARD A NEW AGENDA FOR LOW-INCOME WORKING FAMILIES (2001), http://www.brookings.edu/~/media/Files/rc/papers/2001/05useconomics_sawhill/20010522.pdf

[5] DOUGLAS HALL AND SHELLEY GEBALLE, CONN. VOICES FOR CHILDREN, "WHO PAYS?" HOW OUR STATE AND LOCAL TAX SYSTEM BURDEN'S CONNECTICUT'S POOR AND MIDDLE CLASS (2008), *available at:* http://www.ctkidslink.org/publications/bud08whopays.pdf..

[6] JASON LEVITIS AND JEREMY KOULISH, CTR. ON BUDGET & POL'Y PRIORITIES, STATE EARNED INCOME TAX CREDITS: 2008 LEGISLATIVE UPDATE, *available at* http://www.cbpp.org/6-6-08sfp.pdf.

[7] Bureau of Economic Analysis, National Income and Product Accounts, Table. 1.1.5. Gross Domestic Product, extracted Jan. 11, 2009.

[8] Larry R. Moran & Clinton P. McCully, *Trends in Consumer Spending, 1959-2000*, SURVEY CURRENT BUSINESS, March 2001, 15-21

[9] Indeed, S-Corporations were covered under the corporation business tax until 1996. Many S-Corporations and other businesses exempt from the corporation business tax are large and profitable businesses. According to the Program Review and Investigation Committee, in 2003, 18 of the state's 100 largest business paid only a $250 business entity tax, which applies to these S-Corporations and certain other classes of businesses (such as LLCs, LPs, and LLPs). *See generally* SHELLEY GEBALLE, CONN. VOICES FOR CHILDREN, THE CASE FOR REFORMING, NOT ELIMINATING, CONNECTICUT'S BUSINESS ENTITY TAX (2008). The Office of Fiscal Analysis estimated that the FY 2009 revenue loss from the exemption of S Corporations alone constituted $26.0 million. That analysis did not include the revenue loss from the exclusion of LLCs, LPs, and LLPs. *See* OFFICE OF FISCAL ANALYSIS, CONNECTICUT TAX EXPENDITURE REPORT 9 (2008).

[10] Office of Fiscal Analysis, Connecticut Tax Expenditure Report, January 2008.

[11] Office of Fiscal Analysis, Supplemental Analysis of the Governor's 2007-2009 idterm Budget Adjustments, February 26, 2008, http://www.cga.ct.gov/OFA/Documents/GovBud/Supplemental_Analysis_Feb_26_2008.pdf

[12] At least nineteen states tax one of these types of storage.

[13] This number pertains only to barber shops and beauty parlors/salons.

[14] Number of states that tax investment counseling, which is a broader category than investment advice.

[15] Federation of Tax Administrators, Sales Taxation of Services, Actual Survey Data 2007, *available at*: http://www.taxadmin.org/fta/pub/services/services.html

[16] U.S. Census Bureau, 2002 Economic Census, Geographic Area Series, Connecticut: 2002 (2005), tables available at: http://www.census.gov/econ/census02/guide/02EC_CT.HTM. Although the 2007 Economic Census has been conducted, state-level data will not be released until at least October 2009.
[17] Bureau of Economic Analysis, Regional Economic Accounts, GDP by State and Industry, *available at* http://www.bea.gov/regional/gsp/default.cfm?series=NAICS
[18] Office of Fiscal Analysis, FY 09 – FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information, Nov. 14, 2008, 29-31, *available at*: http://www.cga.ct.gov/OFA/Documents/Statements/2009/111408Statement.pdf