FISCAL POLICY CENTER

At Connecticut Voices for Children

Families First, Prosperity for All:
Making Connecticut's Tax and Benefit System More Family-Friendly

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I. Introduction

Connecticut's tax system should reward—not penalize—families caring for children and seniors. However, penalize is precisely what it does. Our income tax treats households of equivalent income, one with dependents and one without, as though they have the same ability to pay, ignoring the high cost of raising children or taking care of older parents. Only one other state lacks a broad-based income tax feature such as a dependent exemption that takes into account the added costs of caregiving.[1] Without such an exemption, Connecticut's tax system violates the fundamental tax principle of horizontal equity: taxpayers with *less* ability to pay must pay *more*.[2] The state's tax system is unfair, and makes it harder for families to provide for their children, parents, and grandparents.

Connecticut's tax and benefit system should also reward—not penalize—families trying to get ahead. However, in many cases, the interaction of state and federal taxes and benefits creates high marginal "tax" rates and "cliffs," wherein some families who earn more money wind up poorer than when they earned less.[3] This unintended consequence is most evident for low-income families with children in subsidized childcare under Care4Kids. No one intended these perverse effects—they were the result of many decisions layered on top of one another over years at the state and federal levels—and everyone should support efforts to remove the worst among them.

Fortunately, simple policy changes can reduce these problems, rewarding families supporting children and seniors, as well as those striving to move up the economic ladder:

- **Enacting a dependent exemption**, which 38 states already have,[4] would go a long way towards leveling the playing field for caregivers and reducing the impact of high marginal rates and cliffs.
- **Restoring the state EITC, the one feature of the state income tax that *is* responsive to family size**, would assist low-income (but not middle or higher-income) families with children, helping them make ends meet.
- **Adjusting income limits for Care4Kids**, Connecticut's main childcare subsidy program, would remove the particularly deep cliff faced by working families with young children.

Policies such as these are needed today more than ever. Connecticut's young people will enter adulthood in a state with an aging population and shrinking workforce, rising inequality and diminishing opportunities for decent jobs. Worse, over the past two decades Connecticut has shifted public investment *away* from young people, withdrawing support for public education, children's health, and family economic security. Twenty years ago, the state committed about 40% of its budget to programs that benefit children; today that figure is barely 30%. If

Connecticut invested public funds today as it did 20 years ago, the state would spend $1.5 billion more each year on children.[5]

Strategic policy changes are crucial to maintaining the covenant between generations central to every society: the first generation cares for the second when it is young; the second cares for the first when it is old. If Connecticut fails to invest in its young people today, our future workers and parents will find that promise broken. Not only will they be unable to enjoy the opportunities available to present generations, but also they will be unable to provide for present generations in old age. It is in the interest of all to preserve the covenant between generations.

II. Our tax system should reward—not penalize—families caring for children and seniors

Enacting a dependent exemption would improve the fairness of Connecticut's tax system towards working and middle-class caregivers. Currently, the only feature of the state's income tax that adjusts for the cost of dependents is the state earned income tax credit (EITC), which only applies to families with child dependents and incomes below about $50,000. The EITC begins to phase out at about $20,000, depending on tax filing status, and it does not extend to families caring for seniors and other older dependents.[6] As a result, the large majority of Connecticut families do not receive the EITC.

Family A: Married, 2 dependents

Earned income:	$60,000
Dependent expenses:	$18,000
State income taxes:	$1,800
Net income:	**$40,200**

Family B: Married, 0 dependents

Earned income:	$60,000
Dependent expenses:	$0
State income taxes:	$1,800
Net income:	**$58,200**

The EITC alone is simply not enough, which is why every state with an income tax except Connecticut and Pennsylvania uses a child tax credit, child and dependent care tax credit, dependent exemption, or combination thereof to adjust for the cost of caregiving (see Appendix A). The federal government employs all three. A child tax credit reduces a family's tax liability by a certain amount for each qualifying child; a child and dependent care tax credit offsets a portion of a household's qualifying dependent care expenses; and a dependent exemption allows a family to reduce its tax bill by a given amount for each dependent.

Implementing one of the pro-family tax features already used by most other states and the federal government would both bring Connecticut's tax system in line with the rest of the Nation's and make the system fairer and more supportive of families doing the hard, necessary work of raising children and caring for family members.

III. Our tax and benefit system should reward—not penalize—families trying to get ahead

The Problem

Connecticut's tax and benefit system should reward—not penalize—families trying to get ahead. However, the combined effect of state and federal taxes and benefits creates high marginal rates and "cliffs," causing many families who earn more money to take home only a small fraction of it, or in the case of cliffs, to end up poorer than when they earned less.

To explore these effects, Connecticut Voices for Children worked with the Urban Institute[7] to construct a dynamic model of Connecticut's state and federal tax and transfer programs that allows the calculation of "take-home" income (i.e., earned income plus and minus taxes and transfers) for families of different incomes, sizes, and ages.[8]

The model also allows the user to simulate the impact of income changes on take-home income, and these simulations reveal high effective marginal tax rates and cliffs for families with children who earn between approximately $20,000 and $50,000 (see the Appendix for a full explanation of Connecticut Voices for Children's "Benefit Calculator").

For instance, a single-parent household with two children with an earned income of $20,000 before taxes would benefit from income and services totaling approximately $31,000 after taxes and transfer benefits (assuming the family received neither Care4Kids childcare subsidies nor Section 8 housing assistance—two very valuable benefits with very limited availability). If that same family then doubled its income from $20,000 to $40,000, its total take-home income and benefits would increase from $31,000 to just $37,000. This means that a 100% increase in pay would results in only a 30% increase in after tax resources, creating an effective marginal tax rate of 70%.

For families receiving Care4Kids or Section 8, the benefit cliff becomes even steeper. Take the single-parent household with two children earning $20,000. If the family received Care4Kids subsidies for full-day care for one child and after-school care for the other, as well as Section 8 assistance, its take-home income benefits would total about $49,000. If wages increased to $40,000, the family after tax income and benefits would decrease to $44,000: a net loss of $5,000, despite a doubling of take-home pay.

Families with income of approximately $40,000 face the highest penalty because Care4Kids eligibility abruptly terminates as income exceeds 50% of the state median; at that level, families lose the entirety of their Care4Kids benefits, which can total $5,000 or $10,000 annually. For the relatively few families that fall into this precise income range, earning more at work leaves the family with less.

Throughout the $20,000 to $50,000 income range, marginal rates seldom drop below 60%, meaning that families lose the majority of additional money they earn—and that is before non-tax and transfer expenses are included. Earning additional money often means incurring additional expenses for transportation and children, not to mention the fact that it usually comes through working more hours, leaving less time to spend with family. The all-in marginal rates, therefore, can approach—and even exceed—100%. Hard-working families, quite literally, can earn more but wind up with less.

The Response

Enacting a dependent exemption would go a long way towards reducing high marginal rates. A state exemption would deliver a significant benefit to moderate- and middle-income families. These are the same families whose childcare, housing, nutrition, and EITC benefits are phasing out, tamping down on the high marginal rates they face. Analysis by the Institute for Taxation and Economic Policy in Washington, DC found that, depending on its specifications, such an exemption would offer an average benefit ranging from roughly $50 to $100 to moderate-income families, with the majority of the tax benefit flowing to families earning less than $130,000 a year.

Restoring the state EITC, the one feature of the state income tax that *is* responsive to family size, would assist low-income (but not middle or higher-income) families with children, helping make ends meet. The state EITC supports nearly 200,000 working households in each of Connecticut's 169 towns, providing over $110 million in annual benefits. Reduced in 2013 from 30% of the federal credit to 25%, in 2014 the EITC was restored halfway, to 27.5%; full restoration to 30% is planned for this year. Given the importance of the EITC to so many working families with children, restoring it should be a top priority.

Adjusting Care4Kids income limits to phase out more gently would remove a particularly steep cliff. Until 2010, Care4Kids had an eligibility category— "Priority Group 6" (PG6)—that served to smooth out the cliff by allowing families whose incomes begin to exceed the 50% of state median cap to remain on Care4Kids until their incomes exceed 75% of the median. Restoring PG6, at an estimated cost of less than $1 million annually,[9] would be another productive step.

Further steps could be taken at the federal level—to smooth the cliff in Section 8, for instance. And, a larger-scale solution would be to cap the combined marginal rate any family can face at a certain amount—say, 50%. Such a solution would be complicated, however, requiring the calculation of marginal rates for families with a near limitless permutation of incomes, family sizes, filing statues, and so on. A more focused solution may be to provide a one or two-year grace period for families in which a parent is earning a degree, accepting a big promotion, or entering the job market. It is crucial that hard-working families are rewarded—not penalized—for their efforts.

V. Conclusion

Enacting a dependent exemption and restoring the EITC would both level the playing field for caregivers and reduce perverse incentives in the current structure of state and federal benefits. They would also send a clear message to hard-working caregivers that their efforts are valued. Adjusting Care4Kids income limits, as well, would send a positive message and make a large difference for those families whose incomes currently approach the cutoff for eligibility. All three changes would be beneficial in terms of both message and substance.

Admittedly, these changes are just a start. Given the large shift of public resources away from young people—amounting to nearly 10% of the state budget annually—and the very steep marginal rates affecting families trying to get ahead, much more progress is needed. Connecticut Voices for Children's "Children's Budget" tracker[10] and its "Benefit Calculator" model (see Appendix) are important tools in tracking the state's overall investment in young people and the ultimate impact of its tax and benefit structure on families. As much and as quickly as practical, Connecticut should work to increase public investment in young people and assist hard-working families in getting ahead.

Appendix A- Family-Friendly Tax Policies in the 50 States

	EITC	Child Tax Credit	Child & Dependent Care Credit	Dependent Exemption
Alabama				x
Alaska			No State Income Tax	
Arizona				x
Arkansas			x	x
California		x	x	x
Colorado	x	x	x	x
Connecticut	x			
Delaware	x		x	x
Florida			No State Income Tax	
Georgia			x	x
Hawaii			x	x
Idaho				x
Illinois	x			x
Indiana	x			x
Iowa	x		x	x
Kansas	x		x	x
Kentucky			x	x
Louisiana	x		x	x
Maine	x		x	X
Maryland	x		x	x
Massachusetts	x			x
Michigan	x			x
Minnesota	x		x	x
Mississippi				x
Missouri				x
Montana				x
Nebraska	x		x	x
Nevada			No State Income Tax	
New Hampshire			No State Income Tax	
New Jersey	x			x
New Mexico	x		x	x
New York	x	x	x	x
North Carolina		x		
North Dakota				x
Ohio	x		x	x
Oklahoma	x	x	x	x
Oregon	x		x	x
Pennsylvania				
Rhode Island	x		x	x
South Carolina			x	x
South Dakota			No State Income Tax	
Tennessee			No State Income Tax	
Texas			No State Income Tax	
Utah				x
Vermont	x		x	x
Virginia	x		x	x
Washington			No State Income Tax	
West Virginia				x
Wisconsin	x			x
Wyoming			No State Income Tax	
Total:	**24**	**5**	**23**	**38**

Source: Tax Credits for Working Families and the U.S. Federation of Tax Administrators.

Appendix B: Connecticut Voices for Children's Benefit Calculator

The Benefit Calculator was developed by the Fiscal Policy Center at Connecticut Voices for Children, with assistance from the Urban Institute, for two primary purposes. First, it provides policymakers, advocates, and private citizens a fuller picture of working families' net income — that is, earned income adjusted for state and federal taxes and benefit programs such as the EITC, Care4Kids childcare subsidies, and Section 8 housing assistance. Second, the Benefit Calculator uses this information to model how tax and transfer programs affect families of various sizes at different income levels to gain insight into the impact of potential tax or benefit policy changes.

Inputs. The Benefit Calculator requires several inputs to determine a family's marginal tax rate and eligibility for state and federal benefit programs. These inputs, comprehensively, include family earned income (up to $100,000), number and age of children, tax filing status, dependent care expenses and monthly housing costs (rent and utilities).

Parameters. In order to calculate a family's benefits, the Benefit Calculator uses pre-programmed parameters to determine eligibility and amount received under each program. These parameters are drawn directly from current law and include Federal and state marginal tax rates, the Federal Poverty Level, and eligibility thresholds for each of the benefit programs. These parameters are updated annually to reflect current figures.

Eligibility Calculations. Using the inputs, the Benefit Calculator determines program eligibility and, if necessary, benefit amount for each program. As an illustrative example, the Calculator will determine a family's eligibility for the EITC by comparing the relevant inputs — filing status, family size, earned income — to the parameters listed in the model. If a family is determined to be eligible, the Calculator will then compute the credit amount using the inputs.

Individual Net Income. After calculating the amount a family will receive (or pay) under each tax and transfer program, the Benefit Calculator provides a summary. Included in transfer benefits are healthcare benefits (HUSKY A, HUSKY B, and the exchange premium contribution), SNAP (Food Stamps), TANF cash assistance, Section 8 housing vouchers, Care4Kids childcare subsidies, and WIC nutrition assistance for mothers and young children. Tax benefits (and liabilities), meanwhile, include the federal and state income taxes and EITCs, the federal child tax credit and child and dependent care credit, and the payroll tax. Finally, combining earned income, transfer benefits and tax benefits, the Calculator will compute a family's net income.

Simulated Income Changes. The Benefit Calculator takes this analysis an additional step by computing each tax or benefit program's benefit amount and the family's net income across different incomes ($0 to $100,000 in $1,000 increments). This allows for a simulation of the impact of earned income changes on the family's net income, which the Benefit Calculator displays in three charts. The first is a chart showing the total value of tax and transfer benefits at each income (see Figure 1) — as expected, benefits fall (and become negative) as income rises. The second chart displays the effective marginal tax rate, or the amount of each additional dollar earned that a family will pay in additional taxes or decreased benefits (see figure 2). The third chart maps earned versus net income as two lines; as expected, benefits initially drive net income above earned income; as benefits decline and tax liabilities rise, however, the two lines cross and net income becomes less than earned income (see figure 3).

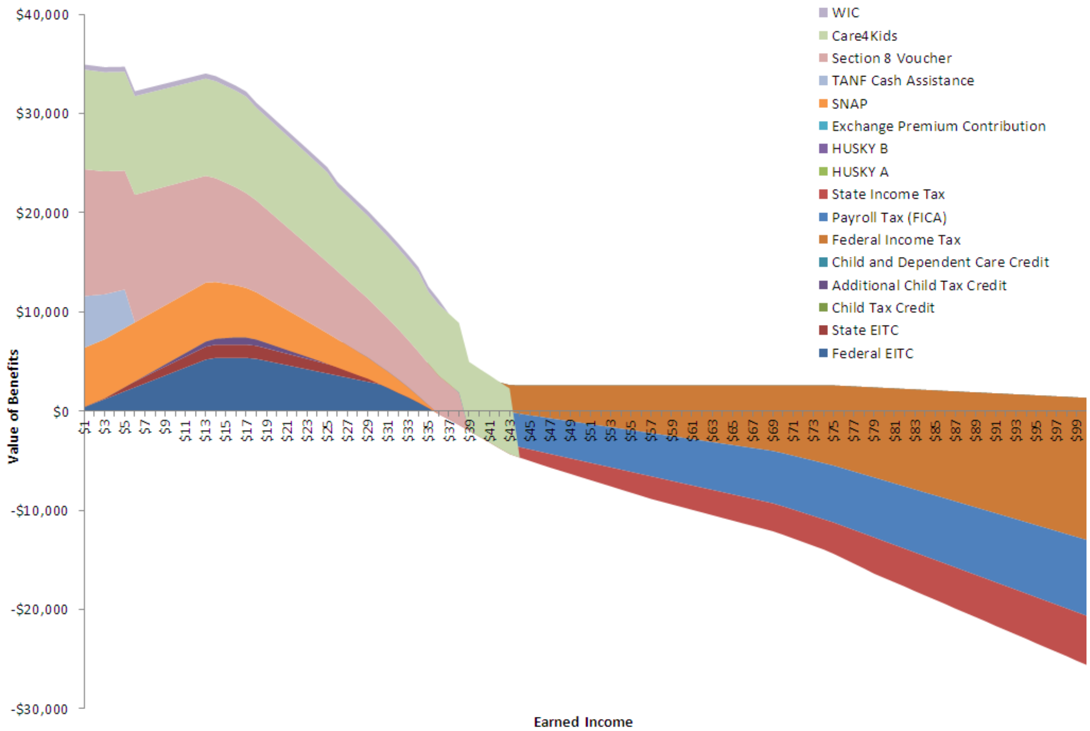

Figure 1. This chart displays the total value of tax and transfer benefits for a given family (filing status, number and age of children, etc.). As expected, benefit value decreases as earned income increases.

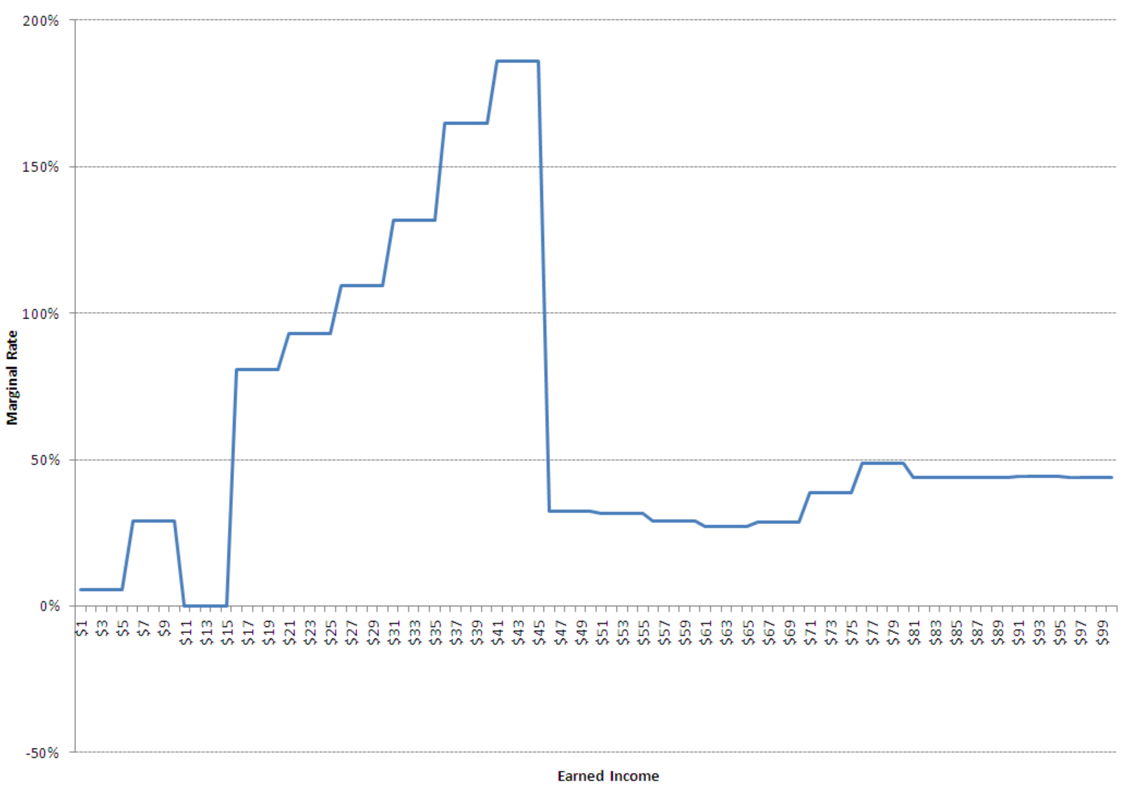

Figure 2. This chart displays the effective marginal tax rate on each additional dollar of earned income for a given family. Due to the particular interaction of tax and transfer benefits, the marginal rate varies widely across incomes.

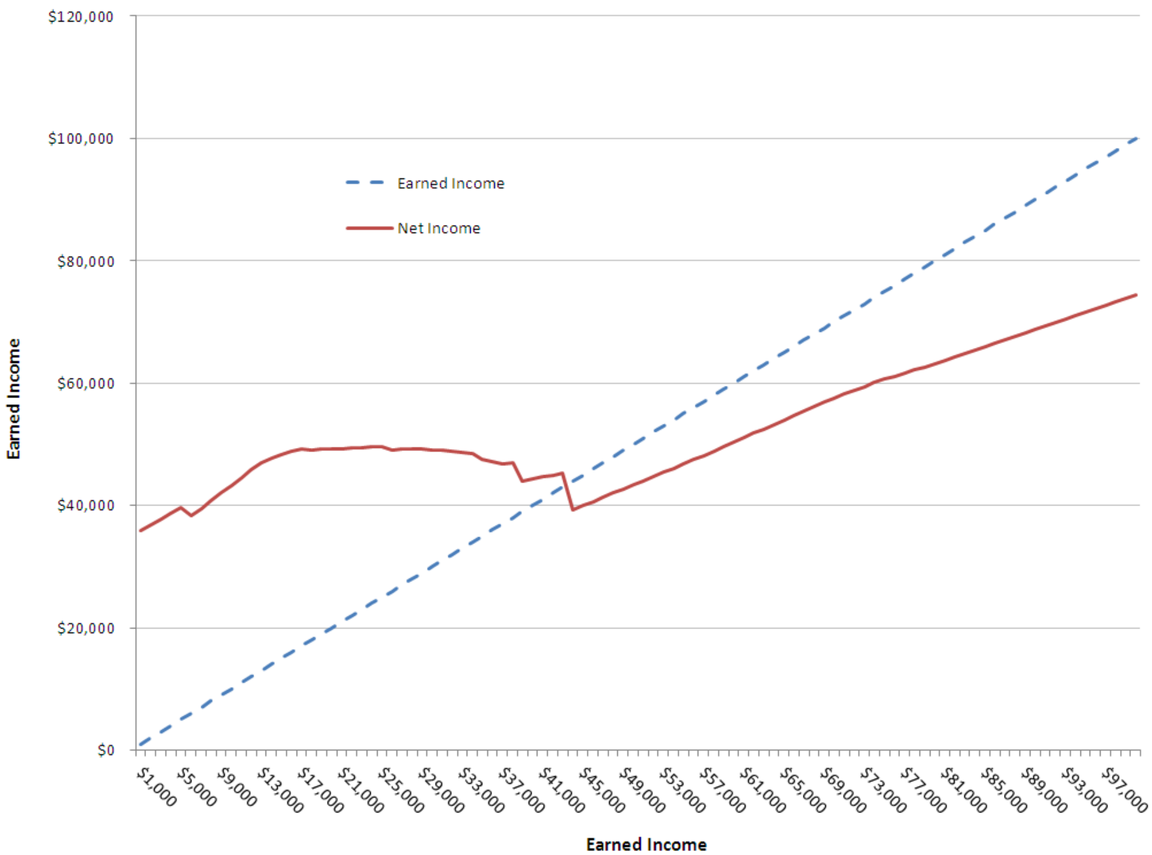

Figure 3. This chart compares a household's earned income (blue dotted line) to its net income (red line). As expected, net income is above earned income at lower income levels, but falls below earned income as income rises.

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[1] Pennsylvania is that state. See Figure 1 for details.
[2] See, National Conference of State Legislatures, "Principles of a High-Quality State Revenue System," http://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx.
[3] The "marginal rates" indicated here include both marginal tax rates in the tax code and implied marginal "tax" rates in the structure of benefit programs—e.g., if you earn $1 more of income, you lose $0.0X in SNAP (Food Stamp) benefits.
[4] See Figure 1.
[5] See, Connecticut Voices for Children, "Children's Budget" online interactive tool, http://www.ctvoices.org/issue-areas/budget-and-tax-fiscal-policy-center/tracking-childrens-budget.
[6] See, Connecticut Department of Revenue Services, "What is the CT EITC?", http://www.ct.gov/drs/cwp/view.asp?a=4165&Q=492164&PM=1.
[7] Great thanks go to Eugene Steuerle and his team at the Urban Institute in assisting Matt Santacroce, Nick Defiesta, and Wade Gibson at Connecticut Voices in building the "Benefit Calculator."
[8] "Take home" income includes both cash benefits such as the EITC (an actual check beneficiaries receive from the state or federal government) and in-kind benefits such as SNAP or Care4Kids, which are only usable for the intended purpose—purchasing food or childcare services. In-kind benefits may not be worth their exact value to beneficiaries—a family that loses Care4Kids subsidies does not have to pay back their cash value and may choose instead to leave their children with friends or family. Nonetheless, the approximation is close and indicates the outlay required in the state or federal budget.
[9] Office of Policy and Management, FY2014-2015 Biennial Budget, http://www.ct.gov/opm/cwp/view.asp?a=2958&Q=518400&.
[10] See, Connecticut Voices for Children, "Children's Budget" online interactive tool, http://www.ctvoices.org/issue-areas/budget-and-tax-fiscal-policy-center/tracking-childrens-budget.