MUNICIPAL REVENUE DIVERSIFICATION- LOCAL SALES TAX POLICY PROPOSAL

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Contents

Policy Proposal: Municipal Revenue Diversification- Local Revenue Through Sales Tax

Executive Summary

Providing municipal governments in Connecticut with a new source of local revenue would help address the longstanding challenge of being overly reliant on local property taxes as the primary funding mechanism for addressing the diverse array of needs facing towns and cities across our State. This paper was drafted in response to issues faced in Stonington, largely driven by the significant pull on local resources from tourism; however, the proposal would benefit all municipalities.

There are several approaches that enable municipal governments to generate revenue from sales tax employed by other States, which include, but are not limited to: allowing local sales taxes set by the local government; distributing State sales tax revenue based on local population; distributing a fraction of State sales tax revenue based on where it was generated; and distributing a portion of State sales tax based on a combination of population and revenue generation.

Introduction

Connecticut has a state-wide 6.35% sales tax on most retail goods, while certain luxury goods are taxed at a higher rate. These include prepared meals and beverages, which are taxed at a rate of 7.35%, and clothing and accessories exceeding $1,000 in value, which are taxed at a rate of 7.75%. In addition, Connecticut uses a room occupancy tax for short-term lodging, which is set at 15% for hotels and short-term rentals, and 11% for bed-and-breakfasts. In Connecticut, local governments are unable to impose additional sales tax, leaving them largely dependent on property taxes. This is problematic for several reasons, one of which being that this tax is only paid by residents, leaving them with the burden of paying the total cost of roads, public safety, sewer infrastructure, and other public works that are also used by nonresidents. Connecticut's per capita property tax burden is $3,215, while the national average is $1,758. Connecticut has the 3rd highest per capita property tax in the nation. This burden has continued to rise, placing more burden on residential and business taxpayers. [1]

Connecticut currently distributes sales tax revenue to municipalities through the Municipal Revenue Sharing Fund (MRSF). This fund's purpose is to fund motor vehicle tax grants to municipalities, payment in lieu of taxes (PILOT) grants to cover lost property tax revenue on State and Federally owned land, and municipal revenue sharing grants[2]. The State allocates 10

[1] CCM 2022 Issues Bulletin

[2] Connecticut General Assembly Office of Legislative Research

million dollars from the MRSF each year for grants[3], representing 1.3% of in-state generated sales tax revenue. These grants are allocated based on each Town's population and mill rate.

The Stonington Example

This is especially challenging in towns with high amounts of tourism, such as Stonington, CT. Stonington is home to popular tourist destinations such as the Mystic Aquarium and Mystic Seaport, which bring over 1,000,000 visitors annually[4]. Significant portions of the Town budget are spent on areas that benefit residents and tourists alike, such as public works (10.71%), police (9.11%), and capital improvements (5.62%). Despite the local economy being significantly driven by tourism, the overwhelming majority of Stonington's Town budget (85.98%) is funded through taxes only paid by local residents[5]. While ranking 63rd out of 169 Towns in the State in population[6], Stonington ranks 36th in sales tax revenue generated[7], contributing over $32 million dollars of state sales tax in FY2022-23. This equates to Stonington contributing roughly 1.75 times its share of sales taxes to the State relative to its population. This discrepancy can, in part, be attributed to Stonington's significant tourist activity. The disparity between Stonington's population and revenue generated is even greater in the 7.35% and 7.75% sales tax categories, where Stonington ranks 13th out of all the towns in the state. In these brackets, Stonington's proportion of sales tax revenue is 3.4 times its share of the state population.

With the existing MRSF distribution in place, in 2023, Stonington received $214,297 in revenue sharing grants.

Unfunded State Mandates

Tourism is not the only reason municipalities are increasingly looking for revenue streams beyond local property taxes. The need to generate additional municipal revenue is, in part, due to an influx of mandates from the State that have not been matched with appropriate funding for execution. According to a CCM report[8], the state has imposed over 1,300 mandates onto municipalities. The majority of these are unfunded or underfunded. By reallocating a portion of the State sales tax to municipal governments, or allowing for an additional local sales tax, the State could offset some of the costs of these mandates, reducing the burden on local property owners.

Sales Tax Policy- A Look in Other States

In the immediate neighboring region, both Rhode Island and Massachusetts have similar tax policies to Connecticut. Both states impose a statewide sales tax (7% and 6.25% respectively), but do provide a percentage of sales tax revenue to go back to municipalities. In Rhode Island, there is an additional 1% local tax on meals and beverages and an additional 6% hotel and

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[3] C.G.S. Section 4-66p
[4] Stonington Economic Development Commission
[5] Stonington Town Budget for Fiscal Year 2024-2025
[6] Connecticut Cities by Population
[7] Connecticut Sales and Use Tax Data
[8] CCM 2022 Issues Bulletin

lodging tax[9]. In Massachusetts, there is a local option to add a 0.75% tax on prepared meals[10], and up to 6% on lodging. For certain tourist communities such as Nantucket, the State allows an additional 2.75% local lodging tax[11]. New York allows counties to impose a sales tax of up to 4.875% with approval from the State Legislature on top of the statewide 4% sales tax, which they can distribute to municipalities.

In all, thirty-eight states permit local sales taxes. These states allow municipal governments to set sales tax rates they deem appropriate within limits set by the legislature, which in many cases must approve the rate set by each local government. This allows Towns and Cities to determine the balance between sales and property taxes as their sources of funding, and set policies they consider favorable to residents and/or businesses. However, given the variable tax rate, this can be difficult to administer and creates an economic incentive for businesses to locate themselves according to local tax laws. This creates competition between municipal governments within the State.

Alternatively, some States choose to distribute a fraction of sales tax revenue to local governments based on population. For example, Illinois distributes about 16% of State sales tax revenue to municipalities as unrestricted aid based on their population[12]. The rationale and benefit behind this approach is that it funds all citizens equally, and does not tie municipalities' state aid to the socioeconomic status of residents and visitors. However, this approach fails to appropriately compensate tourist destinations for the additional strain on public services generated by tourism.

Finally, three states provide municipal governments with a percentage of sales generated within their jurisdiction that is set by the State legislature and is constant throughout the State. This is referred to as a uniform local tax. California, Virginia, and Utah each impose a uniform local sales tax of 1% (Virginia) or 1.25% (California and Utah)[13]. Of note, each of these states allow municipal governments to impose additional sales taxes beyond the uniform rate.

Similar to this approach, several states earmark a percentage of their sales tax revenue to the municipal government of the location it was generated in, which is known as a situs-based distribution. Some states limit this to revenue generated from specific sales tax sources, such as liquor and cannabis sales, and others use this to distribute revenue from general sales taxes.

Advocacy Surrounding Local Sales Tax in Connecticut

In 2017, the Connecticut Conference of Municipalities (CCM), supported implementing a uniform local sales tax of 1% in the State, as well as allowing municipalities to impose an additional 0.25% general sales tax and 1% meals and lodging. In this proposal, the State would

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[9] Rhode Island Division of Taxation
[10] Massachusetts Department of Revenue – Sales Tax on Meals
[11] Massachusetts Department of Revenue – State and Local Room Occupancy Excise Rates and Fees
[12] Lincoln Institute – How States Provide Cities with General Revenue: An Analysis of Unrestricted State Aid
[13] Tax Foundation – State and Local Sales Tax Rates, 2024

reduce its sales tax to 6% or less, creating an effective 7% statewide sales tax before any additional local taxes are imposed. This recommendation was made citing high property taxes compared to the rest of the country, and a need for municipal revenue diversification. Along with other local officials, this proposal was supported by the former Mayor of Danbury and current Commissioner of the Department of Revenue Services- Mark Boughton, who believed it could help municipalities decrease property taxes for residents[14]. Several academic papers have supported similar proposals to institute a local sales tax in Connecticut and consider lowering the State sales tax rate to offset the local tax.

Policy Recommendation

After going through the possible approaches the State of Connecticut could use to provide municipalities with sales tax revenue, the following proposal is being put forward for discussion and feedback, in hopes that a proposal could be put forward for the 2025 CGA Session.

Distributing sales tax revenue based on a combination of population and location of origin. This approach would use an allocation formula that would consider a town's population and revenue generated in determining the allocation of sales tax. This could allow towns that are impacted by tourism to receive funding based on the significant number of visitors each year, while also providing adequate funding to towns with higher populations. It also does not impose a new, additional tax on businesses. While deeper analysis is needed to understand the impact on the State's budget and how existing services and programs could be impacted, the additional funding would certainly be welcomed by municipalities and help get Connecticut into a better nation-wide ranking when it comes to property taxes. To show an example of possible local impact, if the formula was 70% of funding based on tax revenue going to the town it was generated in, and 30% being distributed based on population, Stonington's allocation potential can be seen below.

Projected Revenue for the Town of Stonington by Method of Allocation (FY2022-23 in-State generated sales tax):

Percentage of Gross Sales	**Hybrid** (Approach 4)
0.25%	$1,625,816.67
0.50%	$3,251,633.35
0.75%	$4,877,450.02
1.00%	$6,503,266.69

Another approach, if it was determined that the impact of all Sales Tax was too high, could be to only allow local revenue from sales tax on specific categories such as meals and lodging.

[14] Connecticut Conference of Municipalities – This Report is Different