STEPS TO A FAIRER TAX SYSTEM:
PROPOSALS FOR TAX REFORM,
TRANSPARENCY, AND TIMELY SUPPORT
EXECUTIVE SUMMARY

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Last year in Connecticut, half of the state’s families had difficulty paying their usual expenses (e.g., food, housing, utilities). The percentage of families struggling was even higher for certain subgroups, especially working-class and lower-middle-class families (77 percent and 55 percent), Black and Latino families (65 percent and 70 percent), and families with children (62 percent).

Although Connecticut has the second highest level of per capita personal income in the U.S., making it exceptionally wealthy overall, many families consistently struggle because Connecticut also has the second highest level of income inequality and a substantial racial income gap, meaning a small, disproportionately white portion of the population primarily benefits from the state’s overall wealth. Specifically, in the immediate term, income inequality and the racial income gap make it difficult for working- and middle-class families, especially families of color, to make ends meet; and over time, through both the “investment” and “stress” pathways, income inequality and the racial income gap negatively impact the children from working- and middle-class families, especially families of color, in “virtually every dimension, from physical and mental health, to educational attainment and labor market success, to risky behaviors and delinquency.” These problems in turn weaken Connecticut’s economy and thereby decrease its ability to pay down long-term obligations and make critical investments, which is especially important due the state’s below-average level of economic growth and above-average level of long-term obligations.

At least three features of Connecticut’s approach to taxation contribute to the above problems. First, establishing a fairer tax system through tax reform involves shifting the current disproportionate tax burden on working- and middle-class families to the wealthy so that the tax system either has no impact on income inequality and the racial income gap or reduces both. However, rather than adopt that approach, Connecticut’s fiscal year 2022–23 budget maintains an unfair tax system, meaning it continues to exacerbate income inequality and the racial income gap. For example, although a majority of working- and middle-class families struggled to pay their usual expenses last year due in part to their higher effective state and local tax rate compared to the wealthy, the new budget failed to incorporate a state child tax credit that would have reduced those families’ tax burden by up to $600 per child. Also troubling, the budget included a mix of extended and built-in tax increases on working- and middle-class families notwithstanding the general belief that the budget did not include a “broad-based tax increase.”

Extended tax increases on working- and middle-class families. An extended tax increase is simply a tax increase (or tax credit reduction) that would have expired had policymakers not extended it. For example, when applying the state’s official assessment of who ultimately pays each tax (i.e., the tax incidence report), three policies in the new budget—renewing the corporation business surtax, delaying the phase out of the capital base tax, and renewing the limit on the property tax credit—operate together as a $75 million tax increase on working- and middle-class families in FY 2022. This more than offsets the small tax cuts included in the budget as well as the expansion of the Connecticut earned income tax credit, which was an important but insufficient step.

Built-in tax increase on working- and middle-class families. A built-in tax increase is a tax increase that occurs automatically due to the design of the tax system, and it generally works in
conjunction with inflation, which is an increase in the price of goods and services that decreases the purchasing power of money. Based on one leading measure, prices were 6.8 percent higher in 2021 compared to a year earlier, making it the largest 12-month increase since 1982, or nearly a decade before the creation of Connecticut’s broad-based income tax in 1991. This high level of inflation harms working- and middle-class families in one of two ways. Either it decreases the purchasing power of their income, or if their income increases to keep up with inflation, that nominal increase in income increases their income tax burden because Connecticut’s income tax is not indexed to inflation. The cumulative impact of this built-in, or hidden, annual tax increase is substantial. For example, the average middle-class family in Connecticut currently pays about $4,200 a year in the state income tax, but that family would pay only about $1,800—or $2,400 less—if policymakers had initially inflation indexed the income tax in 1991.

The second problematic feature of Connecticut’s approach to taxation is insufficient tax transparency, which, at minimum, requires knowing the necessary amount of the disproportionate tax burden to shift, the impact of proposed and passed tax legislation, and the size of the tax gap. Consider below the impact of all three components on the budget-making process during the past legislative session.

Outdated estimate of the current tax incidence. Before developing tax proposals for the FY 2022–23 budget, policymakers in Connecticut relied upon an increasingly out of date tax incidence report, meaning, even if they desired to establish a fair tax system, they did not know the precise amount of the current disproportionate tax burden on working- and middle-class families to shift to the wealthy.

No estimate of the tax incidence for proposed and passed legislation. Before voting on tax proposals, the Office of Fiscal Analysis provided policymakers a fiscal note that included a revenue estimate but no tax incidence estimate, meaning there was no assessment of whether the proposals would make the tax system less fair by increasing the burden on working- and middle-class families or more fair by decreasing their burden. There was also no tax incidence estimate once the budget passed. This lack of tax transparency together with the complexity of the tax system reinforced the general belief that the budget was balanced without a “broad-based tax increase” even though, as noted, the budget actually included a mix of extended and built-in tax increases on working- and middle-class families.

No estimate of the current tax gap. The primary opposition to tax reform is not cutting taxes for working- and middle-class families but rather raising taxes on the wealthy to offset the former. One solution is to fund tax reform by decreasing Connecticut’s income tax gap, which is the difference between the income tax owed to the government and the income tax actually paid. According to the Internal Revenue Service, the federal income tax gap is due in large part to both the underreporting of “opaque income sources that accrue disproportionately to higher earners” and the IRS’s limited, decreasing resources for ensuring tax compliance. Unlike the federal government and some states, Connecticut does not provide an estimate of its own income tax gap. However, if we apply the IRS’s current estimate of the federal tax gap to Connecticut—a reasonable starting point given the state’s above-average reliance on “opaque income sources that accrue disproportionately to higher earners” and the substantial reduction in the Department of Revenue Services’s staff over the last two decades—the estimated total
The tax gap in Connecticut is $3.1 billion and the estimated income tax gap component is $2.6 billion. Reducing Connecticut’s income tax gap is therefore potentially sufficient to fully fund the reforms necessary to make the tax system fairer, but developing and implementing such a program requires knowing the size of the income tax gap and the state’s capacity to reduce it.

The third problematic feature of Connecticut’s approach to taxation is the lack of timely support, which involves providing working- and middle-class families the option of receiving refundable tax credits in installments. Currently, eligible families receive the Connecticut earned income tax credit (CT EITC) in a single payment after filing their tax return. For example, the average working-class family with two children receives about $1,800 from the CT EITC and would receive a total of about $2,700 if Connecticut passed the state child tax credit (CT CTC) included in the Finance, Revenue, and Bonding Committee’s revenue package last year. This is a substantial level of financial support—equivalent to nearly 12 percent of the above family’s pre-tax income—and the objective is to offset the state’s highly regressive taxes, such as the sales tax, which is paid throughout the year when purchasing goods and services, and the property tax, which homeowners pay directly and renters pay indirectly throughout the year. The effectiveness of the state’s financial support, however, is diminished if a family pays a substantial amount in bank overdraft fees or relies upon high-interest loans to make ends meet while waiting for an annual tax refund. This is not an insignificant concern. As noted, the majority of working- and lower-middle-class families in Connecticut struggled to pay their usual expenses last year. This occurred even as the majority of working- and middle-class families in Connecticut that received monthly federal Advance CTC payments—the federal government’s adoption of timely support in 2021—mostly spent those payments on usual expenses. These simultaneous developments demonstrate that timely support in general is helpful and that timely support at the federal level is not a sufficient substitute for timely support at the state level.

Altogether, the problems reviewed here show that making Connecticut’s tax system fairer requires tax reform, transparency, and timely support, and that, in simple terms, a fairer tax system would put more money in the pockets of working- and middle-class families, especially families of color. More specifically, in the immediate term, a fairer tax system would reduce income inequality and the racial income gap, which would help working- and middle-class families, especially families of color, make ends meet; over time, it would benefit the children from working- and middle-class families, especially families of color, in “virtually every dimension” of life through both the “investment” and “stress” pathways; and those developments in turn would strengthen Connecticut’s economy, thereby increasing the state’s ability to pay down long-term obligations and make critical investments.

To explain the above process, this report proceeds in five sections. The first section provides an overview of income inequality and its negative impact. The second section provides an overview of Connecticut’s unfair tax system and proposals to reform it. The third section provides an overview of Connecticut’s tax transparency problem and proposals to increase tax transparency. The fourth section provides an overview of Connecticut’s tax credit payment problem and proposals for timely support. The fifth section provides a recommended program of tax reform, transparency, and timely support.
Recommended Tax Reform Program

To reduce the unfair tax burden on working- and middle-class families:

- Inflation index the key components of the income tax (exemption, brackets, and personal credit)
- Establish the Connecticut child tax credit (CT CTC) and inflation index it

To offset the reduction in the unfair tax burden on working- and middle-class families:

- Increase the income tax rate on single filers making more than $500,000 and married filers making more than $1 million, and add a new top tax rate that would only apply to even wealthier families, all of which would raise revenue immediately if necessary
- Provide additional funding for the DRS to decrease the state’s income tax gap, which would raise revenue over time and could supplement or replace revenue from increasing the top income tax rate if the latter is necessary for tax reform
- Require the DRS to focus its increased tax compliance oversight on the wealthy, which is the group that likely benefits the most from the income tax gap

Recommended Tax Transparency Program

To increase tax transparency, which is essential to reducing the unfair tax burden on working- and middle-class families:

- Require the DRS to either (1) confirm that it has sufficient capacity to provide comprehensive tax incidence and tax gap reports on a regular basis or (2) release a report before the start of the next legislative session detailing the additional capacity that is necessary. Once the tax analysis capacity issue is addressed, require the DRS to provide comprehensive tax incidence and tax gap reports on a regular basis.
- Require the OFA to either (1) confirm that it has sufficient capacity in-house or with the support of the DRS to provide a combination of simple and detailed tax incidence estimates of proposed and passed legislation or (2) release a report before the start of the next legislative session detailing the additional capacity that is necessary. Once the tax analysis capacity issue is addressed, require the OFA to provide simple tax incidence estimates in all fiscal notes and detailed tax incidence estimates for three key pieces of legislation—the governor’s proposed tax program, the General Assembly’s proposed tax program, and the tax program ultimately passed into law.

Recommended Timely Support Program

To provide timely support that will help working- and middle-class families make ends meet:

- Require the DRS to either (1) confirm that it has sufficient capacity to setup and administer a timely support program or (2) release a report before the start of the next legislative session detailing the additional capacity that is necessary. Once the tax administration capacity issue is addressed, require the DRS to setup and administer for both the existing CT EITC and, if established, the proposed CT CTC a timely support program that ensures extensive access, provides a range of timely support options, and limits the use of reconciliation.
- Require the DRS to release detailed data each year so that policymakers can improve the design of timely support moving forward if necessary