

MARCH
2021

Revenue Ratchet

Connecticut's Income Tax
At 30

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The author thanks Meghan Portfolio for her assistance in the research for this paper and E.J. McMahon for his tax-policy mentorship.

Executive Summary

Three decades have passed since the historic budget crisis that culminated in the creation of Connecticut's personal income tax.

The tax was enacted out of desperation: a roaring private sector buoyed a multi-year explosion in state spending, which left state government deep in the red as the economy slowed and tax revenues sank.

Supporters eyed the income tax as a way to make the state's tax system less regressive—and to expand the size and scope of state government. And what began in 1991 under Governor Lowell Weicker as a flat 4.5 percent tax on personal income has morphed into a seven-bracket tax with a top rate just under 7 percent. This, the 30th anniversary of the tax, is an appropriate time to re-examine both the rationale behind its adoption and to measure how the tax has performed as a revenue source.

A central argument for the income tax—that unlike a sales tax it would be deductible from federal income taxes—was partially negated in 2017 when Congress restricted the deductibility of state and local tax payments (SALT).

Enacting the income tax allowed other taxes, such as the sales tax and corporate income tax, to be reduced immediately. It lowered the tax rates on capital gains, interest, and dividends.

Those reductions, however, have been partially reversed.

But the primary argument for the state income tax—that it would be a more stable alternative to the state sales tax—has not panned out.

Instead, the state has faced multiple sudden drops in tax revenues—and responded by hiking income tax rates further, making the state increasingly dependent on volatile investment income. This cycle has had a ratcheting effect on state tax revenues—and left Connecticut more reliant on income tax revenues than all but two states.

Key decisions in subsequent years—after Weicker left office—allowed the tax to assume its current form, as the tax was first split into multiple brackets and the top rate was increased on a permanent basis. Those changes have exacerbated the volatility by making the state more reliant on taxing investment income, such as capital gains, as opposed to salaries and wages.

The data also show:

- The share of individuals paying half of state income taxes has shrunk from about 12 percent in 1992 to about 6 percent in 2019.
- Revenue from the tax has jumped 136 percent on an inflation-adjusted basis.
- The state's highest-earning taxpayers appear to be taking steps to avoid paying Connecticut income tax by reducing the time they spend in the state.

Connecticut's income tax experience has been a cautionary tale about increasing the state's reliance on higher-earners. Governor Lamont and the General Assembly should:

- avoid further tax increases;
- perform the repeatedly-delayed Tax Incidence Report to better understand the implications of state tax policy; and
- amend the state Constitution to place a two-year limit on income tax rate increases above a flat base rate.

Background: “The Gang That Couldn’t Count Straight”

The road to Connecticut’s 1991 enactment of a personal income tax began, oddly enough, during the good years.

A roaring national economy, higher federal spending in the defense sector, and a construction and real estate boom had pushed state tax revenues to new heights, reaching what Governor Bill O’Neill in 1988 called “a high and steady level of achievement, a plateau, if you will, in our fortunes.”¹

State government was funded primarily by sales tax, corporate tax, and taxes on capital gains, dividends, and interest. Between July 1983 and June 1987, the state ran surpluses totaling more than \$1.3 billion in current dollars.² Yet by the end of the fourth year, the state’s Budget Reserve Fund—designed to hedge against volatility in state tax revenues—held just under \$320 million.³

State spending, meanwhile, exploded: general fund expenditures swelled 62 percent on an inflation-adjusted basis between fiscal 1983 and fiscal 1991.⁴

Connecticut confronted a grim fiscal reality as the economy slowed. Years of surpluses led lawmakers to make spending decisions that had lasting implications in the outyears. For instance, they diverted a portion of corporate tax receipts from core state functions to cross-subsidize property taxes. They also used state funds to hike teacher salaries, boosting state pension obligations in the process.

O’Neill and the General Assembly tried sopping up the red ink by pushing the sales tax and corporate income tax rates to the highest levels in the nation.⁵ They also used gimmicks such as assuming higher rates of return from state pension investments, which let them trim contributions.⁶

One early income tax proponent was Representative William Cibes of New London, who sought the Democratic Party’s nomination for governor in 1990 on a pro-income tax platform.

“Our real problem,” Cibes said, is “our over-reliance on a static, unpredictable tax base which does not grow with the capacity of our people to fund the services that we have.”⁷

In retrospect, Connecticut’s tax revenues were not so much unpredictable as they were experiencing an anomalous surge—which its leaders spent instead of saving. Receipts from the state’s 7.5 percent sales tax grew three times inflation between 1981 and 1989. Corporate tax receipts jumped, on an inflation-adjusted basis, by 49 percent between fiscal 1984 and fiscal 1986 alone.

Connecticut ended fiscal 1988 with a deficit, drawing from its rainy day fund, and by fiscal 1989 the fund was exhausted.⁸

O’Neill didn’t seek re-election in 1990. Former U.S. Senator Lowell Weicker, running as an independent, prevailed in the three-way race.

Weicker inherited a \$966 million deficit, in a \$6.5 billion budget, upon taking office in January 1991 and faced an additional \$1.4 billion budget gap in the fiscal year set to begin in July.⁹

“A Last Resort”

Weicker had pledged he wouldn't seek a state income tax “except as a last resort.”¹⁰ Given the ongoing economic recession, he'd said that “imposing an income tax would be like pouring gasoline on a fire.”¹¹

The state had, quite simply, run out of dials to turn: its corporate income and sales tax rates in early 1991 were the highest in the nation, and Hartford was collecting a top rate of 14 percent on interest and dividends.¹²

“We were spending, but we weren't paying for it, so obviously something had to be done,” Weicker later recalled. “It wasn't just O'Neill, it was the legislature, it was everybody that just kept on spending and spending and spending, never asking that it be paid for in a logical way.”¹³

Proposing a personal income tax in February 1991, Weicker was confronting a major political taboo. Connecticut was one of just ten states without one. That distinction was even more remarkable because, unlike Alaska, Wyoming, and Texas, Connecticut wasn't collecting severance taxes from oil, coal, or other resource extraction. Nor did it have a significant tourism sector such as the ones allowing Nevada and Florida to operate without one.

A tax on wages and salaries had been approved by Governor Thomas Meskill in 1971, only to be repealed weeks later following public backlash.¹⁴ Governor Ella Grasso vowed not to enact one.¹⁵ And her successor, Governor Bill O'Neill, forcefully confronted a 1983 proposal to impose one.¹⁶

That year, lawmakers introduced legislation to create an income tax, and a coalition of labor unions and religious and civic groups promoted one as a way to reduce sales and property taxes.¹⁷

Connecticut's dire fiscal condition by the beginning of the 1990s buoyed arguments that state government needed an income tax. By then, a contingent in the General Assembly had long pressed to impose one because they wanted the additional cash.

Revenue from an income tax, Representative Miles Rapoport later wrote, would allow the General Assembly to “move on” to spending on “other critical areas of state responsibility.”¹⁸

Income tax opponents and advocates alike recognized that the state's existing tax regime served as a natural check on more ambitious spending plans. Representative Anthony Nania of North Canaan in 1990 summarized the dynamic:

*The reason why we don't do worse than we do right now is that this Legislature can't get its hands on the money. And the income tax would finally and at least provide an engine of raising revenue that had absolutely no restraint. This Chamber could on one side create a spending package, and whatever it decided to spend, it could match it on the other side. I submit to you, ladies and gentlemen, that an income tax without some form of constitutional restraint is an invitation to a kind of fiscal irresponsibility that this state, in fact the civilized world, has never yet seen.*¹⁹

Tax proponents in 1991 argued:

- it would be deductible from federal taxes, unlike sales tax;
- other taxes would be lowered; and
- it would be more stable than the state's existing revenue mix.

Supporters framed the deductibility issue as a matter of “losing” money and giving the federal government “a gift of \$600 million out of Connecticut’s taxpayers’ pockets that doesn’t need to come out of those pockets.”²⁰

Addressing the General Assembly in May 1991, Governor Weicker said:

*The choice is \$300 million in taxes now payable to the federal government in Washington, D. C., [and] that \$300 million staying here in Connecticut. As of 1986, state income taxes are deducted from federal returns and sales taxes are not. Not one penny.*²¹

Deductibility wasn’t an option, however, for the Connecticut residents subject to the federal Alternative Minimum Tax, from which state and local taxes weren’t deductible.

And deductibility overall was substantially reduced further in 2017 when Congress limited the amount of state and local taxes a married couple filing jointly could deduct from their federal income taxes to \$10,000.

“A Cash Machine”

Governor Weicker argued the income tax would be “a stable, consistent engine of revenue that gives us the capacity to face bad times.”²³

But, as shown, Connecticut’s personal income tax¹ has been anything but stable.

Since fiscal 1993 (the first year in which the income tax was fully phased in), the sales tax has not declined more than 7 percent in any one year. By comparison, personal income tax (PIT) receipts have twice—in FY02 and FY09—dropped more than 10 percent amid economic downturns. In both cases, PIT receipts dropped twice as much as sales tax receipts (figure 1).

As to lowering the state’s other taxes, including its highest-in-the-nation sales and corporate tax rates, the 1991 income tax deal had immediate results. The sales tax dropped from 8 percent to 6 percent, and a 20 percent surcharge on corporate income taxes was removed over two years, bringing the effective rate from 13.6 percent down to 11.5 percent. The corporate rate ultimately dropped to its current permanent-law level of 7.5 percent in 2000.²²

However, in 2009, a 10 percent surtax (which later rose for a time to 20 percent) was applied to many of the state’s largest businesses, and it remains in place today. The sales tax, meanwhile, was hiked to 6.35 percent in 2011.

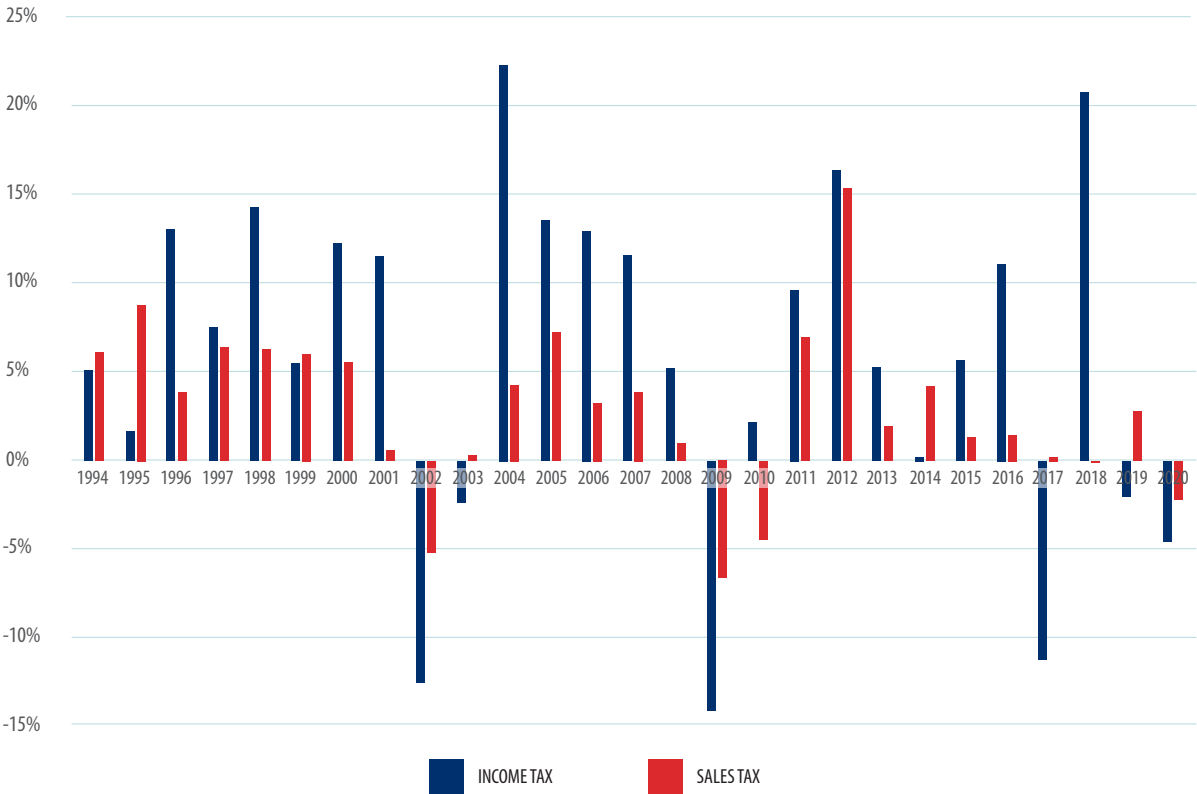
Those setbacks stemmed from a key problem with the pitch for Connecticut’s income tax: it was sold as being more stable than the existing sales tax. But three decades of data have shown the opposite to be true.

Connecticut officials confronted PIT shortfalls by hiking rates in 2003, 2009, 2011 and 2015—each time on a permanent basis. Unlike the sales tax, the income tax can be modified retroactively by the General Assembly, letting it capture a greater share of earnings that have already been realized months after the fact.

¹ State income tax receipts were also affected by the 2018 creation of the pass-through entity tax, which was created to let certain businesses pay a 6.99 percent state tax which is fully deductible from federal taxes and then partially creditable against state income tax liabilities. The treatment of PET credits is noted where appropriate.

Figure 1

Annual Changes in Tax Revenue (Current Dollars)



Source: Office of the State Comptroller, Office of Policy & Management; FY19 and FY20 PIT include pass-through entity tax receipts

As revenues recovered but rates remained elevated, the state collected more money than it previously would have. That let state officials further increase spending, left income taxes making up a larger share of revenues, and made the state more reliant on revenues prone to sudden downturns. This cycle had a ratcheting effect on how much the state income tax costs the people of Connecticut (figure 2).

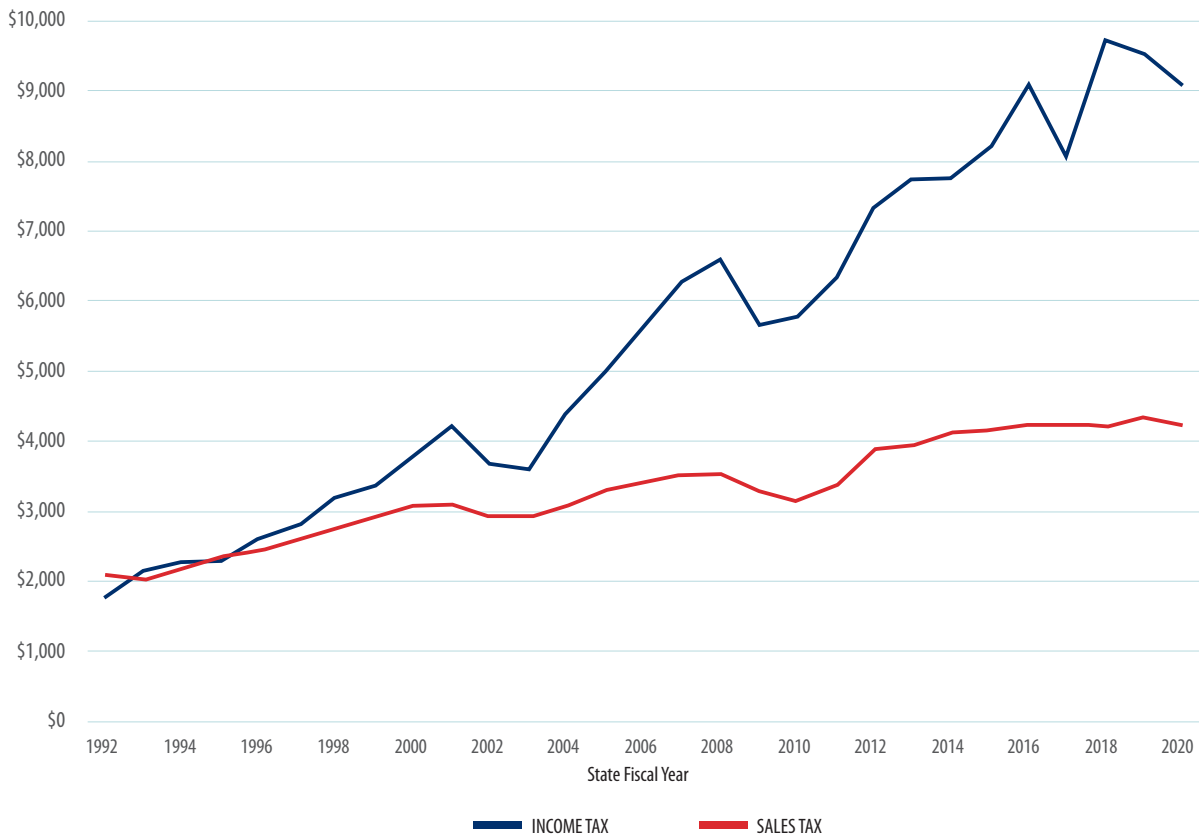
Representative Carl Schiessl of Windsor Locks offered a prescient warning as the income tax was adopted:

Ladies and gentlemen if the recession ends, watch that 6% sales tax with expanded base pump in the dollars, watch that income tax fill our coffers and then watch what happens here in the General

Assembly. There will be an assault on the spending caps we have created today. There will be collective amnesia on spending from initiatives that have received a lot of lip service during 1991 and we will see the resurrection of dormant and deceased programs. Many new legislators who will be here in the General Assembly who did not experience these lean times will be motivated by their desire to serve and will be spending with abandon. And I am sure that some of us in this Chamber will also share and have short memories as well and will join them in their spending.²⁴

Figure 2

State Tax Revenue (Current Dollars, Millions)



Source: Office of the State Comptroller,
Office of Policy & Management;
FY19 and FY20 PIT receipts include pass-through entity tax receipts

Comparing the growth of PIT revenues to sales tax receipts gives a sense of scale for how much the income tax burden has swelled.

The state netted about \$2.2 billion from the income tax during fiscal 1993, the first full year of implementation. In fiscal 2020, the tax—notwithstanding credits to filers who paid the pass-through entity tax (PET) — netted \$9.1 billion. Adjusting for inflation, this reflected a 136 percent increase. Put another way, Connecticut tax filers would have kept more than \$5 billion last year if the income tax had been structured to generate only the original intended amount.

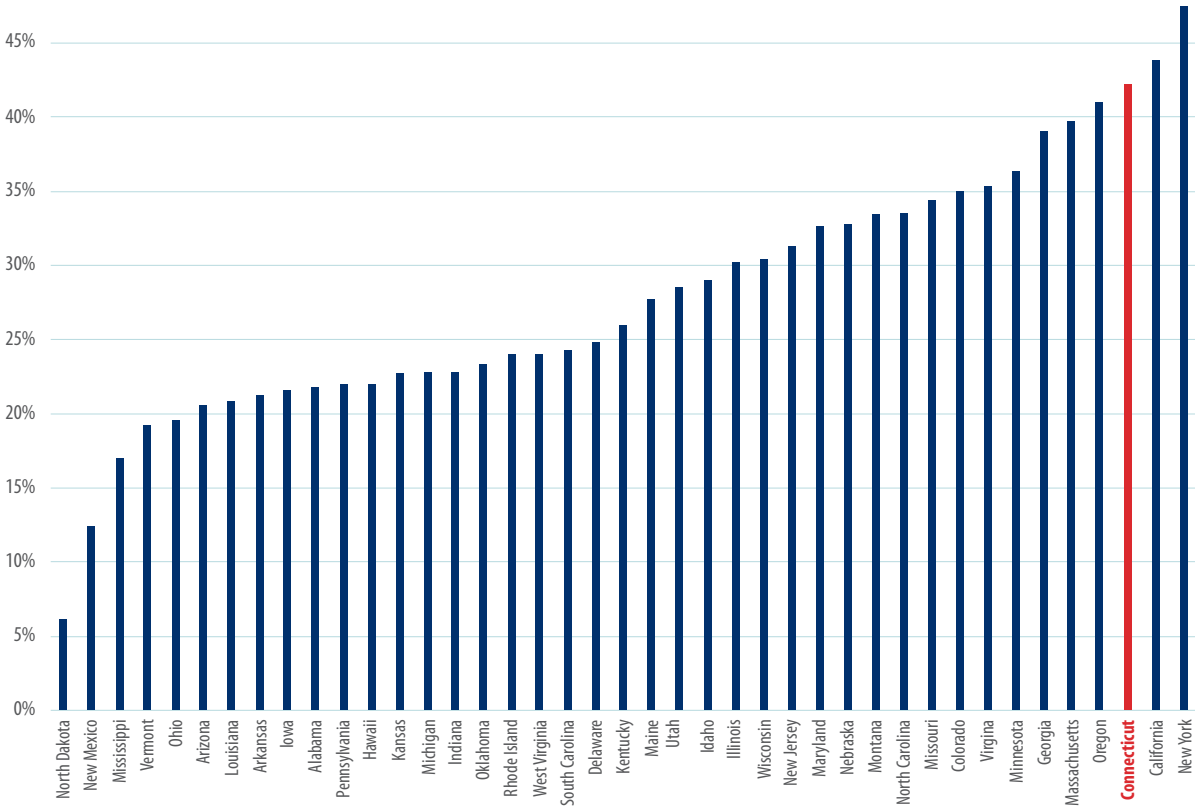
Today, Connecticut state government relies more on PIT receipts, as a percentage of state revenues, than all but two states: New York and California (figure 3).²⁵

Representative Cibes, who ultimately helped design the income tax as Weicker’s budget director, had years earlier acknowledged that the tax could fuel state spending:

“The fear is that with a cash machine like an income tax, the state legislature will go wild and go on a spending spree...And if you look at history and learn from what has happened elsewhere, they may have some basis for that fear.”²⁶

Figure 3

Percentage of General Revenue From Own Sources From Personal Income Tax



Source: U.S. Census Bureau, Annual Survey of State and Local Government Finances, 2018 Data Release

The Turning Points

Speaking about the income tax in 2010, Governor Weicker observed: “It hasn’t been repealed, but it certainly has been spent.”²⁷

Connecticut political lore places the income tax squarely on Weicker’s shoulders, but today’s manifestation of the tax is as much—if not more—a creation of his successor, Governor John Rowland.

Rowland, facing pressure from his right during the 1994 campaign, pledged to eliminate the tax but never presented a plan to replace the revenue or reduce spending.²⁸

Instead, he made two key decisions that helped cement Hartford’s reliance on the income tax.

First, Rowland pushed the General Assembly to cleave the state’s then-flat tax into two brackets: a new 3 percent rate for the first \$9,000 of taxable income for married couples, while leaving the 4.5 percent rate intact. In 1997, that lower bracket was increased to eventually cover the first \$20,000 of taxable income by tax year 1999.²⁹

Weicker, to his credit, had warned against taxing Connecticut residents at different rates. Vetoing an attempt by the General Assembly in 1993 to among other things hike the top rate from 4.5 percent to 6.25 percent, the governor wrote:

*“The introduction of a new, higher tax rate into our current flat rate tax system shatters our recently reacquired fiscal order and confirms the worst fears of those who believe Connecticut has not learned anything from its painful past.”*³⁰

Rather than laying groundwork for the tax’s elimination, Rowland achieved minimal reductions that let him run for re-election in 1998 having cut state income taxes.

And in so doing, he created crucial precedent for the four rate hikes that would follow.

The 2001 recession, and the rocky performance of financial markets in 2002, rattled state revenues. Rowland and the General Assembly in early 2003 hiked the state’s top rate to 5 percent, leaving the 3 percent bracket unchanged.³¹

Here Rowland made a second crucial decision: the 2003 rate hike did not expire.

Connecticut went on to close deficits by hiking income taxes again in 2009, 2011, and 2015. Each time, permanent rate hikes were enacted as immediate solutions to budget gaps, meaning they remained higher through the subsequent economic recovery.

In 2009, Governor Jodi Rell signed legislation that added a new top bracket and taxed individuals with taxable income over \$500,000 and married couples filing jointly over \$1 million at 6.5 percent.³²

The 2011 rate hikes, enacted under Governor Dannel Malloy, were noteworthy because the addition of three new brackets affected taxable incomes as low as \$50,000 for individuals, who found themselves in a new bracket paying a marginal rate of 5.5 percent. The new top rate,

6.7 percent, kicked in at the \$250,000/\$500,000 taxable income level.

In 2015, the higher rates were increased, and a new bracket added for \$500,000/\$1,000,000 filers, who today pay a marginal rate of 6.99 percent.

Connecticut’s neighbors have weathered economic storms differently. New York allowed their temporary tax hikes on higher-earners, imposed in 2003, to expire after 2005 and return the state’s top rate to 6.85 percent.³³ A second round of rate increases in 2009, which set the top rate at 8.97 percent for all filers over \$500,000, expired after 2011.³⁴ However, the Empire State continued taxing filers in the \$1,000,000/\$2,000,000 bracket at 8.82 percent on a temporary—though repeatedly renewed—basis, now set to end by 2024.³⁵

Massachusetts, on the other hand, may only tax wages and salaries at a “uniform rate” of 5 percent. Unlike Connecticut and New York, the commonwealth’s constitution has prevented it from dabbling with higher rates in the first place.³⁶

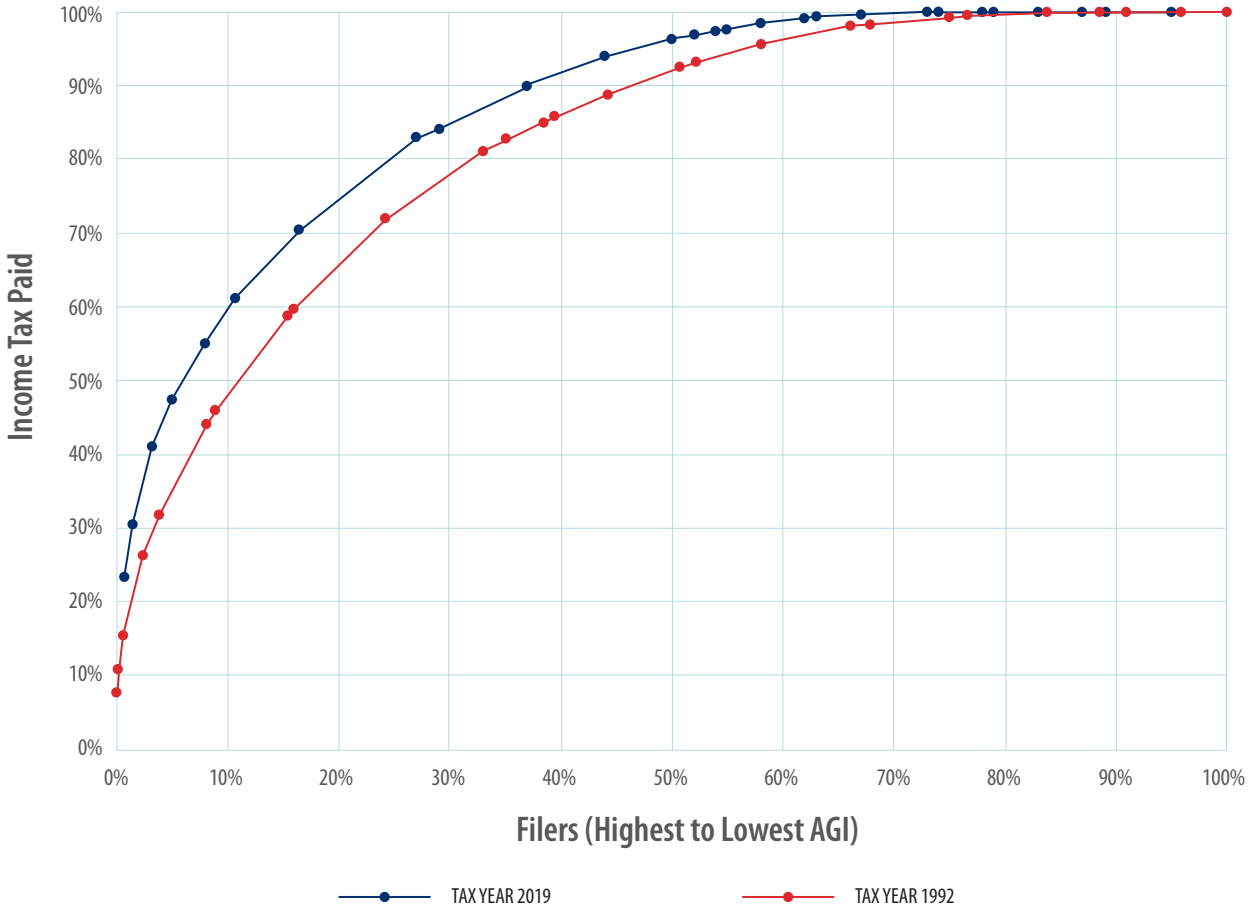
The adoption of higher income tax rates increased Connecticut’s reliance on higher-earners whose incomes are more likely to be tied to investments, and thus fluctuate with market conditions. In 1992, about half of state PIT revenues came from about 12 percent of filers (figure 4). By 2019, it was roughly 6 percent.

In 2013, the General Assembly took a step toward better understanding state taxpayers and their behavior. It ordered what was intended to be a biennial report examining who was paying particular state taxes, which would measure its reliance on higher-earners.

The first and only study, examining tax year 2011 and released in 2014, found Connecticut getting well over half its income tax revenues from fewer than 125,000 households.³⁷ What’s more, it revealed 12 percent of income tax revenues came from just 357 households, whose tax bills averaged \$1.9 million.

Figure 4

Percentage of Personal Income Tax Paid by Percentage of Filers



Source: Dept. of Revenue Services; includes PET credits as PIT payments; points connected for visualization purposes.

“Some Very Wild Swings”

Connecticut has plunged into a vicious cycle: taxing increasingly volatile income, then making spending decisions based on forecasts that have not materialized.

A notable example came in fall 2007 when the state Office of Policy and Management (OPM) estimated gross PIT receipts (not net of refunds) would increase more than 6 percent in each of the next four years (figure 5).

That led Governor Rell and the General Assembly in 2008

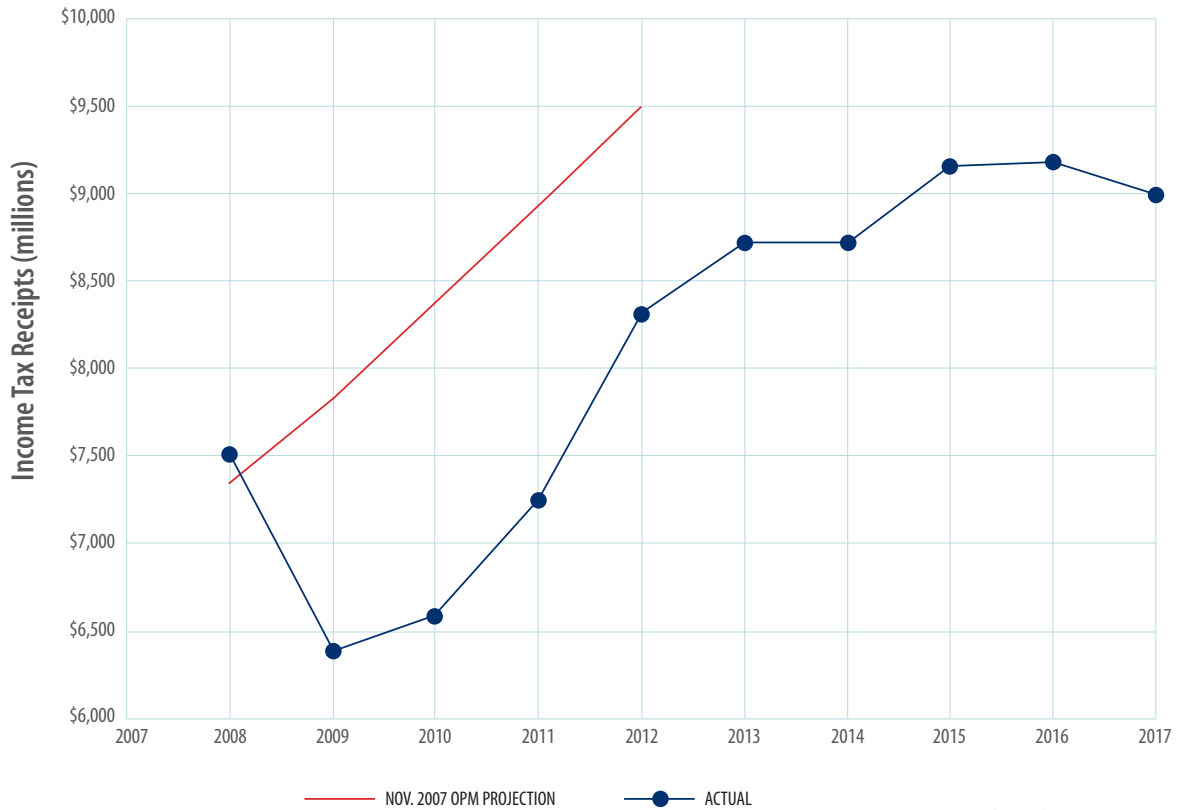
to make spending decisions that assumed PIT receipts would rise more than 29 percent over the next four years.³⁸

But after five years—and three income tax hikes—receipts still hadn’t met the levels expected for fiscal 2012.

State officials can’t be blamed for failing to predict the global financial crisis or the recession that followed. But they assumed, in the sixth year of a national economic expansion, that the good times wouldn’t end.

Figure 5

Projected and Actual Receipts



Source: Office of Policy & Management; Office of the State Comptroller

The volatility of Connecticut’s PIT receipts stems in part from the nature of the activity being taxed.

Capital gains realized by residents, which are taxed as ordinary income, have fluctuated significantly in recent years. They have twice dropped more than 50 percent over two years, from 2000 to 2002 and 2007 to 2009. In fact, as of 2018, Connecticut residents had not yet reported capital gains that topped 2007 levels.

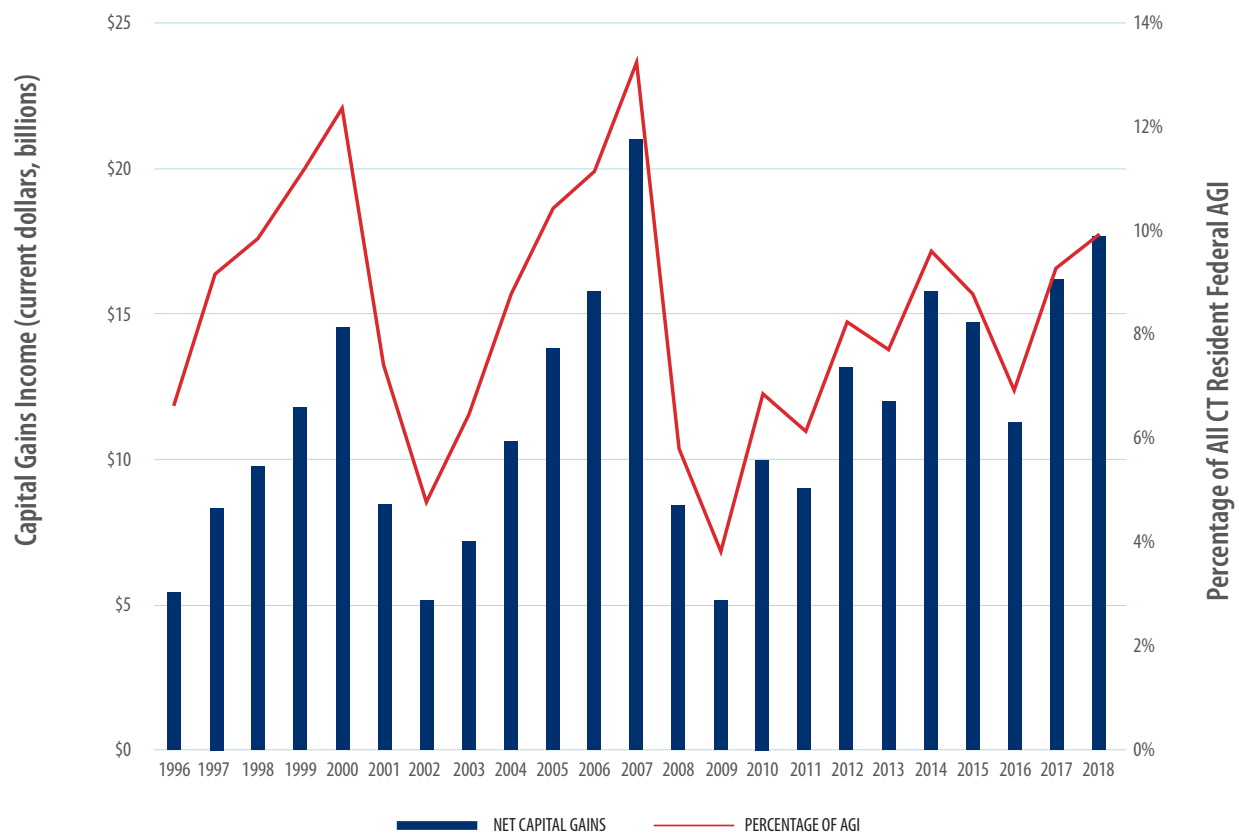
“The reality,” Governor Malloy said in 2017, “is that in Connecticut we get most of our money from very few people and that can produce some very wild swings.”³⁹

The sensitivity to capital gains is highest in Connecticut’s top tax bracket: between 2012 and 2018, Connecticut resident tax filers with federal adjusted gross income (AGI) \$1 million or greater received 26.3 percent of their income from capital gains (figure 6).⁴⁰

In fact, resident filers with federal AGI over \$1 million received more in 2018 from dividends, interest, and capital gains (\$20.4B) than in salaries and wages (\$16.9B).⁴¹ This is notable because increased reliance on higher-earners has made the state more dependent on the same volatile revenues the personal income tax was intended to avoid.

Figure 6

Capital Gains Income - Connecticut Residents



Source: IRS

Some volatility in Connecticut's PIT receipts stems from sensitivity to federal tax policy changes. The state Comptroller's office in 2019 noted a one-time surge in personal income tax receipts as hedge funds realized profits from overseas assets ahead of a December 2017 deadline and as some investments were held until lower federal tax rates took effect in January 2018.⁴²

State tax data suggest higher-earners have changed behavior in response to tax policy set in Hartford, too.

Individuals with residences in other states can curb their exposure to Connecticut's income tax by shifting their permanent residence elsewhere and limiting the time they spend in Connecticut. These non-residents and part-year residents then pay Connecticut income tax on only a portion of their income.

Connecticut in 1992—the first full year in which capital gains, dividends, and interest were treated as ordinary income—had 802 resident filers with AGI over \$2 million and 437 non-resident/part-year filers in the same bracket (figure 7). In both 1993 and 1994, amid a growing national economy, the number of resident filers over \$2 million slid while non-resident/part-year filers in the same range increased.

In fact, those 802 resident filers with AGI over \$2 million in 1992 had combined state AGI of almost \$4.6 billion. By 1994, the number of resident top-bracket filers dropped to 637 and their combined state AGI fell to \$3.4 billion—in a period when the AGI for all state income tax filers climbed from \$63.7 billion to \$65.1 billion. This was the first—but not last—indication that the state would induce behavior changes to shield earnings from the income tax.

Figure 7

CT Personal Income Tax Filers (AGI >\$2M)



Source: Dept. of Revenue Services

Those changes have been especially visible in recent years.

The number of income tax filers with AGI above \$2 million would have been expected to increase over the past decade, especially amid a booming stock market. However, the number of resident filers in that range has been almost flat. The number of non-resident/part-time filers with that income, on the other hand, jumped almost 55 percent from 2016 to 2019 alone.

In 1992, 64.7 percent of filers with AGI over \$2 million were residents, and 35.3 percent were non-resident/part-time filers. But in the decades that followed, the breakdown flipped, and in 2019, just 35.2 percent were Connecticut residents.

The number of resident filers in this top income range still hasn't recovered to pre-Great Recession levels.

Recommendations

Avoid further tax increases. Connecticut must break its cycle of leaning on volatile investment income. The deleterious effects on the state economy aside, the state cannot responsibly plan to spend money that can vanish with market downturns.

The increasing use of remote work presents Connecticut with both a threat and an opportunity. It is, for one thing, easier than ever for individuals and companies to relocate to and operate from states without income taxes.

At the same time, Connecticut's income tax rate could soon play a crucial role in deciding where some people work *each day*.

Connecticut residents employed by enterprises in other states generally pay those states' income taxes on their income even on days they work from home. Those payments, which totaled more than \$1.3 billion in 2018 just for residents working in New York, are credited against what would be Connecticut taxes on the same income.⁴³

But the U.S. Supreme Court may soon hear a challenge by New Hampshire over these rules, which could open the door to people paying Connecticut—and its lower rates—when they work from home. The more tax savings remote work would offer, the more of this \$1.3 billion would flow to Hartford instead of Albany.

Perform regular tax incidence reports. Since tax year 2011, Connecticut has further hiked income taxes and Congress has overhauled the federal tax system. State government must develop a more current read on the taxes it levies.

Require personal income tax increases to sunset. Connecticut can avoid further ratcheting of its income tax burden by amending the state Constitution to limit rate increases above the base rate to 24 months. Treating higher income tax rates as temporary measures will force governors and state legislators to be more cautious in their spending commitments and incentivize a flatter state income tax.

“The reality is that in Connecticut we get most of our money from very few people and that can produce some very wild swings.”⁴⁴

— Gov. Dannel Malloy, 2017

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- ³⁷ “Connecticut Tax Incidence,” CT Dept. of Revenue Services, Dec. 2014. <https://portal.ct.gov/-/media/DRS/Research/DRSTaxIncidenceReport2014pdf.pdf>
- ³⁸ Nov. 2007 Fiscal Accountability Report - <https://portal.ct.gov/-/media/OPM/Budget/FiscalAccountability/FiscalAccountabilityReport111507finalpdf.pdf>
- ³⁹ “Income tax revenue collapses; Malloy says taxing the rich doesn’t work,” WTNH, 28 Apr. 17, <http://www.wtnh.com/news/income-tax-revenue-collapses-malloy-says-taxing-the-rich-doesnt-work>
- ⁴⁰ Statistics of Income, “Table 2. Individual Income and Tax Data, by State,” IRS, 2012-2018.
- ⁴¹ Statistics of Income, “Table 2. Individual Income and Tax Data, by State,” IRS, 2018.
- ⁴² FY2018 CAFR, <https://www.osc.ct.gov/reports/CAFR-2018rev040919.pdf#page=43>
- ⁴³ NYS Dept. of Tax and Finance, 2018 <https://data.ny.gov/Government-Finance/Personal-Income-Tax-Filers-Summary-Dataset-1-Major/73iw-kuxv/data>
- ⁴⁴ “Income tax revenue collapses; Malloy says taxing the rich doesn’t work,” WTNH, 28 Apr. 17, <http://www.wtnh.com/news/income-tax-revenue-collapses-malloy-says-taxing-the-rich-doesnt-work>



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