

DEFAC ADVISORY COUNCIL ON REVENUES

Summary of Final Report

The Report's Origins:

An emerging consensus regarding Delaware's revenue portfolio

Macro - Trends

- Slow pace of economic recovery
- Demographic Shifts
- Persistent demand for public services

Delaware Specific Concerns

- Too many revenue sources that don't grow with the economy
- Volatile & unpredictable revenue sources
- Regional gaming competition
- Escheat – controversial enforcement regime
- Past reliance on “silver bullets”

Executive Order No. 47

- Created DEFAC Advisory Council on Revenues
- Evaluate revenues sources according to whether they are:
 1. Sufficiently responsive to economic growth,
 2. Too volatile, and
 3. Economically competitive.
- Report to the Governor, DEFAC and General Assembly

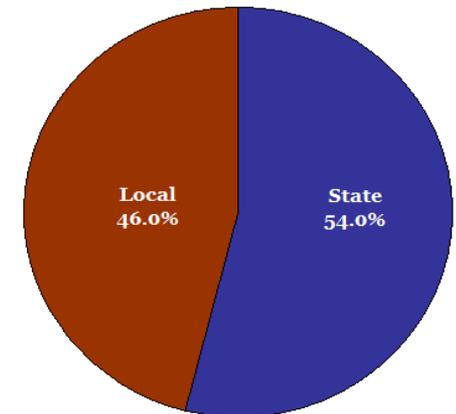
Delaware's revenue system: Centralized and Unique

Distinctive Structure

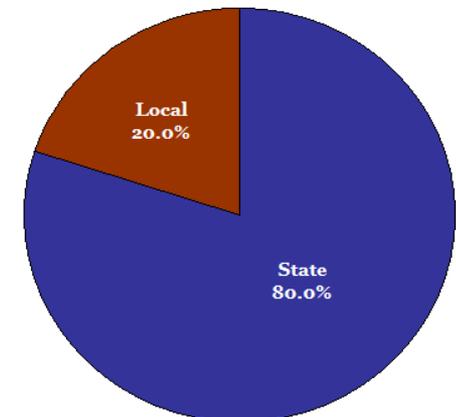
- No Retail Sales Tax
- Low Property Taxes
- Home of Incorporations
- “Silver Bullets”
 - Financial Center Development Act
 - Casino Gaming Revenues
 - Unclaimed Property Revenues

Centralized Revenues

- Average for all States:

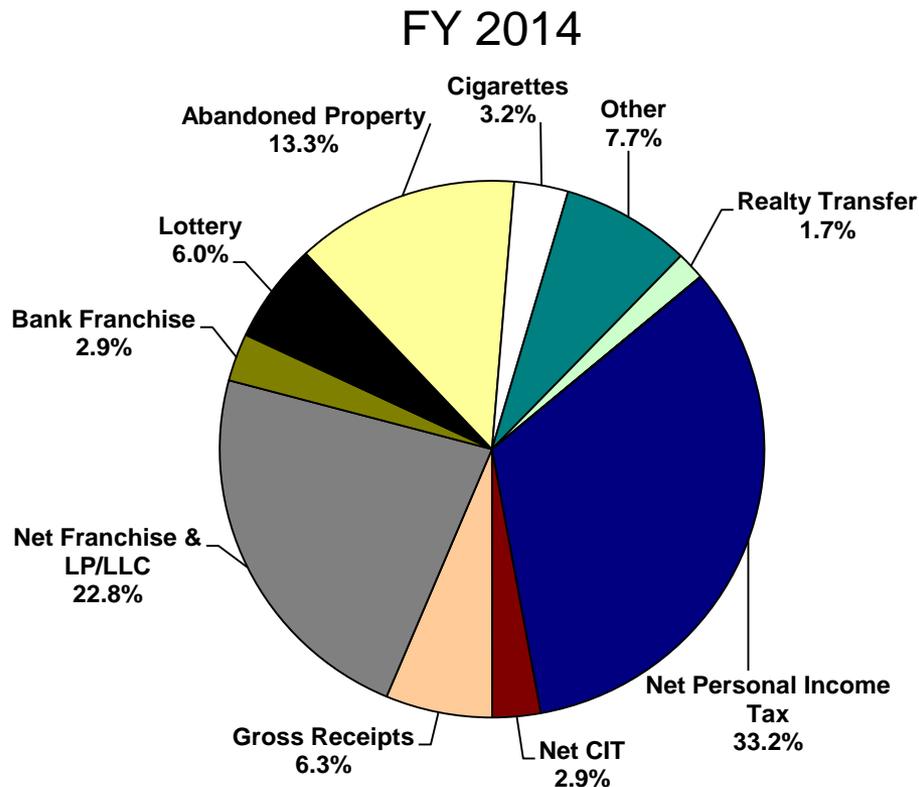


- Delaware:



Doubly Narrow Revenue Structure

Few Major Sources



Statutory Provisions

- Personal Income Tax
 - Itemized deductions
 - Generous senior tax breaks
 - Features not found in all states
 - Limits growth potential

The Council's Portfolio Perspective

Vary Revenue Streams

- **Balanced portfolio**
- **Primary, secondary, and tertiary sources**
- **Complementary structures**
 - Growth potential
 - Stability
 - Competitiveness

Broader Tax Bases

- **Broad base + lower rate**
 - Adds responsiveness
 - Less volatility
 - More competitive
- **Narrow-base + high rate**
 - Adds responsiveness
 - More volatility
 - Less competitive

The Council's Portfolio Conclusions

- Overall, Delaware's revenue portfolio has difficulty keeping pace with the economy.
- Past emphasis on “silver bullets” has allowed Delaware to avoid “routine maintenance” on its core revenue sources.
- Current silver bullets have peaked and are unlikely to rebound.
- Sensible change to core revenues is the most reliable means of improving Delaware's portfolio.
- Changes to improve portfolio should be considered under the constraint of Revenue Neutrality

Primary Source: Personal Income Tax

- Largest revenue source
- Historically, good marks on responsiveness, volatility and competitiveness
- Responsiveness is increasingly challenged by erosion of tax base due to statutory exemptions
- For entire portfolio to keep pace with expenditure pressures, it is critical that PIT remains responsive.
- Focus on tax base
 - Itemized Deductions
 - Elderly tax breaks
 - Means-testing

Primary Source: Personal Income Tax

Scope of senior tax breaks

Personal Income Tax Liability Comparison: Two \$80,000 Income Households

	<u>Working-Age Family of Four</u>		<u>Retired Couple</u>	
	First Spouse	Second Spouse	First Spouse	Second Spouse
Wages	\$40,000	\$40,000	\$0	\$0
Retirement Income	-	-	26,000	26,000
Social Security	-	-	14,000	14,000
Total Income	\$40,000	\$40,000	\$40,000	\$40,000
Exclusions				
Retirement Income (Age 60+)	-	-	(12,500)	(12,500)
Social Security (Age 62+)	-	-	(14,000)	(14,000)
Delaware AGI	\$40,000	\$40,000	\$13,500	\$13,500
Standard Deduction	(3,250)	(3,250)	(3,250)	(3,250)
Additional Std Deduction Age 65+	-	-	(2,500)	(2,500)
Taxable Income	\$36,750	\$36,750	\$7,750	\$7,750
Gross Tax Liability (Before Credits)	\$1,653	\$1,653	\$173	\$173
Personal Credits (\$110 per person)	(330)	(110)	(110)	(110)
Additional Personal Credit Age 60+	0	0	(110)	(110)
Child Care Credit	-	(250)	-	-
Net Liability	\$1,323	\$1,293	\$0	\$0
Total Household Liability	<u>\$2,616</u>		<u>\$0</u>	

Primary Source: Incorporation Revenues

Summary

- Responsiveness: Tax structure requires periodic increases to keep pace with economy.
- Volatility: Among least volatile sources.
- Competitiveness: Delaware brand still commands a premium.

Looking Ahead

- Growth strategy: Increase market share through innovation.
- New product offerings
- Tax Rates: Consult with legal and corporate service communities regarding timing and form of adjustments.

Secondary Source: Business Taxes

Gross Receipts and Corporate Income Taxes

Summary

- **Corporate Income**
 - Reasonably responsive
 - Highly volatile, unpredictable
 - Uncompetitive
 - Outdated apportionment
 - High tax rate
- **Gross Receipts**
 - Responsive & stable
 - Competitiveness – optics of a unique structure

Looking Ahead

- **Reducing reliance on CIT**
 - More weight on sales factor
 - Lower tax rate
 - Even quarterly payments
- **Offset with increased reliance on GRT**
- **Maintains responsiveness**
- **Reduces volatility**
- **Increases competitiveness**

Secondary Source: Abandoned Property

Summary

- Responsiveness:
Disconnected from economic growth
- Volatility: Unpredictable & subject to timing of enforcement settlements, stock sales
- High growth rate in past decade masked lack other sources' responsiveness

Looking Ahead

- Deferred to Unclaimed Property Taskforce
- Recognized flat or declining outlook
- Reinforced conclusion that core revenues' responsiveness need to be strengthened

Tertiary Sources

Summary

- Lottery
 - Regional gaming competition limits responsiveness
- Bank Franchise Tax
 - Lack of responsiveness
- Estate Tax
 - Volatile with minimal revenue
 - Competitiveness concerns
- Realty Transfer Tax
 - Basis of revenue split with local governments

Looking Ahead

- Defer to Lottery & Gaming Study Commission
- Lack of Bank Franchise responsiveness acceptable trade-off for economic competitiveness
- Eliminate Estate Tax
- Change Realty Transfer Tax split

Secondary Source: New Revenues Streams

- Recognized lack of strong second tier revenue sources
 - Lottery and Unclaimed Property ebbing
- Longer-term: Need for better balance at this level in portfolio
- Property Tax is candidate
- Untapped source: Delaware has among lowest burdened in the nation.
- With modern assessment practices, broad-base should ensure responsive and stable revenue stream.

Prudent Fiscal Controls

Summary

- Current fiscal “regulators” (98% rule, Rainy Day Fund) offer protection during downturns.
- Regulators needed for top of business cycle
 - Unexpected surpluses
 - One-time revenues
 - Prudent spending
 - Strengthen State’s balance sheet

Looking Ahead

- Consider additional regulators
 - New mechanism should complement but not replace rainy day fund.
 - Budgetary smoothing fund to store excess revenues and/or
 - Focus on reducing foreseeable liabilities
- Examine other state examples

An Example Revenue Reform Package

Revenue Change vs. Current Outlook

Example of Revenue Neutral Approach

(Millions)

Item	<u>FY 2015</u>	<u>FY 2016</u>	<u>FY 2017</u>	<u>FY 2018</u>	<u>FY 2019</u>	<u>FY 2020</u>
Business Taxes						
1 CIT -- Even quarterly payments (Timing change only)	\$0.0	(\$20.0)	\$0.0	\$0.0	\$0.0	\$0.0
2 CIT -- Double Weight Sales Factor + Rate Cut to 7.7%	\$0.0	(\$4.9)	(\$29.2)	(\$30.6)	(\$32.1)	(\$33.7)
GRT -- 12.73% Across-the-Board Rate Hike (Revenue Neutral FY 17)	<u>\$0.0</u>	<u>\$10.5</u>	<u>\$29.2</u>	<u>\$30.5</u>	<u>\$31.9</u>	<u>\$33.3</u>
Subtotal -- Business Taxes	\$0.0	(\$14.4)	\$0.1	(\$0.1)	(\$0.2)	(\$0.4)
Personal Income Tax						
3(a) Eliminate Itemized Deduction + Approx 9% Across-the-Board Rate Cut (Revenue Neutral for CY 16)	\$0.0	(\$6.6)	\$4.3	\$8.1	\$15.0	\$24.6
3(b) Eliminate Itemized Deductions + Approx 12.4% Across-the-Board Rate Cut + Single Means-tested Exemption for Seniors + Annual increase in eligibility age from 60 to 65. (Revenue Neutral for CY 16)	\$0.0	\$0.0	\$37.3	\$42.1	\$47.1	\$52.6
4 Estate Tax -- Eliminate	\$0.0	(\$1.0)	(\$4.0)	(\$4.0)	(\$4.0)	(\$4.0)
Total -- Using Personal Income Tax Option 3(a)	\$0.0	(\$22.0)	\$0.4	\$4.1	\$10.8	\$20.2
Total -- Using Personal Income Tax Option 3(b)	\$0.0	(\$15.4)	\$33.4	\$38.0	\$42.9	\$48.2