Connecticut Governor Malloy Proposes Multifaceted Tax Plan

By Kailee Tkacz and Mark Robyn

Facing a $3.2 billion deficit, newly elected Connecticut Governor Dannel Malloy (D) recently proposed a FY 2012 budget that would increase taxes by $1.5 billion, cut spending by $758 million and reduce public employee costs by $1 billion. The budget proposes many tax changes, including a fairly broad income tax increase, an increase in the general sales tax rate from 6% to 6.25%, an expansion of the sales tax to some currently exempt items, and increased excise taxes.

The tax increases would raise about $425 per person in Connecticut. In this study we examine many of the proposed tax changes and find that some are advancements toward sound tax policy while others are steps in the wrong direction.

Individual Income Tax
The most substantial proposal in the governor’s budget is the income tax increase. As shown in Table 1, the current income tax rates are flat for earners between $10,000 and $500,000 in taxable income, with a higher 6.5% rate for those earning over $500,000, which was enacted in 2009.

Table 1: Present Income Tax Rates, Single Filers

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<th>Rate</th>
<th>Bracket</th>
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<tbody>
<tr>
<td>3.0%</td>
<td>&gt;$0</td>
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<tr>
<td>5.0%</td>
<td>&gt;$10,000</td>
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<tr>
<td>6.5%</td>
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A shown in Table 2, the governor’s FY 2012 budget proposal would add five new tax brackets to the current three and increase marginal tax rates for anyone with taxable income over $50,000 ($100,000 for couples). The income tax increases, totaling $495 million in fiscal 2012, would be retroactive to January 1, 2011, even if the budget is not approved by the legislature until June or July. Transparency and stability are key principles for good tax policy, and retroactive tax increases violate these principles. Taxpayers should know the tax rates on their income when it is earned and not have to face higher rates after the fact.

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It is worth noting that the income tax increase is targeted at more than very high-income earners. In an era of millionaire's taxes, such a broad income tax increase acknowledges that the state budget should not, and probably cannot, be balanced solely on the backs of very high-income taxpayers. In Malloy's budget, everyone with income over $50,000 will see an increased tax bill.

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<tr>
<th>Rate</th>
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<tbody>
<tr>
<td>5.0%</td>
<td>&gt;$0</td>
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<tr>
<td>5.0%</td>
<td>&gt;$10,000</td>
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<tr>
<td>5.5%</td>
<td>&gt;$50,000</td>
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<td>5.75%</td>
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<td>6.0%</td>
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<td>6.25%</td>
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<td>6.5%</td>
<td>&gt;$400,000</td>
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<td>6.7%</td>
<td>&gt;$500,000</td>
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Table 2: Malloy's Proposed Income Tax Rates, Single Filers

Since income tax rates only apply to income in excess of the associated income tax bracket level, even high-income Connecticut residents have their first $10,000 taxed at 3 percent. However, the governor's budget includes a proposal to recapture the benefit of the 3 percent rate, beginning at an income level of $56,600 for individuals and $100,500 for couples. This proposal would essentially retroactively tax the first $10,000 of a taxpayer's income at the higher 5 percent rate once the taxpayer's income reaches the $56,600 threshold. It is another way of increasing the income tax rate for people in the phase-out range without increasing the statutory rate, and it would raise $126 million in 2012.

It should be noted that because the income tax changes would be retroactive to January 1, 2011, 18 months’ worth of revenue would be collected in FY 2012, resulting in lower revenue estimates for 2013 than for 2012. The governor's budget would also add a state-level Earned Income Tax Credit for low-income individuals and families, which would cost the state $108 million, and eliminate the $500 property tax credit, which would increase revenue by $365 million.

Sales Tax
Governor Malloy's budget would increase sales taxes by both raising the tax rate and broadening the base of taxable transactions. Most substantially, his budget increases the state general sales tax rate from 6% to 6.25% and adds an additional 0.1% sales tax for cities and towns. The rate increase would raise $152 million in FY 2012.

**Broadening the Sales Tax Base**

The governor's budget also broadens the sales tax to include some transactions that are currently not taxed, most notably clothing and shoes. Currently, clothing and shoes under $50 are exempt from the retail sales tax. The elimination of this exemption is expected to generate $137.5 million in FY 2012.

Governor Malloy's proposal would further broaden the tax base to include some currently untaxed services and goods such as:

- Car washes (raising $4 million in FY 2012)
- Pet grooming services ($1.9 million)
- Limousine services (4.5 million)
- Haircuts ($12 million)
- Manicure and pedicure services ($4.9 million)
- Non-prescription drugs ($18 million)
- Boat docking, storage, cleaning, repair, and tow services ($7 million)
- Hazardous waste removal ($4 million)
- Cosmetic surgery services ($5 million)
• Airport valet parking services ($1 million)
• Packing and crating ($1.1 million)
• Automotive storage ($0.2 million)
• Automotive road and towing services ($0.6 million)
• Yoga services ($0.2 million)
• Cloth and fabric for non-commercial sewing ($0.5 million).

Adding taxes to these and other services and goods would generate about $73 million in 2012. In most states, services are either not taxed at all or taxed only in a piecemeal, inconsistent manner. Under a neutral retail sales tax, all consumer goods and services would be taxed and subject to the same rate. Though the governor’s proposal aims to broaden the sales tax base, it does so in a haphazard and inconsistent way, affecting only some services and goods while retaining exemptions for others, ranging from legal services to horse boarding and training. The result is an inconsistent tax code that arbitrarily discriminates between different goods and services. In addition, while broadening the sales tax base would ideally allow lawmakers to lower the overall sales tax rate, Governor Malloy’s proposal increases the rate. Further broadening the sales tax base to include more services would make more economic sense than raising the rate.

**Coupons**

Another interesting sales tax proposal included in the budget relates to the tax treatment of coupons. Currently, Connecticut sales tax is calculated after retailers’ coupons are applied to the sale price. The governor proposes to eliminate this exemption and calculate the tax due before the application of coupons. Since a retailer’s coupon is really just a price reduction, this proposal is hard to justify on economic grounds. Imposing sales tax on retailer coupons would raise $45 million.

**Vehicle Trade-Ins**

Currently, sales tax on the purchase of a new vehicle is charged on the price paid by the consumer after any reduction given in exchange for a trade-in. Another $40 million would be raised by eliminating this trade-in exemption and calculating the tax due based on the pre-trade-in price.

**Luxury Goods**

The governor’s budget proposal would also impose an additional 3% tax on luxury goods, raising a little over $1 million in 2012. Luxury goods taxes may be easy targets politically, but that does not make them good tax policy. A 10% federal luxury excise tax imposed in 1990 devastated the yacht industry and its employees. Because yacht sales fell sharply after imposition of the tax, revenues were far below projections. Ultimately, Congress responded by repealing the tax. The lesson of the yacht luxury tax is instructive: narrow-based taxes are more likely to have distortionary effects than broad-based ones. They are a poor way of promoting progressivity, they increase complexity, and they generate minimal amounts of revenue.

**Eliminating Sales Tax Holidays**

The governor’s budget would eliminate Connecticut’s sales tax holiday, a smart move that would increase revenues by $4.2 million in FY 2012. Tax holidays are mostly political gimmicks that narrow the sales tax base, add compliance costs, distort consumer choice, and shift purchases in time rather than generate new economic activity.²

**Excise Taxes**

Connecticut has the fourth-highest state cigarette excise tax in the country, at $3.00 per pack. Governor Malloy is proposing a 40 cent tax increase for each pack of cigarettes, which would make Connecticut’s cigarette tax the third-highest in the nation. Snuff and other tobacco products will see tax increases as well, and combined with the cigarette tax increase, would raise $57 million. Likewise, existing taxes on beer, wine,

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and liquor sales will all increase 20%, raising $10 million, and the budget proposes increasing hotel taxes from 12% to 14%, raising $12 million.

Cigarette tax rates have been increasing steadily over the years but they often yield less revenue than initially expected, partly because they fuel rising rates of smuggling and organized crime in states with high tax rates.\(^3\) Increasing excise taxes on specific goods such as tobacco and alcohol is defensible only to the extent that consumption of these goods imposes costs on society (through higher health care costs or polluted air, for example). But rarely do policymakers justify tax increases in such a matter; in reality, excise tax increases are used largely as a convenient source of revenue. Targeting politically unpopular minorities to balance the state budget increases volatility and raises equity concerns. If more revenue is needed to fund general government services, the burden of those taxes should be shared by all.

*Transportation Fund Tax Increases*

If the governor’s budget passes, gasoline, oil, and diesel products will be subject to higher taxes, raising $52 million. Connecticut has the fourth-highest gasoline tax at 45.2 cents per gallon, and the budget proposal would increase the gas tax by three cents. Higher fees for motor vehicle licensing, registration and inspection are also suggested in the budget, and are projected to raise over $20 million.

Such tax and fee increases make sense if the revenue is necessary for transportation projects and is used for that purpose, but the reality is that these special funds are often raided to finance general government services. If the tax increases discussed above are just roundabout ways of increasing general fund revenue, then labeling them as taxes or fees for transportation is disingenuous.

*Corporate Income Tax*

The governor’s budget proposes to add a “throwback” rule that would tax in Connecticut any corporate income that is not allocated to another state. The budget would also continue an expiring 10% surcharge established under Malloy’s predecessor.

Malloy also proposes a new tax incentive program, “First Five,” which would offer tax credits to the first five businesses that add 200 jobs or more in the next two years. The effectiveness of job creation tax credits is questionable at best, but they tend to be popular with politicians, who can claim to be creating jobs. For the most part, states reward companies that would have added jobs anyway, and companies that receive the credit may later pack up and move on.\(^4\) On net, the governor’s corporate tax changes increase revenue by $42 million.

*Conclusion*

The governor’s budget raises revenue in many different ways. It increases taxes both by increasing rates and by broadening the sales tax base. While it may not be much consolation to Connecticut residents, some of the base broadening would lead to a more comprehensive and neutral sales tax base—a move toward sound tax policy. At the same time, other provisions simply attempt to raise revenue in politically safe but economically dubious ways, as in the cases of the tax increases on cigarettes, alcohol, luxury goods, and goods purchased with coupons.

The tax increases in Malloy’s budget would amount to more than $400 per Connecticut resident. In 2009, Connecticut received over $4 billion in federal grants and loans as part of the one-time stimulus package. Two years later, the state is still facing a $3.2 billion budget gap, even though Connecticut residents are the third-

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highest taxed in the nation. For taxpayers who already face such a high tax burden, an increase of more than $400 per person will probably not be welcome.