A Balanced Approach to Revenues: Ensuring Fairness and Adequacy

Policy Report
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Our state is facing a projected $4 billion deficit in the Fiscal Year 2020-2021 biennial budget. Governor Lamont has committed to addressing these problems in his first proposed budget through spending cuts, savings, and new and adjusted revenue streams.

As the General Assembly contemplates its proposed biennial budget, Connecticut Voices for Children urges legislators and the Governor to adopt a balanced approach by relying on revenue streams that enhance the fairness of our tax system while providing the necessary funds to sustain us today and to invest for tomorrow. Budget cuts fall most heavily on our children and low income families—those least able to bear them—while our current revenue system asks the least from those who are best able to pay a bit more.

In this paper, Connecticut Voices for Children proposes revenue options that can be used as substitutes for or additions to the revenues in the Governor’s budget, with the twin goals of assuring adequate revenues to support the programs and services vital to the well-being of our children and families and enhancing the fairness of our tax system.

The Need to Rebalance our Revenue System

As a whole, our state tax system is upside down. The wealthy pay a smaller share of their income in state and local taxes than low- and middle-income people do, even though they are best able to pay more. Vertical equity, a measure of how well a tax system distributes tax burden to taxpayers with different abilities to pay, is based on the principle that taxes should be distributed progressively by income. An equitable tax system distributes taxes so that the lowest income taxpayers pay a smaller share of their income than the highest income taxpayers.

According to a recent analysis of all fifty states, the income of Connecticut’s taxpayers is more unequal after state and local taxes are collected than before.¹ Our neighboring states—Massachusetts, New York, New Jersey, and Rhode Island—have more progressive tax systems than Connecticut.
Connecticut’s personal income tax and estate tax are the only two existing state taxes that have a progressive distribution of the tax burden. In order to create a fairer tax system, personal income taxes, capital gains taxes, and estate taxes must be a significant part of the solution.

Below are five specific revenue options that address both adequacy and equity in our tax system by:

- providing adequate revenue to support investments in our state’s economy and offer all families the opportunity to thrive here in Connecticut; and
- increasing fairness in our overall tax system.

1. Increase the top two rates of the personal income tax by one percentage point

Connecticut’s personal income tax is estimated to produce $9.7 billion in revenue in FY 2020, or 45.4 percent of all General Fund Revenue. It is forecast to grow to 46.0 percent in FY 2021. It is one of only two progressive taxes in Connecticut’s current tax system. Even though the personal income tax produces about half of all General Fund revenue, Connecticut’s tax system as a whole remains regressive, with the top 20 percent of taxpayers spending a smaller share of their income on state and local taxes than the lowest 20 percent. Increasing the personal income tax rate on the highest income filers is the only way to achieve a fairer tax system.

Connecticut policymakers have been reticent to raise income tax rates for fear that the wealthy will leave in response. However, recent research strongly suggests that few wealthy households migrate in response to tax increases. Furthermore, our top personal income tax rates are lower than most of our peer states, suggesting that Connecticut can increase its top personal income tax rate and remain competitive with neighboring states.

An increase of one percentage point on the two highest brackets would affect individuals with Adjusted Gross Income (AGI) over $250,000 and couples with AGI over $500,000. It would raise approximately $437 million in revenues. Ninety-four percent of this policy change would be paid by the top one percent of income taxpayers, who all earn above $949,000 per year and on average earn $3.5 million per year. (See Table 1.) This one percentage point tax increase would result in a 0.7 percent tax increase as a share of affected taxpayers’ income.

Table 1: Impact of Personal Income Tax Rate Changes

<table>
<thead>
<tr>
<th>2019 Income Group</th>
<th>Lower 20%</th>
<th>Second 20%</th>
<th>Middle 20%</th>
<th>Fourth 20%</th>
<th>Next 15%</th>
<th>Next 4%</th>
<th>Top 1%</th>
<th>State Tax Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Range</td>
<td>Less Than $25,000</td>
<td>$25,000 - $47,000</td>
<td>$47,000 - $79,000</td>
<td>$79,000 - $136,000</td>
<td>$136,000 - $343,000</td>
<td>$343,000 - $949,000</td>
<td>$949,000 or More</td>
<td></td>
</tr>
<tr>
<td>Average Income in Group</td>
<td>$15,000</td>
<td>$36,000</td>
<td>$64,000</td>
<td>$105,000</td>
<td>$202,000</td>
<td>$522,000</td>
<td>$3,545,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Increase 6.9 Rate to 7.9 and Top 6.99 Rate to 7.99</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Change as a % of Income</td>
</tr>
<tr>
<td>% Facing Tax Increase</td>
</tr>
<tr>
<td>Share of Total Change</td>
</tr>
</tbody>
</table>

+437,145,000

Source: Institute on Taxation and Economic Policy, April 2018
Increasing Connecticut’s top two personal income tax brackets by one percentage point would keep Connecticut’s rates competitive with those of neighboring states.

Table 2: Top Income Tax Rates of Neighboring States

<table>
<thead>
<tr>
<th>State</th>
<th>Single Filers</th>
<th>Married Filing Jointly</th>
<th>Capital Gains/Dividends Tax or Local Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate</td>
<td>Bracket</td>
<td>Rate</td>
</tr>
<tr>
<td>Connecticut</td>
<td>6.90%</td>
<td>$250,000</td>
<td>6.90%</td>
</tr>
<tr>
<td></td>
<td>6.99%</td>
<td>$500,000</td>
<td>6.99%</td>
</tr>
<tr>
<td>New York</td>
<td>6.85%</td>
<td>$215,400</td>
<td>6.85%</td>
</tr>
<tr>
<td></td>
<td>8.82%</td>
<td>$1,077,550</td>
<td>8.82%</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>5.10%</td>
<td>no brackets</td>
<td>5.10%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>8.97%</td>
<td>$500,000</td>
<td>6.37%</td>
</tr>
<tr>
<td></td>
<td>8.97%</td>
<td>$500,000</td>
<td>8.97%</td>
</tr>
</tbody>
</table>

Source: Connecticut Voices for Children

Targeted tax increases on the highest income taxpayers most able to afford the cost will not slow economic growth or cause out-migration of high-income taxpayers.

Opponents of raising income taxes often argue that higher rates will cause high-income taxpayers to flee to lower-tax states, weakening the state’s economy and undercutting revenues. But mainstream research does not support these claims. Empirical studies conducted by economists over the last 40 years find no consensus that raising state income taxes dampens economic growth or causes high-income households to move to another state.3

Studies since 2000 that examined the effect of state personal income tax levels on broad measures of state economic growth found little to no significant effect.4 A comprehensive literature review in 2018 looked at 36 studies of the impact of increases to state personal income rates on the highest income households and broad measures of economic growth.1 Regarding state tax policies overall, they concluded:

The overall state and local tax burden is not a major driver of economic growth differences across states. The vast majority of the academic studies that examined the relationship between state and local taxes and economic growth found little or no effect. Where [statistically] significant effects were found, they generally were modest at most.
As for state personal income taxes in particular, the researchers found evidence suggesting that “states recently reducing their personal income taxes more likely harmed economic growth and states increasing their personal income taxes more likely spurred their economic growth.”

A landmark analysis in 2016 by researchers from Stanford University and the U.S. Treasury Department reviewed tax returns for all million-dollar earners nationwide over 13 years and found that millionaires rarely move from one state to another, and when they do, it is usually not because of taxes. Of the roughly 500,000 households that report income of $1 million or more, only about 12,000, or 2.4 percent, move to a new state in any given year, compared to 2.9 percent among the general population.

A targeted tax increase on the highest income taxpayers most able to afford the cost would generate substantial revenues for investments in people and communities that provide economic and social benefits over the long term.

Modest increases on the relatively small group of taxpayers at the top of the income distribution—those who can most easily afford to pay more—can generate significant revenues that would allow lawmakers to minimize harmful cuts to essential services and programs when budgets are tight. Further, these revenues will enable the legislature to invest in initiatives such as expanding early childhood care and education, economic development, and strengthening the budget reserve fund in preparation for the next recession.

Some examples of other states that have increased their top income tax bracket and invested in expanding opportunities for all its children and families include:

- **Minnesota**
  - Minnesota created a new 9.85 percent bracket for top earners, two percentage points above its prior top rate, which applied to incomes over about $250,000 for married couples and $150,000 for single filers (adjusted annually for inflation). The new revenue-raisers prevented more than $600 million in cuts over two years and enabled the state to make a number of promising investments in education in particular. These included making free full-day kindergarten possible in all public school districts, helping more low-income children afford preschool, bolstering financial aid for low- and middle-income college students, and helping stabilize tuition after years of higher education cuts.

- **California**
  - In California, just 0.3 percent of taxpayers reported more than $1 million in income when the state’s 2005 millionaires’ tax took effect, yet they accounted for more than 21 percent of all income in the state. The first tax, passed in 2004 and still in effect, levies an additional one percent on incomes above $1 million to help local communities fund mental health services such as prevention and early treatment. A rigorous study found that the tax, which raises about $2 billion a year, has helped local governments improve mental health outcomes, minimize unnecessary hospitalizations, and reduce homelessness and incarceration.
  - In 2012, California voters approved Proposition 30, which added new rates of 10.3, 11.3, and 12.3 percent on varying levels of income starting at $250,000, bringing the state’s top rate to 13.3 percent on incomes above $1 million. The state used the resulting revenues to increase investments in K-12 and college access and to rebuild the state’s “rainy day” fund.
A targeted tax increase on the highest income taxpayers most able to afford the cost will help Connecticut advance racial equity.

Targeted income tax hikes for high-income residents will allow state lawmakers to pursue another crucial goal beyond raising revenue and curbing runaway economic inequality: redressing historic and current racial inequities and building a more inclusive economy.

Although policymakers typically think of tax policy as neutral with respect to race, Connecticut’s tax system actually worsens racial and ethnic inequities, because they fall harder on lower-income households, which are disproportionately households of color. And, as stated previously, in Connecticut lower-income households pay a larger share of their income in state and local taxes than high-income households. The poorest fifth of Connecticut households pay an estimated 11.5 percent of their income in state and local taxes, on average, whereas the top one percent of households pay just 8.1 percent.

Increasing the rate on the highest income taxpayers is a sound strategy for making Connecticut’s tax system more equitable, for two reasons. First, the tax falls exclusively on taxpayers at the very top, who are disproportionately White. Racial gaps in wealth are also stark: White families comprise 65 percent of U.S. households but own an estimated 87 percent of the nation’s wealth, whereas people of color make up 35 percent of all households but own just 13 percent of the wealth.

Second, targeted income tax increases provide revenue necessary to improve schools in low-income communities of color, invest in safer water systems and other public infrastructure that support these communities, expand access to affordable health care, and make other crucial investments that reduce racial and ethnic inequities and help build an economy whose benefits are more widely shared.

**Recommendation**

- Increase the top two income tax brackets by one percentage point.

2. *Adopt a Capital Gains and Qualified Dividends Tax on the Top Two Income Tax Brackets of 8.5% and 10.75%*

Taxing capital gains and qualified dividends at a higher rate than other income would represent a return to historical treatment of unearned income in Connecticut. When policymakers enacted Connecticut’s income tax in 1991, they also cut taxes for wealthier taxpayers by eliminating a seven percent tax on capital gains and a 14 percent tax on dividends and interest. Thereafter, investment incomes were subjected to the state income tax at a much lower rate of 4.5 percent. While the top income tax rate has increased to 6.99 percent, it is still below pre-1991 levels on unearned income.

One way Connecticut can build a more broadly shared prosperity is by strengthening our taxes on capital gains—the profits an investor realizes when selling an asset that has grown in value, such as shares of stock, mutual funds, real estate, or artwork. Capital gains go overwhelmingly to the wealthiest households in Connecticut and are a relatively large component of the personal income tax base. Capital gains are generated by wealth. Because wealth is highly concentrated, so is capital gains income. About 80 percent of capital gains goes to the wealthiest five percent of taxpayers; 69 percent goes to the top one percent of
taxpayers. Wealthy households are disproportionately White: White families are three times more likely than families of color to be in the highest one percent of household incomes.

Table 3: Impact of Proposed Capital Gains Rate Changes

<table>
<thead>
<tr>
<th>2019 Income Group</th>
<th>Lowest 20%</th>
<th>Second 20%</th>
<th>Middle 20%</th>
<th>Fourth 20%</th>
<th>Next 15%</th>
<th>Next 4%</th>
<th>Top 1%</th>
<th>State Tax Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Range</td>
<td>$25,000</td>
<td>$47,000</td>
<td>$79,000</td>
<td>$136,000</td>
<td>$343,000</td>
<td>$949,000 Or More</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Income in Group</td>
<td>$15,000</td>
<td>$36,000</td>
<td>$64,000</td>
<td>$105,000</td>
<td>$202,000</td>
<td>$522,000</td>
<td>$3,545,000</td>
<td></td>
</tr>
</tbody>
</table>

Table 4: Impact of Capital Gains Rate Changes

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Income</th>
<th>New Rate on Capital Gains and Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single and married filing separately</td>
<td>$250,000 to $500,000</td>
<td>6.9% to 8.5%</td>
</tr>
<tr>
<td></td>
<td>Over $500,000</td>
<td>6.99% to 10.75%</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$400,000 to $800,000</td>
<td>6.9% to 8.5%</td>
</tr>
<tr>
<td></td>
<td>Over $800,000</td>
<td>6.99% to 10.75%</td>
</tr>
<tr>
<td>Joint Filers</td>
<td>$500,000 to $1,000,000</td>
<td>6.9% to 8.5%</td>
</tr>
<tr>
<td></td>
<td>Over $1,000,000</td>
<td>6.99% to 10.75%</td>
</tr>
</tbody>
</table>

Source: Connecticut Voices for Children

This tax on capital gains and qualified dividend income would apply only to the taxpayers described in Table 4 below.

Adopting this increase to capital gains and qualified dividends could raise $427 million annually. Based on the rates proposed in Table 4, Connecticut would remain competitive with neighboring states.

Table 4: Adopt Capital Gains Tax for Top Two Personal Income Tax Brackets
The federal carried interest loophole provides an added rationale for taxing capital gains and dividends at a higher rate. By increasing the tax on capital gains and dividends at the state level, Connecticut could redress the large preferences these two types of income enjoy in the federal tax code.

Managers of private equity and hedge funds, many of whom are among the highest-income taxpayers in the state, benefit from special tax treatment of a large share of their income at the federal level. Typically, they receive both a management fee, or a percentage of the value of the assets they manage, and a performance fee, which equals a share of their clients’ gains. The latter is called carried interest. The federal tax code taxes carried interest at the lower capital gains rate rather than the higher federal tax rate imposed on ordinary income, even though carried interest is compensation for work the managers perform in managing the investments, not a return on capital of their own that they invested.

By increasing the state tax rate on capital gains and dividends, Connecticut could partially address the loophole that currently exists.

**Recommendation**

- Adopt a state tax on capital gains and dividends on the top two income tax brackets.

3. Broaden the Base of the Sales Tax, Only if Paired with a Progressive Tax

The sales tax has been declining as a share of our state’s tax system. Our sales tax policy has not kept pace with changes in our state’s economy. Spending on services, online purchasing, and the “shared economy” have grown, but have not been subject to the sales tax. Over the past 40 years, the share of household spending on services has increased from one-third to close to half of household budgets. Broadening the sales tax base to include services and eliminate many exemptions on goods will modernize our sales tax policy while raising an estimated $650 million in new revenue annually at the current sales tax rate of 6.35 percent.

Sales taxes are highly regressive in distribution. As shown in Chart 1, the lowest income earners pay a much larger share of their income in sales taxes than the top income taxpayers.

**Chart 1: Sales & Excise Tax**

![Chart 1: Sales & Excise Tax](https://itep.org/whopays/)

Governor Lamont’s proposed sales tax changes are regressive, falling most heavily on the lowest income taxpayers.

Table 5: Impact of Components of Governor Lamont’s Tax Proposal

<table>
<thead>
<tr>
<th>Impact of Components of Governor Lamont’s Tax Proposal</th>
<th>All Connecticut Residents, 2019 income levels</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019 Income Group</td>
<td>Lowest</td>
</tr>
<tr>
<td>Income Range</td>
<td>Less Than $25,000</td>
</tr>
<tr>
<td>Average Income in Group</td>
<td>$15,000</td>
</tr>
<tr>
<td>State Tax Change</td>
<td>State Revenue Impact (including taxes paid by non-residents)</td>
</tr>
<tr>
<td>Tax Change as % of Income</td>
<td>0.5%</td>
</tr>
<tr>
<td>Share of Total In-State Tax Change</td>
<td>7%</td>
</tr>
</tbody>
</table>

Source: Institute on Taxation and Economic Policy, February 2019

Connecticut Voices for Children supports modernizing our sales tax by expanding the sales tax base to include services and eliminating certain exemptions on goods. However, in order to counterbalance the regressive nature of the current tax structure and the proposed changes, the progressivity of the personal income tax and estate tax must be enhanced to prevent our tax system as a whole from becoming more unfair.

The Final Report of Policy Recommendations of the Connecticut Tax Panel suggests broadening the base of the sales tax to include goods and services, taxing remote purchases and digital downloads and ensuring that the shared economy is taxed similarly to the traditional economy. The Panel recognized the regressive nature of sales taxes generally, because the ratio of consumption to income decreases as income increases. But it counseled against trying to address the inequity of the sales tax by legislating changes to its broad base and instead urged:

*What can work, however, is for Connecticut to view vertical equity as a goal for the tax system rather than a goal for each tax, and then use taxes linked directly to households, such as the general income tax, to achieve the vertical equity goals.*

Connecticut is 29th on the Tax Inequality Index, more unequal than Massachusetts, Rhode Island, New York, Maine and New Jersey. California has the most equitable state and local tax system. To support broad-based economic growth and to avoid increasing the existing vertical inequities in Connecticut’s tax system, the sales tax expansion must be paired with an increase to the personal income tax and estate tax.

**Recommendations**

- Expand the base of the sales tax to include goods and services sold at retail, only if paired with a progressive tax that effectively mitigates the regressive impact on the state and local tax system as a whole by:
  - Expanding the personal income tax on the highest two brackets by one percentage point,
Adopting a state tax on capital gains and dividends on the top two income tax brackets, and

Repealing the estate tax cap and decoupling Connecticut’s estate tax from the federal exemptions.

4. Preserve the Estate Tax and Make it More Progressive

The estate tax raises substantial revenue for the State of Connecticut.

Over the past three years, the estate tax has raised an average of $221 million per year. In FY 2013, the revenue from the Estate and Gift Tax was $439 million. Even with the exemption on state estate taxes scheduled to increase next year, the tax is projected to raise $155.8 million. To put these numbers in context, $155.8 million is more than the Governor’s budget proposes for the Care 4 Kids child care subsidy program ($144 million) or the Connecticut State University System ($145 million).

By 2023, the maximum amount of estate value (above the excluded amount of $11.2 million) that will be taxed is $130 million, and this at a time when the number of billionaires in Connecticut is increasing. Thus, without reform, a smaller and smaller number of very large estates are subject to the Connecticut estate tax, less revenue is being realized, and the progressive impact of the estate tax on Connecticut’s overall regressive tax system is being reduced.

The estate tax is progressive, and it should be made more so by decoupling from the federal exemption increases and by removing the state $15 million cap.

Connecticut currently imposes an estate tax on the amount that an estate exceeds $3.6 million, at rates ranging from 7.8 to 12 percent. The $3.6 million exemption is currently scheduled to increase every year until 2023, when it reaches the federal exemption of $11.2 million. At that time, the rate will be a flat 12 percent on the amount of the estate exceeding $11.2 million, with a total cap on estate taxes due of $15 million.

The Department of Revenue Services estimated that the gift and estate taxes fell on less than one percent of Connecticut households in 2011, when the exemption was $2.6 million. The number of estates subject to the estate tax will surely shrink as the exemption level continues to rise along with the federal level to $11.2 million. Connecticut should decouple from the federal estate tax exemption increases.

Connecticut should also remove the $15 million cap on estate taxes owed. By capping the total amount of estate tax that can be due at $15 million, regardless of the size of the estate, Connecticut has determined that no tax is due on the amount of an estate exceeding approximately $146 million, making the tax regressive among the ultra-wealthy.

The estate tax is levied, in large part, on asset appreciation that would otherwise go completely untaxed.

Appreciated assets in an estate receive a stepped-up basis equal to the value of the assets at the time of death. The estate tax captures revenue that would otherwise be imposed through the capital gains tax on the transfer of these appreciated assets. Without an estate or inheritance tax that captures these capital gains, they wholly escape taxation, and a very small number of wealthy families would be able to continue passing along large concentrations of wealth from generation to generation, free from state taxation.
Unrealized capital gains account for a significant proportion of the assets held by large estates, ranging from 25 to 32 percent of the value of estates worth between $3.5 and $10 million and as much as 55 percent of the value of estates worth more than $100 million.\textsuperscript{12}

The estate tax addresses income inequality and the even more extreme wealth inequality.

Inequality in Connecticut has reached record highs. Connecticut is the third most extreme state in terms of income inequality, with one percent of families taking home 27.3 percent of all income.\textsuperscript{13}

Wealth, or net worth, is the sum total of one's assets minus liabilities. According to Inequality.org, a project of the Institute for Policy Studies, in 2018, the three wealthiest Americans held combined fortunes worth more than the total wealth of the poorest half of Americans.\textsuperscript{14} And low levels of wealth are much more prevalent among Black and Latino households than among White households, as shown in Chart 2.

**What is Stepped up Basis?**

Consider a taxpayer who bought 1,000 shares of stock for $10 each ($10,000 investment) and held them until death, when their value had risen to $50 per share ($50,000). Had she sold them prior to her death, she would owe tax on her $40,000 gain, just as someone who earned $40,000 at her job would have to pay tax on that income. This taxpayer, however, did not sell the shares prior to her death, but left them to her daughter, who sold them a number of years later, after their value had risen to $55 per share ($55,000). The daughter would then pay tax on the increased value of the stock, not from a cost basis of $10, but from a cost basis of $50, the value at the time of her mother’s death.

The stepped up basis means that the daughter’s taxable capital gains would reflect the $5-per-share increase ($5,000) that occurred while she owned the stock, not the $45-per-share increase ($45,000) that occurred since her mother bought it. Importantly also, this transfer of untaxed wealth can continue from generation to generation.

**Chart 2: Racial Wealth Inequality Is Rampant in the U.S.**

*Median household wealth by race/ethnicity in the United States (1983-2024)*

Source: Prosperity Now & Institute for Policy Studies, Statista

Eliminating the estate tax would help to perpetuate these racial and ethnic disparities by allowing unlimited, untaxed, inter-generational transfers of wealth.
During the Gilded Age of the late 19th early 20th centuries, when wealth disparities were at an earlier peak, President Theodore Roosevelt became a vocal supporter of progressive taxation:

*We grudge no man a fortune in civil life if it is honorably obtained and well used. It is not even enough that it should have been gained without doing damage to the community. We should permit it to be gained only so long as the gaining represents benefit to the community … The really big fortune, the swollen fortune, by the mere fact of its size, acquires qualities which differentiate it in kind as well as in degree from what is possessed by men of relatively small means. Therefore, I believe in a graduated income tax on big fortunes, and … a graduated inheritance tax on big fortunes, properly safeguarded against evasion, and increasing rapidly in amount with the size of the estate.*

The equalizing trends that followed progressive tax reform have now been largely undone and “the wealthiest Americans now hold as large a wealth share as they did in the 1920s.”

Almost every other state in the Northeast has an estate or inheritance tax.

New York, New Jersey, Pennsylvania, Rhode Island, Massachusetts, Vermont, Maine, and the District of Columbia presently have an estate tax. By 2023, when Connecticut’s estate tax exemption is scheduled to match the federal exemption of $11.2 million, most of these states will have exemption levels that are significantly lower than the exemption level in Connecticut. These states also do not impose a cap on the amount of tax owed, as Connecticut does.

**Recommendations**

- Preserve Connecticut’s estate and gift tax,
- Decouple from the federal increases in exempt estate size, and
- Lift the $15 million cap that benefits only the very wealthiest of the very wealthiest.

5. **Return to the Legislature the Authority to Make Spending Decisions**

Policymakers need the flexibility to meet rapidly changing needs today and build thriving communities tomorrow, in part by raising the revenue needed to support these communities. However, the FY 20-21 biennial budget is handcuffed by the adoption of four new fiscal restrictions—a spending cap, appropriations cap, volatility cap, and bond cap—that diminish this flexibility, greatly limiting Connecticut’s ability to spend revenue it raises. What’s more, control of these counter-productive caps has been ceded by the General Assembly to Wall Street bondholders through a law known as the “Bond Lock.”

The Bond Lock requires the State Treasurer to write a promise into the covenants of all bonds issued “on or after May 15, 2018, and prior to July 1, 2020” that the state will not redefine or alter the four caps above—spending, appropriations, volatility and bond. The Bond Lock, and the budget rules it freezes in place, is in practice an austerity lock, ensuring that Connecticut remains in a permanent state of fiscal deprivation, starving our schools, health systems and infrastructure of crucial investments. The bond lock has now ensured that bondholders, not the legislature, have control over the state’s spending and saving decisions for the next five years, absent exercise of specific procedures to exceed the caps.

The volatility cap requires that all revenues from the Estimates and Finals portion of the personal income tax above a certain threshold be deposited in our Budget Reserve Fund (BRF) and excluded from budget making. Connecticut’s current volatility cap requires revenue transfers to the Budget Reserve Fund (BRF)
even when there are projected deficits, as projected in 2020 and in 2021. (See Table 6.) In these years, the Office of Fiscal Analysis projects deposits of more than $550 million into the BRF, despite projection of almost $4 billion in deficits. Eliminating budgetary access to $550 million in revenues is having real consequences for people’s lives and forcing unnecessary cuts to programs upon which children, families, and communities rely.

Best practices volatility caps are good budget policy, and Connecticut adopted a well-designed plan to capture and save volatile revenues in 2015 (PA 15-244) that was set to go into effect in 2021. Best practices volatility caps encourage responsible budgeting based on reliable revenues rather than one-time influxes, and they encourage saving revenues that can be used later to dig the state out of recessions. But, unlike best practices volatility policies, our current cap forces us to deposit revenues into the BRF even when we are facing deficits. It is also is capturing normal growth in a part of our personal income tax stream, not volatility. (See Chart 3.)

**Table 6: Budget Reserve Fund Projections (in Millions)**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Beginning Balance</th>
<th>Volatility Cap Transfer</th>
<th>Revenue Cap Transfer</th>
<th>Surplus</th>
<th>Ending Balance</th>
<th>% of Net Appropriations</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>$1,185.3</td>
<td>$648.0</td>
<td></td>
<td>$135.1</td>
<td>$1,968.4</td>
<td>10.2%</td>
</tr>
<tr>
<td>2020</td>
<td>1,968.4</td>
<td>280.2</td>
<td>96.8</td>
<td>8.9</td>
<td>2,354.3</td>
<td>11.8%</td>
</tr>
<tr>
<td>2021</td>
<td>2,354.3</td>
<td>269.1</td>
<td>150.3</td>
<td>20.2</td>
<td>2,793.8</td>
<td>13.6%</td>
</tr>
<tr>
<td>TOTALS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1,197.3</td>
<td></td>
</tr>
</tbody>
</table>

(1) Anticipated FY 2019 surplus after $381.0 million transfer to Teachers’ Retirement System Special Capital Reserve.


The volatility policy that the current volatility cap replaced was developed in conjunction with academics and policy experts, and is explained in detail in a report that can be found here: [https://www.osc.ct.gov/brf](https://www.osc.ct.gov/brf)
Further hampering our budget sustainability, the appropriations cap (sometimes referred to as the revenue cap) requires that the legislature only appropriate a certain proportion of revenue to allow for unanticipated needs. In FY 2020, legislators can only appropriate 99.5 percent of revenue, and this amount declines gradually to 98 percent starting in FY 2026 (PA 17-2, Sec. 705). This budget rule is eliminating over $247 million from the FY 20-21 budget appropriations process and lowering the spending cap each year going forward. (See Table 6.) The appropriations cap can be exceeded for the purposes of an adjusted appropriation and revenue plan by simple majority vote, which would result in an additional $247 million for the General Fund in the next biennial budget.

Although the legislature may wish to change one or more of the budget rules adopted in 2017 and 2018, the existing covenant in bonds issued by the state since June of 2018 forbids any changes for at least five years. Connecticut is the first and only state to ever embed its spending and budget rules into bond covenants, and there are many philosophical and constitutional questions to be debated. But the immediate impact that the specific budget rules, now frozen in promises to Wall Street, are having on Connecticut’s ability to fashion a responsible budget is undeniable and crushing to our state’s future.

After repealing the Bond Lock, we encourage the legislature to return to the original, research-based volatility policy so that we can save in a way that is responsible and not unduly burdensome to children and families who rely on programs and services that would be cut under the current policy.

**Recommendations**

- Repeal the Bond Lock,
- Use legal strategies to free the state from the covenants in bonds that have already been sold,
- Reinstitute the volatility cap to reflect the best practices volatility policy enacted in 2015 (PA 15-244), and
- Adjust the appropriation and revenue plan to capture the $247 million currently being swept by the revenue/appropriations cap.


5 https://www.cbpp.org/research/state-budget-and-tax/raising-state-income-tax-rates-at-the-top-a-sensible-way-to-fund-


7 Of special note, the wealthiest 10 percent of White households own 65 percent of the nation’s wealth, whereas the remaining 90 percent of White families own just 22 percent. Leachman et al.

8 While Voices’ proposal only covers capital gains and qualified dividends, ordinary dividends and taxable interest could also be included.


11 ITEP Tax Inequality Index, https://itep.org/whopays/


14 http://inequality.org/facts/wealth-inequality/

15 http://www.wbur.org/onpoint/2010/12/15/teddy-estate

16 http://inequality.org/facts/wealth-inequality/


18 As long as the Bond Lock stays in effect, each cap can only be exceeded for one year at a time. To exceed the spending cap or bond cap, the governor must declare an emergency or extraordinary circumstances and at least three-fifths of both houses must vote to do so. This also works to exceed the appropriations cap, or the appropriations cap can be exceeded for the purposes of an adjusted appropriation and revenue plan by simple majority vote. The volatility cap can be exceeded with three-fifths vote of both houses – the governor does not need to declare extraordinary circumstances. http://www.ctvoices.org/sites/default/files/b19CTBudgetRules.pdf