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# THE #1 POLICY OPTION FOR IMPROVING CONNECTICUT'S FISCAL BUDGET

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# The Case for Improving Connecticut's Budget

## An Overview of Connecticut's Pre-Tax Income Inequality and Racial and Ethnic Income Gaps

Pre-tax income inequality decreased in Connecticut last year, but the state still has the third highest level during a period of historic income inequality in the U.S. as a whole.

Pre-tax racial and ethnic income gaps decreased in Connecticut last year, but the state still has substantial gaps that tend to result in higher levels of income inequality for families of color.

Pre-tax income inequality contributes to poverty, especially for families of color due to the addition of substantial racial and ethnic income gaps, and poverty negatively impacts children in “virtually every dimension” of life.

## An Overview of Connecticut's Unfair Tax System

Connecticut's tax system is unfair because it disproportionately burdens low- and middle-income families, which increases post-tax income inequality and offsets in part the recent, important reduction in pre-tax income inequality.

Connecticut's unfair tax system especially increases post-tax income inequality for families of color, which offsets in part both the recent, important reduction in pre-tax income inequality and the recent, important reduction in pre-tax racial and ethnic income gaps.

Connecticut has a low overall tax burden compared to most states and the U.S. as a whole, further supporting the case that the primary problem with Connecticut's tax system is not the overall burden but rather the unfair distribution that increases income inequality and racial and ethnic income gaps.

## An Overview of Connecticut's Unfair Spending System

Compared to most states and the U.S. as a whole, Connecticut has a high level of long-term obligations.

Connecticut's spending system is unfair because the high level of spending required to service long-term obligations past generations insufficiently funded limits spending on public services and investments that support the current generation of low- and middle-income families.

Connecticut should certainly make the required full pension debt payments each year, but *additional* payments increase the unfairness of Connecticut's budget and are not necessary to fully fund the state's two major pension systems on a set schedule.

# Policy Options for Improving Connecticut's Budget

## Reforming Connecticut's Tax Revenue Restrictions

Connecticut used restricted revenue in fiscal years 2020 through 2022 to pay down \$5.8 billion in additional pension debt and is projected make an additional payment of about \$2.8 billion in fiscal year 2023, which decreases the amount of the required annual pension debt payments in the budget moving forward but also increases the unfairness of Connecticut's budget and is not necessary to fully fund the state's pension systems on a set schedule.

In addition to the estimated \$490 million to \$735 million in newly available revenue moving forward due to past and projected additional pension debt payments, Connecticut could generate an average of \$1.5 billion a year in unrestricted revenue in the upcoming budget by reforming two major tax revenue restrictions.

## Eliminating or Reducing Connecticut's Tax Gap

Compared to the U.S. as a whole, Connecticut has a greater share of "opaque income sources that accrue disproportionately to higher earners" and that are underreported at a high rate, which is one of two key causes of the tax gap.

Similar to the IRS, the Connecticut Department of Revenue Services (DRS) has insufficient auditing capacity, which is the other key cause of the tax gap.

Connecticut could potentially generate up to \$2.6 billion a year in revenue, primarily from high-income and wealthy tax filers, by providing additional funding for the DRS to increase its tax compliance capacity and thereby eliminate or reduce the state's income tax gap.

A "tax incidence" analysis differs from a "tax gap" analysis, and both are essential for creating a fairer tax system.

## Eliminating or Reducing Connecticut's High Cost, High Growth Tax Expenditures

Connecticut could generate up to nearly \$770 million a year in revenue by eliminating or reducing six of the state's high cost, high growth tax expenditure programs.

Even according to the state's own broader economic impact analysis, Connecticut loses an average of nearly \$80 million a year from its film production tax expenditure program, which more than offsets the average total gain from the other major business assistance tax credit programs.

## **Increasing Connecticut's Taxes on the Wealthy**

### Connecticut's Migration by Income Level

Connecticut recently lost low- and middle-income tax filers to net migration and gained high-income tax filers.

### Increasing Connecticut's Top Income Tax Rates on All Taxable Income and/or Investment Income

Based on a cross-state comparison of the top income tax rate and income base, it would be reasonable for Connecticut to increase its top rate on all taxable income.

Based on a historical comparison of Connecticut's top income tax rate and income base by type of income, it would be reasonable for Connecticut to increase its top tax rate on investment income.

### Increasing Connecticut's Estate and Gift Tax

Based on a historical and cross-state comparison of Connecticut's estate and gift tax rate, income base, and maximum lifetime tax, it would be reasonable for Connecticut to increase the estate and gift tax.

### Establishing a Statewide Property Tax on High Value Homes

Based on a within-state comparison of Connecticut's towns with the highest and lowest mill rates, it would be reasonable for Connecticut to establish a statewide property tax on high value homes.

## **Summary of Policy Options for Improving Connecticut's Budget**

To generate revenue, policymakers could pass legislation that incorporates one, some, or all of the proposed broad approaches: reforming Connecticut's tax revenue restrictions, eliminating or reducing Connecticut's tax gap, eliminating or reducing Connecticut's high cost, high growth tax expenditures, and increasing Connecticut taxes on the wealthy.

To create a fairer tax system, policymakers could use a portion of the newly generated revenue to fund major tax reforms, such as adding a cost of living adjustment to Connecticut's income tax, creating the Connecticut child tax credit (CT CTC), increasing and expanding the Connecticut earned income tax credit (CT EITC), and improving the Connecticut property tax credit (CT PTC).

To create a fairer spending system, policymakers could use a portion of the newly generated revenue to fund major spending reforms, such as increasing funding for early child and education, increasing funding for public sector jobs, and ensuring funding for CT Baby Bonds.