Yankee Institute Policy Brief

High Taxes Hurt

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If Connecticut lowered its taxes, every state resident would benefit. The state's current tax burden contributes to our high cost of living and sluggish economic growth. This year, as lawmakers look to close a $2.7 billion gap in the next two-year budget, they should not increase taxes to make up the difference. Higher taxes will mean fewer jobs, and could cause more high-income earners to flee the state. When individuals who pay a lot of taxes leave, everyone left behind has to pay more.

Other states, including our neighbor New York, have enacted taxpayer-friendly reforms that will help them in the long run. It is time for Connecticut to similarly reform its tax system, and to reduce the overall burden on taxpayers.

What Happens When Rich People Leave Connecticut?

In 2006, Fortune magazine called Edward Lampert the "best investor of his generation." Lampert, known for his investment in retail giant Sears, is not a household name, but in 2004 he reportedly became the first investor to earn more than $1 billion in a single year.[1] That was a good thing for him, but also for Connecticut's treasury. He probably paid something like $50 million in income taxes that year, which is about the size of the budget for the Department of Criminal Justice.

Since then, Lampert could have paid even more than $50 million in his best year, depending on the estimate, just in income taxes. However Connecticut is no longer reaping the fruits of Lampert's labors, since in June 2012 he moved his residency from Greenwich to Florida, where there are no state income taxes.

Great wealth gives a person options, including where they live. No one making $75,000 a year is going to live states away from their workplace, but when you own your workplace you can move it. And if you own a jet, it doesn't matter where your office is.

All of Connecticut's residents benefit from sharing a state with some of our country's most successful and wealthy people.

According to a recent study released by the Department of Revenue Services (DRS), the 357 top-earning households pay 5.4 percent of all Connecticut taxes, or about $2.7 million per family. If these people were to suddenly disappear – or to stop being so successful – every other family would need to contribute $631 to make up for their lost contributions. Just to replace the lost income taxes from these 357 households, everyone else's income tax bill would need to go up by 13 percent.

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[1] Sellers, Patricia. "Eddie Lampert: The Best Investor of His Generation." Feb. 6, 2006. CNN Money, Fortune. http://money.cnn.com/2006/02/03/news/companies/investorsguide_lampert/

While many instinctively want to see higher taxes on the very rich, such a change could cause more wealthy families to leave the state, leaving a higher burden for the people left behind. That's why tax increases targeting the wealthy are so shortsighted. They may increase revenue today, but could lead to less revenue in the long-term.

Besides the income tax, there are also other losses to the state when wealthy residents leave. These individuals hire others through their businesses and at their homes. The recent DRS tax study suggests the most successful families spend about $1 million per year in Connecticut. That means more jobs for everyone else.

People Are Moving Out of Connecticut

There is no exit poll for people leaving the state, so we don't know if they're moving because of the high cost of living, the state's high taxes, or if they just want to retire somewhere warmer. But we do know, from examining Internal Revenue Service tax return data, that more people are leaving the state than are moving in.[2]

Comparing 2010 to 2011 tax returns, the latest years available, 6,715 households more households left Connecticut than moved in, taking with them $132 million in taxable income. When the 2011 to 2012 data are released, we will see what happened after the 2011 tax increase.

Between the years of 1993 and 2010, IRS data show that the state lost a net total of $8.7 billion of income, and more than 193,000 people, to other states. Since 1993, there was only one year – 2003 – when more people moved into the state than moved out.[3] Because of foreign in-migration and births, Connecticut has usually seen a slight uptick in population even as people have moved to other states. However, the most recent Census estimate suggests the state's population is declining.

All of those people moving out represent lost tax revenue as well, which is one of the reasons Connecticut continues to struggle to match revenues to rising expenditures. This puts the state in a conundrum – even as the demand for tax revenue grows because of increased costs and enlarged state programs, the growth in tax revenue will slow if the state increases taxes further, since tax increases provide another incentive to move out of the state.

Connecticut's High Taxes Hurt Everyone, Especially the Poor

The poor are hit hard by Connecticut's high taxes. The DRS study of tax incidence shows the cost of the state's taxes by combining simple dollar cost and the larger economic cost.

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[2] IRS tax migration data for Connecticut for the years 2004-2011 can be found at http://www.irs.gov/uac/SOI-Tax-Stats-Migration-Data-Connecticut

[3] These figures were calculated using the Tax Foundation's state to state migration data calculator, which uses IRS data, found at http://interactive.taxfoundation.org/migration/

Unsurprisingly, the study shows the costs of taxes – in lost jobs, higher costs for goods and services, and lower incomes – weigh more heavily on the state's poorest residents.

The study does not address the redistribution of income that takes place after taxes are collected, but it does show that while people in the lowest income brackets pay a relatively small amount of taxes to the state as a total dollar figure, they bear the largest burden from the incidental costs of the state's tax policies. The bottom half of taxpayers bear 20.4 percent of the total state tax burden, but have losses due to taxes equal to 23.6 percent of income. The higher-income half of taxpayers pay nearly four out of five tax dollars, an amount equal to 10.2 percent of their income.[4]

Local property taxes generate 45 percent of total tax revenue, followed by the personal income tax (28 percent) and the sales tax (16 percent).

Incidence Isn't Everything

The tax incidence study, while an important research document, has room for improvement.

- This study highlights one year, 2011. A multi-year study would have been better.
- The study does not separate taxes paid from unpaid tax burdens.
- The study groups all excise taxes together, conflating consumption taxes, like the gas tax, with behavior taxes, like alcohol and tobacco taxes.
- It is unclear how differences between state and federal filings impact the study results.
- The study does not disclose its sensitivity to assumptions.[5]

The most important flaw of the study is that it only looks at relative burdens (incidence) without considering the effects of taxes on behavior (incentives). Changes to incidence will also change incentives, sometimes in ways that undo the effect of the initial change.

Tax Reform in Other States

Other states have taken the next step and have begun the difficult task of tax reform.

New York restructured its corporate tax system last year, with plans to eventually drop its top tax rate from 7.1 percent to 6.5 percent. North Carolina also recently made significant reforms to its tax system, which changed its overall ranking on the Tax Foundation's business tax climate index from 44th place to 16th place. It moved from a multi-bracket income tax system with a top rate of 7.75 percent to a single 5.8 percent rate. It is also gradually lowering its corporate tax rate.[6]

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[4] Connecticut Department of Revenue Services. "Connecticut Tax Incidence." December 2014. http://www.ct.gov/drs/lib/drs/DRSTaxIncidenceReport2014.pdf
[5] See appendix for detailed explanation of bullets.
[6] Drenkard, Scott and Joseph Henchman. "2015 State Business Tax Climate Index." Oct. 28, 2014. http://taxfoundation.org/article/2015-state-business-tax-climate-index

As more states change their tax systems to lower their overall tax burdens, they put more pressure on Connecticut. To remain competitive, Connecticut should reform its tax system and reduce its overall tax burden.

Smart Tax Reform Will Help Everyone

There are several ways Connecticut could reform its taxes to create a more streamlined and taxpayer-friendly environment.

Policymakers should adopt a sustainable budget under the spending cap. Such a budget would not require any tax increases.

The DRS study found that low-income residents feel the most pain from the corporate tax, mostly by reducing income and job opportunities. Reduce this tax rate with the savings from ending corporate welfare programs.

In addition, eliminate the business entity tax, which takes in a small amount of revenue and is biased against small and new businesses.

Help towns and cities reduce the property tax burden by eliminating costly state mandates. Start by getting rid of the minimum budget requirement, which says towns and cities cannot reduce their overall education budgets without state consent; by eliminating binding arbitration requirements; and by eliminating the prevailing wage, or at least raising the thresholds for projects that fall under the prevailing wage mandate.

By expanding the earned income tax credit, the state could eliminate other costly programs and instead give money directly to those who need it most.

A Way Forward

"Nothing is certain except death and taxes," Benjamin Franklin famously once said. Clearly taxes play a role in our society – they enable us to pay for schools, roads, and other important government services. But Connecticut's tax system is out of balance. It places too high a burden on state residents, as we can see by the number of people moving to states with lower taxes.

This year, lawmakers need to reject any efforts to increase taxes, and instead need to look for ways to improve Connecticut's tax system.

Appendix: Improving the Tax Incidence Study

This study highlights one year, 2011. A multi-year study would have been better.

The study only considered 2011. This is relevant for a few reasons. It was a good year for many investors, which translates into higher incomes for top earners. In bad years, some wealthy people are likely to have negative effective incomes while still paying taxes.

Also, a number of policy changes began taking effect that year, including the largest tax increase in state history, part of which was retroactive; and the implementation of a new earned income tax credit. For these reasons, a multi-year approach would have been more enlightening.

The study does not separate taxes paid from unpaid tax burdens.

Taxes hurt, but not always directly. Taxes on commercial property and corporate income, for example, hurt the incomes and job prospects of all Connecticut residents. However, these unpaid burdens should be reported separately from the tax bills actually paid by Connecticut residents. This is especially the case because the distribution of unpaid burdens is highly dependent on assumptions. It would be cost prohibitive to exhaustively allocate burden by income or population.

Unpaid tax burdens could also exceed the total cost of taxes paid. This study limits their impact to taxes actually paid by Connecticut residents, yet another assumption.

The study groups all excise taxes together, conflating consumption taxes, like the gas tax, with behavior taxes, like alcohol and tobacco taxes.

Taxes on behavior should be broken out for clarity.

It is unclear how differences between state and federal filings impact the study results.

DRS mentions this complication, but does not explain how better data would affect the study.

The study does not disclose its sensitivity to assumptions.

The study relies on a number of assumptions as any study of this kind would. It would have been useful if the study disclosed its sensitivity to certain assumptions. For example, the lost job and income opportunities are distributed evenly, according to income. However, isn't it possible that the income lost due to taxes rises with income? If so, certain taxes would appear less regressive than in the study results.

Another example is conflating corporate taxes and dividend earnings. In a national study, these two may be related. However, a retiree with dividend-paying investments in companies based in New York and California is not really bearing the cost of the Connecticut corporate income tax.

Finally, the property tax analysis does not appear to take into account the variety of tax rates paid across Connecticut towns.