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Improving the Connecticut Business Tax Climate

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I. Summary

The Tax Foundation's 2006 edition of the *State Business Tax Climate Index* ranked Connecticut's business tax climate as 39th best in the country. With only 11 states ranked worse, Connecticut should use its revenue surplus to improve its business tax climate.

Governor Rell has been on the right track with suggestions to eliminate the state estate tax and the corporate income surtax. She has also pushed to cut a local property tax that would force the state to reimburse localities. Predictably, some legislators would prefer to spend the surplus, and some have even talked about raising taxes.

The Connecticut legislature should follow the Governor's lead — though not necessarily on the local property tax — and use the surplus as an opportunity to make fundamental changes to the state's business tax climate.

The University of Connecticut has recently observed that the state enjoyed bigger job gains by cutting its statutory tax rate on corporations than by carving out special exemptions and deductions for targeting industries or firms.[1] Similarly, the Tax Foundation has observed that states get a bigger boost by repealing a tax, even one that collects comparatively little revenue, than they get by enacting a small cut in a bigger tax. That's because total repeal eases the administrative burden as well as the tax burden, and in the fierce interstate competition for business, no marketing tool is better than a zero rate.

The *State Business Tax Climate Index* points to two areas ripe for reform in Connecticut: sales taxes and wealth taxes. Specific changes are detailed below, and if Connecticut had entered the current year with these changes already on the books, its ranking in the Index would have been 21st best overall instead of 39th, greatly improving Connecticut's standing in the tax competition for new jobs.

Connecticut has considerable room for improvement, especially in its sales and wealth tax systems.

Wealth Taxation

- Repeal the franchise (capital stock) tax; only one other New England state has one.
- Repeal the estate tax.

[1] Lott, William F. and Stan McMillen, "The Economic Impact of Connecticut's Corporate Tax Policy Changes: 1995-2012," Connecticut Center for Economic Analysis, December 8, 2005.

- Repeal other taxes on wealth, including the inheritance tax, generation skipping transfer tax, and gift tax.

Sales Taxation

- Gradually lower the sales tax rate from 6 percent to 5 percent, matching Massachusetts.
- Exempt as many business-to-business transactions from retail sales tax as is practical. This could include custom, modified canned, and downloaded software, as well as cleaning, repair, and professional services. These are largely business inputs and the sales tax should be paid only by the end-users of consumer goods and services. There are many unjustifiable exemptions from Connecticut's sales tax that could be eliminated to make up the revenue.

II. Connecticut: An Economic Overview

Connecticut is blessed with many attributes that make it an attractive place to live and work. The standard of living is high and nearby metropolitan areas are numerous, which stimulates commerce.

One of those attributes — proximity to New York and Boston — can also be a challenge for Connecticut's business tax climate. Both Massachusetts and New York have various non-tax advantages in their competition with Connecticut for area jobs. Rhode Island and New York have heavier tax burdens than Connecticut and less business-friendly tax codes, but Massachusetts out-competes Connecticut on both counts.

There's also competition for Connecticut beyond its immediate border states. Regional businesses that are extremely tax-sensitive can locate in New Hampshire, which taxes neither sales nor wages. Furthermore, in today's global economy, many businesses are looking outside of New England—and the United States—for investment opportunities in low-tax countries. Thus, Connecticut must have a nationally competitive tax burden and business tax climate.

As a backdrop for deciding state-level taxes in Connecticut, legislators must be aware of Connecticut's peculiar federal tax burden. Personal income and federal taxes in Connecticut are the highest in the country (see Table 1). Income is $51,391 per capita, and the federal government takes 23 percent of it due to the progressive nature of the federal income tax. Connecticut residents have led the region in federal taxes paid since 1997, and have been either first or second in the region since 1991.

In the last five years, no state in the region has seen personal income grow more slowly,[2] and while taxes are not the only determining factor, it is clear that Connecticut must make its business tax climate more competitive. In fact, the *Hartford Courant* recently opined, "Business and government officials in Connecticut are expressing appropriate alarm over the findings in a new study showing that the state is

Table 1: Connecticut Has the Highest Income and Federal Taxes in the Region

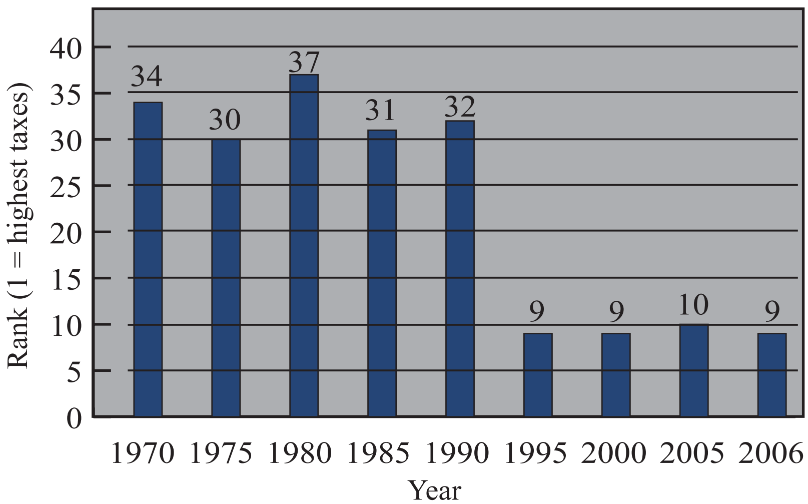
State	Income Per Capita (2005)	Rank	Percentage of Income Paid in Federal Taxes (2005)	Rank
Connecticut	**$51,391**	**1**	**23%**	**1**
Maine	$33,844	7	18%	7
Massachusetts	$47,047	2	21%	2
New Hampshire	$41,258	4	20%	4
New York	$43,119	3	21%	3
Rhode Island	$37,881	5	19%	5
Vermont	$36,050	6	18%	6

Source: Tax Foundation.

[2] According to the Bureau of Economic Analysis (BEA), Connecticut personal income grew by 8.20 percent from 2001 to 2004.

[3] See "Connecticut in the Doldrums," Hartford Courant (October 23, 2005), located at www. courant. com/news.opinion/hc-economy.artoct23,0,4923500.story

Chart 1: Connecticut Joins Ranks of High-Tax States After Enacting A State Income Tax in 1991



Note: total taxes divided by state income to compute tax burden
Source: www.taxfoundation.org/taxdata/show/445.html

losing its competitive edge. A more business-friendly attitude on the part of state and local government would help."[3]

III. The Need for Reform

Connecticut hasn't always been in its current high-tax predicament. The most famous change in the state's tax policy in the last 20 years took place in 1991, when it began taxing wages. Connecticut had been one of the ten states that levied no tax on wages, and its overall level of taxation had been comparatively low up to that point. In a ranking of combined state-local tax burdens, Connecticut jumped from 33rd highest in 1991 to 16th in 1992 after the new income tax kicked in (see Chart 1). The state has ranked between 7th and 14th ever since.

None of the other nine states have followed Connecticut's lead to enact an income tax. Ironically, if Connecticut had never enacted a personal income tax, not only would its tax burden likely be lower, but its overall business tax climate could rank in the top 10, since no state without a major tax ranks less than 15th in the State Business Tax Climate Index (SBTCI) (see Section IV below).

Governor M. Jodi Rell is attempting to improve the business tax climate with a number of changes she outlined in her 2006 State of the State Address. These include dropping the locally levied property tax on automobiles, eliminating the corporate income surtax, and removing the estate tax "cliff" [4] and eventually phasing out the estate tax entirely. [5]

While Governor Rell's proposals are a good beginning, Connecticut needs more meaningful and lasting relief for its business tax climate. Our SBTCI analysis indicates that changes in Connecticut's sales and wealth tax systems would have the most impact. If Connecticut truly wants to increase its business tax competitiveness, it needs to focus reform in these areas.

IV. Connecticut's Rankings in the State Business Tax Climate Index

Connecticut's ranking in the SBTCI reveals how much work Connecticut lawmakers have to do to make their state more business-friendly. Fortunately, Connecticut lawmakers can make tangible changes to their tax climate that will — all else being equal — make the state a more attractive place for business investment.

Table 2: Connecticut's National and Regional Rankings in the State Business Tax Climate

State	National Rank	Regional Rank
Connecticut	**39**	**3**
Maine	45	4
Massachusetts	27	2
New Hampshire	6	1
New York	50	7
Rhode Island	48	6
Vermont	46	5

Source: Tax Foundation

[4] This odd provision levies no tax at all on estates of less than $2 million, but if an estate goes over the $2 million cliff, then it is taxed on the entire amount, receiving no exemption on the first $2 million.
[5] Governmor M. Jodi Rell, State of the State Address, February 8, 2006
www.ct.gov/governorrell/view.asp?Q=309894&A=2425

Table 3: Connecticut's Overall and Sub-Index Rankings (1 is best)

Overall	Corporate	Individual Income	Sales	Unemployment Insurance	Wealth
39	16	19	33	26	50

Source: Tax Foundation

The 2006 SBTCI is composed of five sub-indices that tier up to a national ranking. The sub-indices include data from the five major tax systems that influence business investment: direct corporate taxes, individual income taxes, sales taxes, unemployment insurance taxes, and wealth taxes. When measures of these five areas are combined, Connecticut has the 39th best (or 12th worst) business tax climate in the country (see Table 2). It does have the 3rd best business tax climate in its region, but only because so many states in the northeast have poor rankings overall.

Table 4: Connecticut Has a High Per Capita Property Tax Burden, Fiscal Year 2005

State	Property Tax Per Capita	Regional Rank
Connecticut	**$ 1,819**	**1**
New Hampshire	$ 1,718	2
Maine	$ 1,581	3
Vermont	$ 1,488	4
Massachusetts	$ 1,463	5
New York	$ 1,451	6
Rhode Island	$ 1,448	7

Source: Tax Foundation projection from Census Bureau data.

Connecticut's low ranking in the SBTCI is mostly due to the design of its sales and wealth tax systems. Its rankings in these two sub-indices are its poorest, and thus Connecticut stands more to gain from improvement in these two tax systems (see Table 3).

V. Connecticut's Tax System: Recommendations for Change

Given its poor rankings in the 2006 SBTCI, Connecticut has considerable room for improvement, especially in its sales and wealth tax systems. The long-term goal of tax reform should be to make the Connecticut tax system the most competitive in the region. Connecticut should take incremental steps toward these goals, using a portion of its budget surplus to invest in its business tax climate each year.

Wealth Taxation

Connecticut has the worst wealth tax system in the U.S., ranking dead last in the wealth tax component of the SBTCI. Connecticut taxes wealth in many ways: property taxes, capital stock taxes, and asset transfer taxes on real estate, gifts, estates, and generation skipping transfers As to the largest of them, local property taxes, state lawmakers should not be expected to save property tax payers from the local officials who levy the tax. On the other hand, they must be aware of the property taxes citizens are paying, and they should address the proliferation of different taxes on other assets.

Residents of Connecticut face a high local property tax burden, paying an estimated $1,819 in property taxes per capita, the highest in the region (see Table 4) and one of the highest in the nation.

Connecticut's franchise (capital stock) tax is levied on business entities operating in Connecticut, exempting insurance companies, regulated investment companies, and real estate investment trusts. The tax is computed using capital stock and surplus reserves. The tax is levied at the rate of .31 percent, with a maximum payment of $1 million and a minimum payment of $250. Connecticut firms only pay the franchise tax if their computed liability is higher than their corporate business tax liability.

Table 5: Connecticut Has the Highest Franchise (Capital Stock) Tax Rate in the Region

State	Corporate Franchise Tax Rate	Rank (1 is highest)
Connecticut	**.31 percent**	**1**
Rhode Island	.025 percent	2
New Hampshire	n/a	n/a
New York	n/a	n/a
Maine	n/a	n/a
Massachusetts	n/a	n/a
Vermont	n/a	n/a

Source: Tax Foundation; CCH State Tax Guide.

Connecticut is one of only two states in the region with a franchise tax measured by capital stock (see Table 5). Rhode Island levies one at a lower rate (.025 percent) but as a tax on every domestic corporation organized in Rhode Island, not as an alternative calculation like Connecticut's.

It is clear that Connecticut's wealth tax system is uncompetitive.

Connecticut also taxes wealth by levying numerous taxes on the transfer of assets. While Connecticut repealed its inheritance tax (called the succession tax) on June 30, 2005, it still levies a general transfer tax that covers estates and gifts. The estate tax is levied on estates valued in excess of $2 million. Progressive rates apply as the value of the estate increases.

Connecticut is the only state in its region that imposes an estate, gift, and generation skipping transfer tax (see Table 6). It is also the only state in the region—and one of only four states in the country—that levies a tax on gifts.

Recommended Changes

It is clear that Connecticut's wealth tax system lags behind its regional competitors. Thus, Connecticut lawmakers should work to create a wealth tax system that is friendly to economic growth. This type of wealth tax system will allow Connecticut to better compete with neighboring states for new business investment.

The governor's proposal to eliminate the property tax on cars is a good start to lowering the overall property tax burden on state residents. However, because property taxes are levied almost exclusively at the local level, the state will have to replace the money generated by the tax. Either local governments will lose revenue and seek to replace it through increases in property tax rates, or the state will have to raise other taxes to replace the revenues. There are better options for tax reform that will have a more meaningful impact on Connecticut's

Table 6: Regional Taxation of Asset Transfers

State	Estate Tax	Inheritance Tax	Generation Skipping Transfer Tax	Gift Tax
Connecticut	**Yes**	**No**	**Yes**	**Yes**
Maine	Yes	No	No	No
Massachusetts	Yes	No	Yes	No
New Hampshire	No	No	Yes	No
New York	Yes	No	Yes	No
Rhode Island	Yes	No	Yes	No
Vermont	Yes	No	No	No

Source: Tax Foundation State Business Tax Climate Index (2006) business tax climate.

The following changes represent sound steps that Connecticut can take toward fundamental wealth tax reform:

- Eliminate the capital stock (franchise) tax
- Eliminate the transfer tax (which covers the estate tax and gift tax)
- Eliminate the generation skipping transfer tax.

Connecticut is only one of two states in the region with a capital stock tax, and the alternative calculation unnecessarily complicates the tax code. Eliminating the tax would reduce the tax code's complexity, reduce the tax burden associated with investment in Connecticut, and put Connecticut on equal footing with the five states in the region without such a tax. Eliminating the asset-based wealth taxes are particularly important to prevent highly mobile business owners from moving to a state without such asset transfer taxes.

If Connecticut had entered 2006 with these changes in place, its wealth tax system would have ranked 30th—instead of 50th—in the wealth tax sub-index.

Table 7: Connecticut Has the Third Highest Sales Tax Rate in Region

State	State Sales Tax Rate	Weighted Average of County Rate	Total Rate	Rank
New York	4.0	3.96	7.96	1
Rhode Island	7.0	0.0	7.0	2
Connecticut	**6.0**	**0.0**	**6.0**	**3**
Vermont	6.0	0.0	6.0	3
Maine	5.0	0.0	5.0	5
Massachusetts	5.0	0.0	5.0	5
New Hampshire	0.0	0.0	0.0	6
Average	*4.71*	*.057*	*5.28*	

Source: Tax Foundation State Business Tax Climate Index (2006)

Table 8: Connecticut's Sales Tax Treatment of Common Business-to-Business Transactions

Transaction	**Connecticut's General Sales Tax Treatment**	**Treatment by Majority of States in Region**
Insecticides and pesticides	Exempt	Exempt
Fertilizer, feed, and seed	Exempt	Exempt
Seedlings, plants and shoots	Exempt	Exempt
Manufacturing machinery	Exempt	Exempt
Utilities	Exempt	Exempt
Farm machinery	Exempt	Exempt
Raw materials	Exempt	Exempt
Office equipment	Taxable	Taxable
Pollution control equipment	Exempt	Exempt
Cleaning services	Taxable	Exempt
Transportation services	Exempt	Exempt
Repair services	Taxable	Exempt
Professional and personal services	Taxable	Exempt
Custom software	Taxable	Exempt
Modified canned software	Taxable	Exempt
Downloaded software	Taxable	Exempt
Motor vehicles	Taxable	Taxable
Rooms and lodging	Taxable	Taxable

Sales Tax

Connecticut levies a sales tax on a wide variety of transactions, including retail sales and a host of services. The sales tax rate is 6 percent. There are no local rates added on to the Connecticut sales tax.

Connecticut has a relatively high sales tax rate compared to its regional neighbors (see Table 7). At 6 percent, Connecticut is tied for the third highest combined (state and local) sales tax rate in the region. New York (7.96 percent) and Rhode Island (7 percent) both have higher combined rates. Maine and Massachusetts both levy sales taxes at a 5 percent rate, and New Hampshire does not have a sales tax.

In addition to this high rate, Connecticut's sales tax base is uncompetitive because it includes too many business-to-business transactions (see Table 8). Out of the large number of tangible goods that are purchased largely as business inputs (e.g., manufacturing machinery, agricultural goods, raw materials, and office equipment), Connecticut exempts most of these items from its sales tax, as do most states in the region. On services,

Lowering the sales tax rate can dramatically decrease the cost of goods and services compared with neighboring states in the region.

Connecticut lags behind the region since it largely treats services as taxable, including cleaning, repair, and other professional services. On software, Connecticut also lags behind the region as it includes custom, modified canned, and downloaded software in the sales tax base.

Since many businesses are purchasers of these types of goods and services, their inclusion causes tax pyramiding—i.e. tax will be accumulated on top of tax, which can distort investment decisions and decreases the visibility of the tax system. Thus, their inclusion in the sales tax base has a negative impact on Connecticut's tax system.

Recommended Changes

To improve its business tax climate and tax competitiveness, Connecticut should consider the following changes to its sales tax system:

- Exempt cleaning, repair, and professional services from the retail sales tax base
- Exempt custom, modified canned, and downloaded software from the retail sales tax base
- Lower the statutory state sales tax rate to 5.0 percent

Lowering the sales tax rate can dramatically decrease the cost of goods and services compared with neighboring states in the region. A high sales tax that fails to exempt business-to-business purchases can act as a direct financial disincentive for Connecticut-based businesses to purchase those goods from Connecticut companies, if those services can be purchased tax-free in a neighboring state.

The Legislative Program Review and Investigations Committee of the Connecticut General Assembly also saw the need for Connecticut to remove business inputs from the sales tax base. In their findings, they noted that Connecticut businesses pay a higher share of sales tax than businesses in most other states.[6] This is undoubtedly due to the fact that Connecticut includes too many business services in the sales tax base, and could be remedied by taking the steps outlined above.

If Connecticut had entered 2006 with these changes in place, it would rank 9th—as opposed to 33rd—on the sales tax sub-index.

Connecticut has a relatively high sales tax rate compared to its regional neighbors . . . tied for the third highest combined sales tax rate in the region.

[6] See "Findings, Recommendations, and Policy Options," Connecticut Legislative Program Review and Investigations Committee, located at http://www.cga.ct.gov/2005/pridata/Studies/CT Tax System Digest.htm

VI. Conclusion

The fundamental tax changes outlined in this paper are designed to give Connecticut a business tax climate that is nationally competitive. Specifically, if Connecticut had entered 2006 with the changes outlined in Table 9, it would have the 21st—as opposed to the 39th—best business tax climate in the U.S. As Connecticut develops a more attractive business tax climate, it should improve its reputation as a destination for business investment.

Of course, making these changes will not be easy. Nor will they be quick. Reducing the sales tax rate by 1 percentage point will reduce state revenues by roughly $500 million, and lawmakers may want to consider incremental rate reductions to achieve these goals. It will take a long-term commitment to restore competitiveness to Connecticut's business tax climate, but this is an investment that its lawmakers cannot afford to forego.

Table 9: Summary of Recommended Changes to Connecticut's Overall Tax System

Tax System	Reform Proposals
Wealth Taxation	-eliminate capital stock tax -eliminate transfer (estate and gift) tax -eliminate generation skipping-transfer tax
Sales Tax	-reduce rate to 5.0 percent, subjecting all end-user goods and services to the tax. -exempt from sales taxation business-to-business transactions for such services as cleaning, repair, and professional services and products such as custom, modified canned, and downloaded software.

Source: Tax Foundation.

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