Pro-Family Tax Reform in Connecticut: A Roadmap for Improvement

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April 2014

This year’s tax filing deadline provides an opportunity to think about whom we tax, how we tax and if our current policies treat families with children fairly. For a healthy economy tomorrow, we need to ensure that our state tax and spending policies promote healthy children and thriving families today. Connecticut’s tax code violates this fundamental rule. Out of the 41 states in the U.S. with personal income taxes, Connecticut is one of only two that fail to offer any adjustments in income tax liability for families raising kids.

It is crucial that Connecticut make a concerted, consistent investment in children and families on both sides of the budget, both expenditures and taxes. This is not a new concept; for decades, Connecticut – like most other states and the federal government – has used its personal and corporate income tax laws to encourage economic growth through business tax credits, exemptions, deductions and differential tax rates. These kinds of “tax expenditures” – so called since they are akin to direct spending – can foster important investments in our state’s economy if they are well-targeted and routinely scrutinized.

Using the tax code to support children and their families is an equally important investment in our future workforce. But today, children are virtually invisible in Connecticut’s income tax code. To address this problem, as Connecticut embarks on major tax reform, it should consider:

- Protecting and expanding the successful state earned-income tax credit;
- Implementing a refundable child tax credit;
- Providing a tax credit that offsets the high costs of childcare; and
- Offering a deduction from a filer’s taxable income for each dependent in the household.

Taxes and the Family: Why They Matter

For generations, communities across our nation have counted on a simple inter-generational bargain: working adults pay taxes that support the health and wellbeing of children and older adults, knowing that as they age, the children they once supported will become tomorrow’s workers, in turn supporting the next generation of children and retirees. Dramatic demographic and economic changes are now placing this previously self-sustaining cycle in jeopardy. First, the Baby Boom of 65 years ago has now created a disproportionately large number of retirees, especially in slow-growing states such as Connecticut. Second, the replacement of manufacturing jobs that could support a whole family by service jobs that can scarcely support one person has dimmed the prospects of young workers. Third, the shift of risk from companies offering stable jobs and secure retirements to families struggling to provide dependable incomes on their own has strained even those who do everything right. Just as a prosperous

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1 We would like to acknowledge the invaluable assistance of Lucy Xu of Yale University in researching and presenting the interstate data on child-friendly tax policies below.
new generation of adults is needed to support Baby Boomers in retirement, prospects for Connecticut’s rising workforce have deteriorated. For Connecticut to sustain the generational exchange, it must make significant investments that address the opportunity gap and prepare our young people for success in the workforce.

Yet today, the opposite is true. Over the past two decades, Connecticut has committed less and less of its state budget to public services for young people. The share of the budget providing education, health, and human services for children has fallen from 40 to 30 percent over the past two decades. Connecticut’s tax code, meanwhile, is uniquely hostile to children. With the notable exception of the earned income tax credit (EITC) for low-income families, no feature of Connecticut’s income tax accounts for the substantial cost of raising kids. We tax two families earning $60,000, one with three children and one with none, the same, despite the vastly lower ability to pay of the family raising kids. Only one other state has a tax system that disadvantages children in this manner.

Not only does the failure to adjust income taxes to reflect the costs of child rearing discourage having children, but also it violates a basic principle of tax policy – that that those equal in ability to pay should be taxed equally, while those not equal should be taxed differently. This uncontroversial idea, horizontal equity, is a core component of overall tax fairness. The principle of equity is one of the seven core principles used by the nonpartisan National Conference of State Legislatures to evaluate state tax systems. Without a dependent child deduction, child tax credit, or other tax expenditures to offset the cost of child rearing, Connecticut falls far short of the goal of horizontal equity.

Other States Already Have Family-Friendly Tax Codes

Fortunately, there are concrete steps Connecticut can take to improve the family-friendliness of our tax code and help sustain the generational exchange. Many other states incorporate pro-family features into their tax systems. This report will explore these features and recommend several as proven strategies for making sure state tax systems are fair and support the exchange among generations.

First, the good: Connecticut’s state earned-income tax credit (EITC), implemented in 2012, is an important and well-targeted investment that builds off the existing federal tax credit to support low-income working families with children. With our state EITC, Connecticut joins some two dozen other states – including every state in New England with an income tax – in building on the successful federal tax credit. The state EITC provided an average boost of $600 to some 186,000 working families last year, with over 95% of the credit’s value flowing to families with children. The credit incentivizes work, since a filer’s credit amount increases with each additional dollar earned on the job, at the same time as it advances horizontal equity. Studies have also recently found that the children of families receiving the tax credit have improved health and educational outcomes, increasing children’s opportunities for success in school and beyond.

The EITC alone, however, is not enough. While most other states incorporate additional pro-family credits or exemptions into their income tax codes, Connecticut’s tax code makes no adjustment in tax liability for the presence of dependent children; as a result, families that do not qualify for the EITC face an effective child penalty. In contrast, the federal government and most other states make an adjustment in their respective tax codes to mitigate any such penalty.

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The following four family-friendly tax policies (detailed in Figure 1 below) are utilized effectively in other states:

1. A dependent exemption, which allows filers to reduce their taxable income by a certain amount for each dependent;
2. A child tax credit (often refundable) that reduces tax liability by a certain amount for each qualifying child;
3. A child and dependent care tax credit, which offsets a percentage of a household’s qualifying childcare expenses; and
4. An earned-income tax credit, described above.

Figure 1. Pro-Family Tax Policies in the 50 States
By building on the federal child tax credit, child and dependent care credit, and dependent exemption, Connecticut could advance pro-family, pro-child tax reform with little administrative costs. Indeed, these policies could serve as a roadmap for reform and bring our tax code in line with other states’ and the federal government’s. Each of these pro-family tax programs has existed for years and has received strong bipartisan support.

Moreover, as Figure 1 indicates, many states have already adopted policies that mirror the federal framework. Nearly every other state with a personal income tax has included one or more of these features into its own state tax code – reducing or eliminating the aforementioned child penalty, while improving fairness and economic security for families. Along with Pennsylvania and North Carolina, Connecticut is one of only three of the 41 states with a personal income tax that do not include an exemption on state tax returns for dependents. In addition, more than half of the states with an income tax (24 of 41 states) further subsidize the cost of raising children with a child and dependent care tax credit, child tax credit, or a combination of these.

While the specific design, income thresholds, credit amounts, and refundability of these credits vary across states, Connecticut’s failure to provide any but an EITC is unique, and is an aspect of our tax system that disadvantages families with children in our state. It is critical that policymakers explore the full range of tax policy options available that would increase the state’s commitment to families with children and eliminate the child penalty that currently exists in our tax code. Implementation of such family-friendly tax features would constitute a significant state investment in Connecticut’s children and future.

Simple Steps to Make Connecticut’s Tax System Family Friendly

Connecticut has ample room to improve the family-friendliness of its tax system. The final section of this report lays out four proposals that would mark significant steps forward in this regard. In general, these proposals are modeled after those that exist in other – often neighboring – states. Connecticut should consider the following options, particularly as state policymakers consider fundamental tax reforms in the years ahead:

1.) Protect and expand the state EITC

Enacted in 2011, the Connecticut EITC represents an important first step towards a family-friendly tax system. It is crucial that the state hold the line on the state credit’s amount – originally 30 percent of the federal EITC, a level that will be restored next year – and its refundability. In addition, Connecticut should consider expanding the credit to non-custodial parents – a step New York took in 2005, and one that has been recently proposed at the federal level by President Obama. This expansion would increase the value of the state EITC for low-income, working

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6 President Obama included non-custodial parents in his recent proposal to expand the federal EITC. See: http://www.whitehouse.gov/sites/default/files/docs/eitc_report.pdf
non-custodial parents, helping boost their labor force participation and ability to support children financially.\(^7\) This proposal would incorporate the key features of the New York State credit – including, importantly, the requirement that credit recipients be 100 percent current on child support. In Connecticut, this would give a boost on the order of $650,000 to about 1,600 working parents\(^8\) – supplementing their wages, helping make ends meet, and keeping them on the job. As family structures continue to shift away from traditional two-parent arrangements, non-custodial parents have an important role to play in promoting and sustaining the well-being of their kids. It’s time to extend the EITC to responsible, working but non-custodial parents.

2) Implement a refundable state Child Tax Credit

In addition, Connecticut should implement a refundable state Child Tax Credit (CTC) modeled after the credit New York implemented in 2006. A state child tax credit, similar to the child credit offered for federal income taxes, is a substantial investment in families with children and would ensure that they are treated equitably when filing their taxes. Congress created the federal child tax credit as part of the Taxpayer Relief Act of 1997. Importantly, the credit is fully refundable for filers with incomes greater than $9,667 – meaning that if the amount of the credit is greater than what they pay in taxes, they receive the balance as a refund.\(^9\)

The federal child tax credit plays a significant role in offsetting the costs of child rearing for low- and moderate-income families in our country. From 2010 to 2012, the refundable portion of the credit, combined with the federal EITC, lifted some 36,000 children in Connecticut above the poverty line – as well as more than 5.1 million kids in the United States.\(^10\)

Connecticut should build on the successful federal child tax credit – just as it has done with the federal EITC through its state earned income credit – as an effective and targeted way to make a major state investment in our future workforce. A refundable Nutmeg State Child Credit pegged at 33 percent of the federal credit would boost the take-home pay of more than 400,000 families in our state, increasing net income by more than $117 million for these households based on 2013 income estimates.\(^11\)

3) Implement a Child and Dependent Care Tax Credit

About half of all states with an income tax – as well as the federal government – also include some form of deduction or credit to offset the substantial costs of childcare. Though the federal child and dependent care credit (CDCTC) is not refundable – meaning that families whose credit amount exceeds their tax liability do not receive the excess as a cash refund – it is a family-friendly tax feature that is broadly accessible. The credit is available to all households with federal income tax liability – unlike the more targeted CTC and EITC, this credit does not phase out for higher earners.

Some 23 other states currently offer a tax credit meant to offset childcare costs. Again, New York State is a model: its state child and dependent care credit allows filers with incomes below $25,000 to claim up to 110 percent of the federal credit amount, with this percentage decreasing as income increases beyond $25,000. Filers with incomes above $65,000 may claim 20 percent of the federal credit amount. About 78,000 households in Connecticut claimed the federal dependent care credit in 2011, receiving an average credit amount of $526 per household. A Connecticut state dependent care credit – figured, like our EITC, as 30 percent of a filer’s federal credit amount – would have a

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\(^7\) For a detailed explanation of New York State’s noncustodial parent EITC, see: [https://otda.ny.gov/workingfamilies/noncustodial.asp](https://otda.ny.gov/workingfamilies/noncustodial.asp)

\(^8\) Fiscal Policy Center analysis of Connecticut and New York state personal income tax and Earned Income Tax Credit data.

\(^9\) For a household with one qualifying child. Filers with two children receive the full credit amount when their income reaches $16,333; for each additional child, the minimum income to receive the maximum credit increases by $6,666.

\(^10\) Brookings Institution calculations based on U.S. Census Bureau Current Population Survey (CPS) data.

\(^11\) Institution on Taxation and Economic Policy tax simulation model. This revenue estimate assumes a state child tax credit in the amount of 33% of the filer’s federal credit attributable to qualifying children, or $100, whichever is greater, and limits the credit to filers with AGI below $75,000 for single filers and $110,000 for joint filers.
revenue impact of approximately $12.4 million while providing an additional $160 per household to defer childcare expenses.\textsuperscript{12}

4.) Create a Dependent Exemption

Finally, Connecticut should allow an exemption for dependents – children and adults alike – on its state income tax return. Except for Pennsylvania and North Carolina, every other state with an income tax allows at least a dependent exemption. This exemption allows parents and guardians to deduct from their reported income a certain amount for each dependent claimed, reducing the amount of taxes paid by families raising children.

Without a dependent deduction, a Connecticut couple with $60,000 in taxable income and three children pays virtually the same amount in taxes as a childless couple earning the same amount – even though the couple with children has much less capacity to pay taxes given how much more of its disposable income is used to buy clothes, food, school supplies and other things for their children.\textsuperscript{13} Similarly, a single parent in Connecticut will pay more in state income tax than a married couple with no children and the same income. In 2011, Connecticut tax filers claimed over a million dependent exemptions on their federal returns. Allowing a similar exemption on the state return – in the amount of $1,000 – would reduce overall tax liability by about $43 million for households supporting dependent children and adults.\textsuperscript{14} Since the dependent exemption is not refundable, however, it would largely benefit middle- and upper-middle income households: accordingly, if enacted it should be paired with other changes that include a strong refundable component – such as those mentioned above.

These four pro-family proposals – totaling approximately $173 million based on the estimates above – should be a major part of any comprehensive tax reform effort. The implementation of one or all of them should be informed by the state’s pending tax incidence analysis and tax study, and should be aligned with other changes to the personal income, sales, corporation business, estate, and property taxes.

Altogether, these four policy options offer a menu of proven, pro-family tax policies. Given the challenges to sustaining Connecticut’s generational exchange, options such as these are a crucial part of refocusing both sides of Connecticut’s budget – revenues and expenditures alike – towards the future of our economy and state.

\textsuperscript{12} CT Voices analysis of 2011 IRS federal tax return data.
\textsuperscript{13} As mentioned above, a lower-income family with children may qualify for the state EITC, which would modestly offset their state tax liability.
\textsuperscript{14} Institution on Taxation and Economic Policy (ITEP) tax simulation model.