How Does Connecticut Fare?

The estimated model fits the data well and provides a useful way to assess each state's tendency to spend more or less than predicted, based on their particular characteristics. Substituting each state's population, average income, and land area into the estimated model provides a predicted level of state and local spending. A state with actual spending above the level predicted for such a state could be wasteful or might simply have special features not accounted for by the model. Similarly, a state that spends less than predicted could be unusually efficient or possess features that the model omits. The graph summarizes this comparison of actual and predicted levels of total state and local government spending in each state.

Alaska's state and local public spending is almost 53% above the amount predicted for a state with its population, average income, and area. At the other extreme, New Hampshire spends about 23% less than the model predicts for such a state. The Granite State is one of only ten states that seem to be relatively more frugal than Connecticut. Our state and local spending in 1995-96 was 9.3% less than predicted for a state with almost 3.3 million residents, a 1995 per capita personal income of nearly $32,000, and 4,845 square miles of rocky turf. This translates into a total annual estimated "savings" of $2.03 billion, or about $620 per person. This outcome is all the more striking in the context of neighboring states' performance. New York, Rhode Island, and Massachusetts exceeded their predicted levels of public spending by about 36%, 20%, and 6%, respectively.

Some Caution

The ranking in the graph—from "overspenders" to "underspenders"—provides only a relative indicator of performance. Slack could remain in even the thriftiest public sector, but the ranking tells us nothing about that. Also, as noted before, a state with unique features that are omitted from the estimated model could be inaccurately ranked. Finally, dollar-based comparisons offer no direct information about the physical quantity and quality of public services—such comparisons would require much more information than is currently available. Yet, despite these and other more technical limitations, the model offers a better way of evaluating popular claims of government waste than simply looking at spending levels.

Criticizing Connecticut's state and local spending of $6,047 per person, more than 15% above the national average, may seem warranted until someone points out that the bulk of government spending involves direct or indirect payments for labor services, and per capita personal income in Connecticut exceeds the national average by more than 42%. Controlling for income, population size, and land area, Connecticut state and local government looks pretty lean and may be a contributor to the state's economic dominance rather than an economic burden.

State Income Tax Now Biggest Fiscal Horse

By William A. McEachern

As the 1990s began, the sales tax was the biggest fiscal horse in the barn, accounting for about half of all state tax revenue. That changed in 1991 when the new broad-based income tax was introduced. For better or worse, state government in Connecticut has hitched its wagon to the new income tax. As a result, the 1990s could be called the decade of the income tax. What's more, the new tax will likely dominate state finances in the next century. What does this horse-trade mean for Connecticut's future?

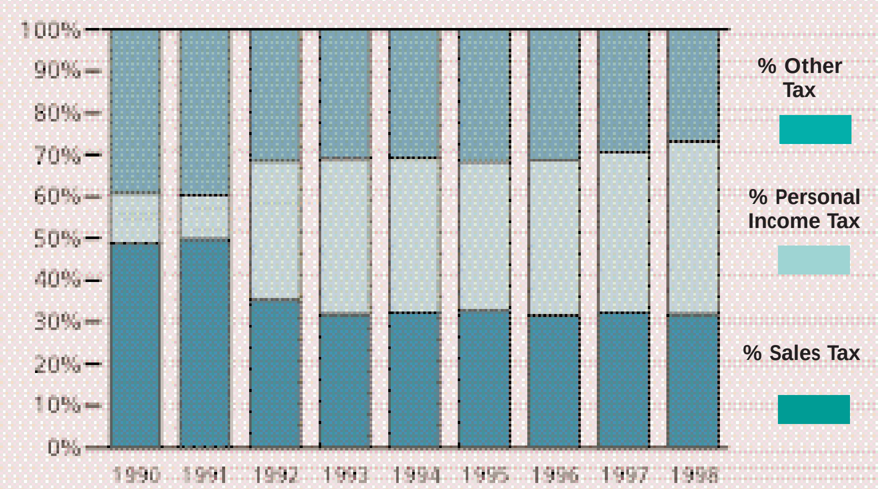
Profile of the 1990s

The accompanying bar chart shows the composition of state taxes in Connecticut by fiscal year during the 1990s. Since the state broadened the base of the income tax, that tax has captured a growing share of tax revenue, increasing from 33.3% in 1992 to 41.2% in 1998. Meanwhile, the sales tax share dropped from 35.1% in 1992 to 31.8% in 1998.

The share of other taxes as a group dwindled from 31.6% of the total in 1992 to 27.0% in 1998. These other taxes declined because of some tax cuts and some unresponsive tax bases. For example, to promote a more competitive, business-friendly climate, lawmakers cut corporate tax rates from 11.5% in 1994 to 7.5% by 2000. And to discourage retirees from moving out of state, lawmakers are phasing out the inheritance tax. Finally, revenues from taxes on cigarettes and motor fuels lag growth in the economy.

What about non-tax sources of revenue? Gambling revenue increased during the 1990s, but only because of the slot-machine agreement with the casinos. Other gambling revenues, such as lottery receipts, have been virtually flat for the last dozen years. Despite the growth of slot revenues, this source still accounts for less than 3% of all state revenue and can hardly be viewed as a revenue engine for the new century. One month's data may not mean much, but slot receipts from Foxwoods in March were virtually unchanged from March 1998, suggesting a possible slowing of this cash machine.

Composition of State Taxes in Connecticut By Fiscal Year



Source: Developed by *The Connecticut Economy* based on data from the Connecticut General Assembly's Office of Fiscal Analysis.

E-Commerce and the Sales Tax

The sales tax, or more officially, the "sales and use tax," will diminish in importance in the new century as e-commerce grows. The U.S. Supreme Court has ruled that sellers do not have to collect the tax if they do not have a significant "physical presence" in the state. Thus most who sell via mail-order catalogs, telephones, or the Internet are not obliged to collect taxes for the state.

Catalog sales have nagged tax officials for decades, but e-commerce is the real threat to the sales tax base. On-line sellers escape the overhead involved with a physical presence and thus have a competitive price advantage over local merchants from the get-go. The absence of a sales tax boosts this advantage. For example, a Connecticut merchant who sells the video *Titanic* for the list price of $29.99 will charge $31.78 after the sales tax. In contrast, Amazon.com sells the video over the Internet for $17.99 plus $3.95 shipping, for a total of $21.94, or about one-third below the in-store list price. A University of Chicago economist argues that the absence of a sales tax accounts for at least one quarter of Internet sales.

Connecticut residents who purchase on-line are still liable for Connecticut's 6% sales and use tax. Revenue officials try to collect the tax through the only direct contact they have with most state residents—the state income tax return. As you may have noticed, that return includes an "Individual Use Tax Worksheet" warning residents: "If you purchased taxable goods or services for use in Connecticut during the calendar year and a Connecticut or out-of-state merchant failed to collect Connecticut sales tax, you must pay the Connecticut use tax." Despite the worksheet and the warning, the state collected under $1 million from the use tax in 1997, implying that residents spent only $15.4 million on goods subject to the use tax, or just $12 per filer. In contrast, actual sales tax receipts imply that filers that year spent an average of about $36,000 per return on taxable items. The tiny use tax number combined with the ubiquity of UPS trucks in the state suggest that many residents are not "'fess'n up" to their share of the use tax.

The exploding on-line commerce will erode the sales tax base for years to come, especially in Connecticut, one of the most "wired" states in the country. Residents here have the income and the computer links to lead the nation in on-line shopping. On-line sellers such as eBay and Amazon.com have huge stock market values based on the promise of this sales channel. Ebay, an on-line auction house, has a capitalized value of about $23 billion—three times the value of K-mart. Amazon.com is also worth $23 billion—more than ten times that of Barnes & Noble. Granted, most Internet stocks seem to be encased in a speculative stock market bubble, but nobody doubts that on-line sales are going nowhere but up.

Married to the Income Tax

For better or worse, Connecticut has married its public finances to the state income tax. But that tax base has been narrowed by recent legislation. Because of generous exemptions for low income filers combined with property tax credits, especially for low and middle income groups, a growing share of all filers escape the tax altogether.

Exemptions and credits at the lower end of the income distribution combined with the bull run on Wall Street have boosted the share of the tax paid by the high end. For example, the number of Connecticut filers reporting an adjusted gross income in excess of $2 million increased from 802 in 1992 to 1,945 in 1997, a jump of 143%. State income taxes paid by this top group climbed from $144.9 million in 1992 to $401.9 million in 1997, a growth of 177%. These high rollers, who account for only 1 of every 657 filers, paid more state income taxes in 1997 than the bottom two thirds of all tax filers combined. Thus high-income filers pay the overwhelming share of the tax. (For more on the distribution of the tax burden, see my "Straws in the Wind" on page 18.)

Although most low-income filers pay little or no state income tax, *The Connecticut Economy's* April poll found the least support for the tax among this low-income group. Among those with incomes below $30,000, 41% favor the current income tax and 49% oppose it. Among those reporting income above $100,000, 64% favor the tax and 33% oppose it.

Overall, 46% of the 500 residents polled favor the income tax and 48% oppose it. Time has softened opposition to the tax, however. In 1992, the year when Connecticut residents filed their first state income tax return, 31% of the 500 state residents polled favored the tax and 66% opposed it. So back then, the opposition held a two-to-one edge. Now it's a toss-up.

Path of Least Resistance

Since 1992 income taxes have grown at an annual rate of 10.5%—more than twice the 4.9% rate for the sales tax and the 3.9% rate for other taxes. If this growth continued, the income tax would account for about 70% of all tax revenue by 2018.

Since the income tax was first introduced, lawmakers have exempted a growing fraction of lower income filers from the tax through a combination of lower rates, broadened exemptions, and property tax credits. There are plans to expand the exemptions and credits. The bottom half of filers based on adjusted gross income paid only 5.8% of all state income taxes collected in 1997 (down from 7.6% in 1995). They will pay even less of this tax in the future.

Given the growing importance of the income tax in the fiscal system, what are the implications of having that tax paid primarily by a small subset of the population? Will voters eventually realize this and be more inclined to support increases in state spending because the burden falls primarily on others? Also, it's great fun cutting taxes during good times, but will the resulting erosion of the tax base come back to haunt us when the music stops and Wall Street turns bearish?