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## **FINAL REPORT OF THE DEFAC ADVISORY COUNCIL ON REVENUES**

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ESTABLISHED UNDER THE PROVISIONS OF  
EXECUTIVE ORDER NO. 47

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## EXECUTIVE SUMMARY

The long-term health of Delaware's budget is threatened by revenue challenges in the face of consistent expenditure pressures. Delaware is not the only state facing challenges related to the aging of our nation's workforce amidst a slow economic expansion. Yet overall, Delaware's revenue portfolio has not responded to broader economic growth, and it contains certain revenue sources that are volatile and others that could be more competitive.

Delaware's track record of exporting tax burdens has served Delawareans well in past times of need. As each "silver bullet" is spent, however, it becomes more difficult to avoid structural revenue reform. Delaware's existing tax structure is doubly narrow: individual tax bases are defined narrowly, and revenue is heavily generated by just two sources. It is within this context that the Delaware Economic and Financial Advisory Council's ("DEFAC") Advisory Council on Revenues (the "Council") evaluated the responsiveness, volatility, and competitiveness of the various elements that make up Delaware's revenue portfolio.

The Council's recommendations should be considered in their entirety as a "framework." Implementing the Council's recommendations in a piecemeal fashion may improve the portfolio's performance on some of the Council's criteria but have negative or no effect on other portfolio measures. Many of the Council's recommendations should be phased in so as to prevent shock changes to businesses' and individual's legitimate tax-planning decisions. Still other recommendations are intended to be considered over the long-term, pending broader policy review.

The Council expresses no view on the absolute level of revenues appropriate to meet Delaware's service-level needs. Council members agreed to craft their recommendations to be revenue neutral in the first full year of implementation—aware

that changes to the revenue portfolio could affect future levels of expenditure, and mindful that the Council's work and recommendations are advisory to the General Assembly's decision-making authority.

Ultimately, it is for policymakers to determine the appropriate amount of revenues and service levels. The Council's recommendations can provide guidance regarding how best to construct a portfolio of revenues that will demonstrate better economic responsiveness, lower volatility, and superior interstate competitiveness relative to Delaware's current portfolio.

### **Recommendations for Delaware's Revenue Portfolio**

The following recommendations represent the Council's consensus on each respective topic and are not necessarily the conclusions of each individual Council member.

- *Personal Income Tax*: Broadening the Personal Income Tax base would improve the portfolio's responsiveness without increasing volatility or reducing competitiveness. The Council recommends base broadening via the elimination of itemized deductions and a scaling back of elderly tax preferences. The latter should come by phasing-in higher eligibility ages for certain provisions, means-testing, or a combination of both approaches. Base broadening would be achieved in a revenue-neutral fashion by simultaneously reducing tax rates.
- *Corporate Franchise Taxes and Fees*: The Council recommends continuing to focus on Delaware's Corporate Franchise brand. Emphasis should be on growing Delaware's market share and the number of services offered. Further, the Council recommends that the Secretary of State's Office endorse changes to the State's franchise tax levels when doing so is deemed prudent.

- *Corporate Income Tax*: Structural elements within Delaware's Corporate Income Tax increase volatility and reduce competitiveness. Reduced volatility can be achieved at a one-time cost by evening out the distribution of quarterly-estimated payments made on corporate profits. Competitive gains could be made by modifying the framework under which multi-state firms assign portions of their profits to Delaware and by reducing the Corporate Income Tax rate.
- *Gross Receipts Tax*: History has shown the Gross Receipts Tax to be consistent and responsive, with fewer competitive concerns than the Corporate Income Tax. Relatively modest rate hikes across each category of business licenses would be designed to neutralize the decreased revenues that follow from the Corporate Income Tax recommendations.
- *Bank Franchise Tax*: The Council assessed the Bank Franchise Tax largely based on the value it provides Delaware as an economic development tool. While small changes that could increase responsiveness were discussed, the Council makes no recommendations, so as to avoid undermining the Bank Franchise Tax's ability to attract and keep banking jobs in Delaware.
- *Lottery*: Lottery revenues have been largely disconnected from macro-economic factors in recent years, are affected by an explosion in regional competition, and show consistent decline. The Lottery and Gaming Study Commission's recommendations intended to stabilize Delaware's casino industry would reduce General Fund revenues derived from the Lottery even further. The Council offers no recommendations for changes to the Lottery but is aware that this revenue source will likely continue to wane.

- *Abandoned Property:* Volatility and legal controversy, coupled with unsustainable historic growth, suggest Abandoned Property will generate less revenue for Delaware in the long term. The Unclaimed Property Taskforce's recommendations seek to improve the fairness, efficiency, and predictability of Delaware's Abandoned Property laws for holders while stabilizing the revenue source for the State. The Council offers no recommendations for Abandoned Property; its proposals are designed to counterbalance the projected erosion of Abandoned Property revenues.
- *Estate Tax:* The Estate Tax is volatile, unresponsive to the economy, and puts Delaware at a competitive disadvantage. Due to concerns about the Estate Tax's negative influence on revenues from the Personal Income Tax, the Council recommends repealing the Estate Tax and replacing the revenue it generates via a small increase in the Personal Income Tax.
- *Property Tax:* A Property Tax would likely be the best available revenue source on which to place greater emphasis as an alternative to less responsive, more volatile sources of revenue. State-level property values are typically correlated with many of the cost-drivers associated with state government, and property values typically exhibit less volatility relative to other tax bases. Given that Delaware's current assessment levels and practices are inconsistent and largely out-of-date, greater reliance on a Property Tax should include the upfront investment of a statewide reassessment. The Council considered the addition of a Property Tax in conjunction with further competitive improvements to the Corporate Income Tax, but discussion was neither in-depth nor united enough to justify a recommendation. The Council also gave consideration to possible

changes by which counties would enjoy more authority for policy as well as the responsibility for funding same. Under the current system, the State provides for the dramatic bulk of services.

- *Fiscal Controls:* Delaware is known as a state that takes prudent budgetary precaution in preparing for potential economic downturns. This reputation is built upon fiscal restraints such as the 98% appropriation rule, the Budget Reserve Account, and a sensible aversion to the use of “rainy day” funds in non-emergency situations. An explicit control of unexpected surpluses would keep unforeseeably strong revenue growth or one-time revenues from expanding expenditures unsustainably. The Council suggests applying definitions of “extraordinary revenues” similar to those used in other states, and implementing a fiscal control which requires that a portion of unexpected surpluses be spent on foreseeable future liabilities and/or held in a budgetary “smoothing account” to be applied to operating deficits during downward swings of business cycles.

## INTRODUCTION

The Council was created at the request of various members of DEFAC by Governor Jack Markell via Executive Order No. 47. The Council was charged with assessing Delaware's revenue portfolio and individual revenue sources, particularly in terms of their responsiveness to economic growth, their volatility over time, and their competitiveness relative to other states. The Executive Order required that the Council's findings and recommendations for alterations to Delaware's revenue portfolio be presented to DEFAC, the Governor, and the General Assembly. This Report is submitted in fulfillment of Executive Order No. 47's requirements.

This Report does not directly address many related issues outside of Executive Order No. 47. Topics that are not addressed include the fairness, simplicity, and neutrality of Delaware's revenue structure. Similarly, the Council generally avoided discussion of whether Delaware's expenditures could be made more efficient, whether certain expenditures categories were necessary, and the appropriate levels of expenditure. Council members noted the importance of examining both revenues and expenditures, but the Council focused only on the former, given that its mandate from Executive Order No. 47 did not include an analysis of expenditures.

This Report does offer one set of recommendations not directly in line with the mandate of Executive Order No. 47. In studying the forty-year history of Delaware's current revenue portfolio, a great deal of discussion focused on elasticity problems resulting from periods of economic downturn during which revenue "silver bullets" were added to Delaware's core revenues. The Council observed that Delaware's 98% budgetary test (designed to limit current expenditures to current revenues) has also permitted total revenues to grow at a rate beyond that of core revenues. This relatively higher growth in total revenues has exacerbated the tax base's lack of economic responsiveness, given



that over time various “silver bullet” revenues have peaked and begun to decline. On the basis of this observation, the Council has formed a strong desire for Delaware policymakers to explore fiscal controls to modify the 98% budgetary test and limit the growth of spending to a rate more consistent with core revenue growth. Several examples of such measures are included in this Report.

The Report is divided into two sections. The first section presents the Council’s findings as measured by the responsiveness, volatility, and economic competitiveness of Delaware’s revenue portfolio. The first section also addresses potential new sources of revenue. The second section presents a revenue-neutral, consensus proposal for how the General Assembly could adjust Delaware’s revenue portfolio to be more economically responsive, less volatile, and more competitive. The second section also discusses fiscal controls that, if adopted, would establish a default link between spending and core revenue performance.

## **FRAMEWORK AND CONTEXT**

The Council’s deliberations began with the premise in Executive Order No. 47 that Delaware’s revenue portfolio is disconnected from economic growth and, as a result, generates revenue inconsistently. Concern was voiced with the practice of defining elasticity in terms of personal income growth. Several Council discussions focused on the need to choose a target rate of growth for the revenue portfolio and define elasticity in terms of that target rate. Although the Council did not adopt an explicit target for spending, there was broad consensus that any revenue system should aim to achieve a growth rate consistent with the sum of two figures: the inflation rate for providing government-based goods and services, and the growth rate of Delaware’s population. Moreover, the Council agreed to forego any conclusions as to the appropriate absolute levels of both revenues and growth; those choices are for policymakers to determine and are outside the scope of this Report and the Council’s mandate.

The Council focused on the fact that Delaware’s existing tax structures are “doubly narrowed.” In the first instance, there is a heavy reliance on two large, dependable revenue sources, with the balance of Delaware’s revenues coming from sources that either are a small percentage of total revenues or are relatively volatile. In the second instance, the Council noticed an observable narrowing of the tax base across many revenue sources over time. In order to address these concerns, the Council has articulated a two-fold strategy of (1) broadening Delaware’s largest, most responsive, and consistent revenue streams (Personal Income Tax and Corporate Franchise Taxes and Fees) and (2) developing a stable and diversified second tier of revenue streams to support Delaware’s primary sources. In short, the Council intends for Delaware to continue to garner the majority of its revenues from its two “star” revenue sources while also developing a stronger, more stable “supporting cast.” The Council also urges that consideration be given to deepening and narrowing Delaware’s “revenue bench” over the longer term.

The foregoing framework as well as the Council’s findings and recommendations are made with the awareness that Delaware’s fiscal organization bears some similarities to other states but also has several unique features:

- Delaware’s reliance on the Personal Income Tax (PIT) is somewhat high compared to other states. According to U.S. Census Data for 2012<sup>1</sup>, Delaware derives roughly 18% of state revenues from the PIT whereas the national average is 15%.
- No other state enjoys the scale of revenues derived from Delaware’s Corporate Franchise Tax (CFT). At the state level, the CFT comprises nearly 25% of

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<sup>1</sup> Source: U.S. Census Bureau: 2012 Census of Governments: State and Local Finances by Level of Government and by State: 2012. Web Address: <https://www.census.gov/govs/local/>

Delaware's revenues. Privilege taxes, such as Delaware's CFT, are so inconsequential in other states that the U.S. Census Bureau does not even report these taxes as a separate line item in its publications. Delaware's CFT and other states' versions thereof are instead included within the "All Other Taxes" category. Delaware derives 21% of total own-source state and local revenues from "All Other Taxes," compared to 4% nationally.<sup>2</sup>

- Delaware has no general retail sales tax (RST) and is one of just a handful of states with a Gross Receipts Tax (GRT). The average state in the nation derives roughly 16% of state revenue from the RST, and only 4 other states forego an RST.<sup>3</sup> Delaware's GRT partially offsets this lack of an RST, comprising roughly 6% of state revenues. Only 4 other states have a general GRT.<sup>4</sup>
- Delaware depends on two large non-tax sources—lottery and abandoned property—for 20% of its state revenues. In addition to the CFT and GRT, these sources make up for Delaware's lack of an RST and low reliance on property taxes.
- Relative to other states, Delaware has centralized revenues and very low property taxes. Delaware ranks 44th lowest in per-capita property taxes. Overall, property taxes provide 22% of total state and local revenues nationally; Delaware derives just 10% from property taxes<sup>5</sup>. This in part explains the

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<sup>2</sup> *ibid*

<sup>3</sup> *ibid*

<sup>4</sup> Tax Foundation: *Location Matters: A Comparative Analysis of State Tax Costs on Business*, p. 6, (February 2012).

<sup>5</sup> Source: U.S. Census Bureau: 2012 Census of Governments: State and Local Finances by Level of Government and by State: 2012. Web Address: <https://www.census.gov/govs/local/>

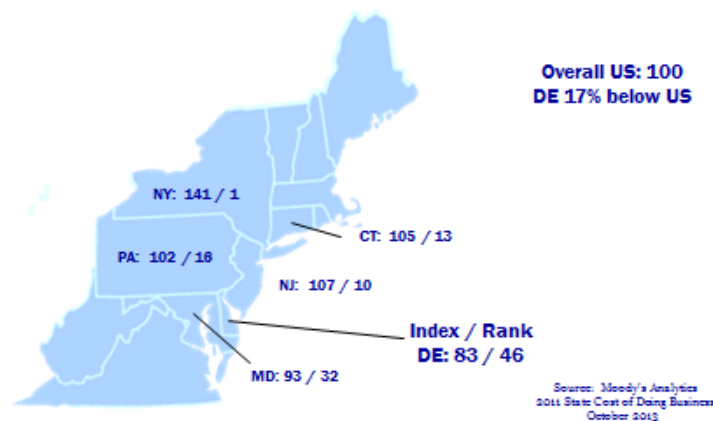
centralization of Delaware's revenues, which are highly concentrated at the state level. Whereas on average across the nation, local governments represent roughly 46% of states' own-source revenues, in Delaware local governments represent only 20% of the state's own-source revenues.<sup>6</sup> This distribution of resources and responsibilities has some distortionary effect on interstate comparisons of both revenues and expenditures.

- Owing to the composition of its revenue portfolio, Delaware enjoys a high level of relative spending at a relatively low tax burden on its citizens. Delaware's state and local spending ranks 6th in the country on a per capita basis (nearly 20% above the national average)<sup>7</sup>, but as shown in Figure 1 Delaware's tax burden ranks as the 5<sup>th</sup> lowest in the nation (roughly 17% below the average).

*Figure 1.*

Moody's Analytics  
State & Local Tax Burden

Expressed as an Index where Overall US equals 100



<sup>6</sup> *ibid*

<sup>7</sup> *ibid*

Delaware's current revenue structure derives from and is inextricably linked to Delaware's innovative track record and its ability to export its tax burden. Over the past three decades, "silver bullet" revenue sources have enabled Delaware to establish a variety of programmatic spending initiatives and tax cuts. These innovative initiatives include the Financial Center Development Act, the implementation of video lottery, table gaming, and sports betting, and the rapid increase in abandoned property revenues. The existence of such unique revenue streams has allowed Delaware to avoid difficult choices regarding more conventional revenue sources.

Historically, Delaware has seen the rise, peak, and decline of two silver bullets: the bank franchise tax (BFT) and casino revenues. The former peaked in FY 1994 at 6.5% of revenues and now accounts for only 2.4% of the current DEFAC-forecasted revenues. Similarly, casino revenues peaked in FY 2002 at 8.0% of revenues and now account for 4.1%, with further erosion expected.<sup>8</sup> Abandoned property—Delaware's latest and greatest "silver bullet"—recently accounted for as much as 16% of revenues but may be in relative decline. This Report is drafted in the context of seeing such one-time revenue sources that peak and wane as an unsustainable formula for long-term fiscal health and discipline.

Abandoned property will likely remain a meaningful source of revenue for Delaware into the foreseeable future. Likewise, neither casino revenues nor the bank franchise tax are likely to disappear entirely. This Report, however, takes a dim view of excessive reliance on volatile, potentially unreliable, and outsourced bases of revenues. Moreover, the Council suggests that seeking additional "silver bullets" should take a backseat to the difficult but ultimately more certain approach of thoughtfully

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<sup>8</sup> State of Delaware, Department of Finance: "Delaware Fiscal Notebook: 2014 Edition" Web Address: [http://www.finance.delaware.gov/publications/fiscal\\_notebook\\_14/front/greetings.shtml](http://www.finance.delaware.gov/publications/fiscal_notebook_14/front/greetings.shtml)

constructing a portfolio of own-source revenues that are adequate, stable, and likely to encourage economic growth.

Per the foregoing and the mandate of Executive Order No. 47, recommendations discussed in this Report were considered according to the following tax-policy criteria, in order of importance:

- **Adequacy and Stability** – The chief purpose of the Council is to ensure that Delaware’s revenue portfolio is able to raise revenues in a reliable manner that keeps pace with the cost of providing services (both price levels and population growth).
- **Competitiveness** – A second purpose is to ensure that any changes meant to enhance adequacy and stability do not endanger Delaware’s economic growth by discouraging citizens from continuing their residence here or businesses from establishing workplaces and headquarters in Delaware.
- **Fairness, Simplicity, Neutrality** – In the rare instance when findings or recommendations involved options that the Council found to be equivalent as to adequacy, stability, and competitiveness, the Council considered fairness, simplicity, and neutrality.

In assessing the revenue portfolio’s adequacy and stability in the face of the above concerns, the Council employed a consensus approach focused on transparency, inclusiveness, bipartisanship, and objectivity. This Report is prepared and presented in that same spirit.

## SECTION I. COUNCIL FINDINGS

### PAST PERFORMANCE

Before presenting the Council's general findings about Delaware's revenue portfolio, this Report will discuss the assessment measures. All measures have been adjusted to remove the effects of legislative changes on each revenue source over time. These adjustments ensure that findings and recommendations of the responsiveness and volatility of revenue sources are not skewed by legislative increases and decreases to those sources. These adjustments are based on fiscal-impact estimates made at the time the legislation was enacted and may include some imprecision as a result of inaccuracies in information available at the time of enactment. For the sake of structural and analytical simplicity, federal tax law changes—which the Delaware Code automatically accepts—are treated as economic phenomena and require no adjustments.

For each of the largest revenue categories from 1997 to 2013, assessment involved a variety of measures:

#### **Responsiveness**

- Estimated Annual Growth Rate – the “slope” calculation for each adjusted revenue source.
- Elasticity – the percent change in a revenue relative to a 1% change in Delaware's personal income.
- Forecast Elasticity – the above “Elasticity” measure, but based on December 2014 DEFAC forecasts for each revenue stream.
- Sharpe Ratio – revenue growth compared to some “risk-free” measure (personal income growth) and scaled by the revenue's standard deviation to include some volatility component.

- Weighted General Fund Elasticity – a total elasticity for Delaware’s entire portfolio, weighted by the percentage of the General Fund each revenue source represented in FY 2013.

### **Volatility**

- Negative Growth Years – a simple measure of the number of years (out of sixteen examined) in which revenues fell below the level of the prior year.
- Standard Deviation – an absolute measure of each revenue’s average variation.
- Coefficient of Variation – a measure of variability weighted by the average size of each revenue source.

These measurements were the analytical means for considering each revenue source in the portfolio and will be addressed in the findings for individual revenue sources. The Weighted General Fund Elasticity presents an aggregate measure of the entire revenue portfolio’s responsiveness for the sixteen years of history and over the forecast period from FY 2014 to FY 2019.



Table 1.

<b>Weighted General Fund Elasticity [1997-2013]</b>	<b>0.84</b>
<b>Weighted General Fund Elasticity (excluding escheat) [1997-2013]</b>	<b>0.47</b>
<b>Forecast Weighted General Fund Elasticity [2014-2019]</b>	<b>0.60</b>

Table 1<sup>9</sup> demonstrates that General Fund revenues have risen 8.4% for every 10% increase in Delaware personal income. If abandoned property revenue is excluded, however, General Fund revenues have risen less than 5% for every 10% of personal income growth. This measure suggests that Delaware's General Fund revenue portfolio has failed to keep pace with fiscal pressures as measured by personal income. In fact, Delaware's General Fund revenue portfolio has also failed to keep pace with the combination of (1) Implicit Deflator for State and Local Government Purchases (CPI for states) and (2) Delaware's population growth. This deficiency has been masked by the extraordinary growth in abandoned property revenues over that same period.

Furthermore, current DEFAC estimates suggest that Delaware's General Fund will not be much more responsive in the future, growing roughly 6% for every 10% increase in Delaware personal income even when including abandoned property revenues.

Delaware's "silver bullet" revenues have peaked, and they face external pressures that will likely prevent them from returning to past growth trajectories. The failure of revenue growth to respond to recent upticks in the economy indicates that structural elements, and not cyclical forces, play a significant role in Delaware's recent revenue performance. This generalized lack of responsiveness seen across a substantial portion of Delaware's revenue sources is the motivating force behind the Council's

<sup>9</sup> Data for generating Table 1 derived from "Delaware Fiscal Notebook: 2014 Edition" and historical fiscal impact estimates made by the Department of Finance. The calculation shown are updates and modifications of Department of Finance methodology used in *Delaware's General Fund Revenue Portfolio* (February 2008) Web Address: <http://www.finance.delaware.gov/publications/GP2008.pdf>

recommendations to twice broaden the State's portfolio in the near-term and balance the portfolio in the medium- and long-terms.

### **ACKNOWLEDGING EXPENDITURE**

The Council's discussions did acknowledge the importance of state-level expenditures as the other side of the proverbial budgetary coin. However, the Council did not undertake an analysis of historic expenditure growth, nor does the Council take a position on whether current levels of Delaware's expenditures are appropriate. Both issues are outside the scope of the Council's mandate under Executive Order No. 47. As a complement to its recommendations on revenue portfolio construction, the Council submits two observations that pertain to spending growth rates.

First, regardless of expenditure levels, members do agree that a revenue system should embody sufficient elasticity to meet ordinary increases in the cost of providing services. The Council's consensus suggests that ordinary cost increases could be embodied by some measure of inflation plus population growth. The Council examined different inflation measurements—including the Consumer Price Index and Implicit Deflator for State and Local Government Purchases—but ultimately decided to leave it to policymakers to decide what constitutes the appropriate inflation measure for assessing increases in the cost of providing government services in Delaware.

Second, Council members were aware that changes to Delaware's revenue portfolio could result in changes to the future level of expenditures. Concern was voiced that prior budget problems have been exacerbated by rapid revenue growth beyond core spending from prior periods—a scenario that subsequently elevates baseline spending. To avoid this problem in the future, the Council offers recommendations relating to certain fiscal controls. That discussion and analysis follows.

Owing to its narrow mission and desire to produce a unanimous report, the Council agreed to craft its recommendations as a complete policy package that would be revenue neutral in the first full year of implementation. It is up to the General Assembly to decide whether to proceed with this revenue neutrality in the first year or to adopt recommendations so as to raise revenues now.

### **EXTRAORDINARY REVENUES AND FISCAL PRUDENCE**

Delaware's 98% rule and Budget Reserve Account are fiscal controls intended to smooth budgetary volatility during economic downturns. Currently no fiscal controls exist that have the express purpose of smoothing budgetary volatility arising from unexpected surpluses. While the Council's proposal seeks to smooth revenue generation through a twice-broadened portfolio approach, the historical reality is that revenue is more volatile than expenditures. An explicit control of extraordinary revenues or revenue growth beyond baseline expenditure growth would guard against unsustainable expansion of expenditures. Such budgetary prudence could reduce the difficult future decisions faced by budget planners and augment Delaware's reputation as a state guided by responsible fiscal principles.

In filling their own "Rainy Day Funds," other states have a variety of definitions for "extraordinary revenues." Delaware could choose to enact one of these definitions or a hybrid thereof. One option is to designate legal settlements or audit revenues over a certain threshold as "extraordinary revenues." Other options rely on General Fund revenues exceeding some specific growth thresholds. These trigger points are based on rolling averages of recent General Fund growth or specific annual target growth rates, and treatment of extraordinary revenue varies from excluding some capped revenue share from the General Fund to excluding all extraordinary revenue. Borrowing some combination of "extraordinary revenue" definitions from other states would go a long

way towards developing an institutional control for unexpected surpluses in Delaware's General Fund.

There are many ways to design institutional restraints to deal with unexpected surpluses. The simplest method would be to remove the soft limit on Budget Reserve Account transfers and deposit all extraordinary revenues in the current Budget Reserve Account. Delaware currently treats the Budget Reserve Account as an emergency cash fund and requires a supermajority of the General Assembly to use the fund. In discussions with the Department of Finance, various ratings agency representatives have expressed appreciation for Delaware's sensible aversion to tapping the Budget Reserve Account. This may suggest that expanding the Budget Reserve Account in exchange for an increased willingness to tap these reserves may not have intended enhancements to Delaware's fiscal reputation.

An alternative option is to create budgetary rules that require revenues defined as "extraordinary" be spent on specific one-time outlays and foreseeable liabilities, or contributed to a new "budget smoothing account" designed to store surplus from prior years for use when economic cycles produce revenue shortfalls. These rules would temper human nature towards profligacy in the event of revenue spikes (in the same manner as expanding the Budgetary Reserve Account). Such rules also would help reduce the State's door-opening costs in the future. The core intent of any such budgetary rules is to reduce clear future liabilities in times of good fortune and ease expenditure pressures during recessions. This would enable Delaware to maintain its reputation as a fiscally responsible state that plans for emergencies and does not open up its piggy bank at the first signs of discomfort.

## THE PERSONAL INCOME TAX

Historical Performance								
<b>Responsiveness</b>								
	<i>Growth Rate</i>	<b>4.83%</b>	<i>Elasticity</i>	<b>.89</b>	<i>Sharpe Ratio</i>	<b>.007</b>	<i>Forecast Elasticity</i>	<b>1.08</b>
<b>Volatility</b>								
	<i>Negative Years</i>	<b>6</b>	<i>Standard Deviation</i>	<b>182.5m</b>	<i>Coefficient of Variation</i>	<b>21.3m</b>		

With good reason, the Personal Income Tax (PIT) is the revenue stream Delaware relies upon most heavily as a consistent, responsive, and competitive revenue source.

However, the PIT suffers from structural problems. These include a disparity between growth in tax revenues and growth in Delaware's personal income, as well as a significantly narrow PIT base. Delaware's PIT has fairly strong tax preferences that favor the elderly and a base that is narrowed by the allowance of itemized deductions. These two elements limit Delaware's PIT of responsiveness and consistency and reduce the PIT's effectiveness as the leading light in Delaware's revenue portfolio. In terms of economic competitiveness, the tax literature on the significance of marginal rates on business location and re-location decisions is inconclusive; the Council noted Delaware's top marginal rate of 6.6% is above the national median of 6%.<sup>10</sup>

**Responsiveness:** Historically the PIT has been strongly responsive to economic growth, both considering elasticity alone and adjusting responsiveness by some measure of volatility. Relying more heavily on the PIT could allow Delaware to reduce its dependence on more volatile and less responsive revenue sources.

However, this sort of rebalancing must be done carefully in order to prevent the

<sup>10</sup> Based on analysis of state statutes provided by Thomson Reuters: Checkpoint. Median calculation excludes states that do not impose a tax on personal income. Calculation also adjusted Maryland tax rates upwards based on a median local income tax of 2.98%.

PIT from becoming less responsive. Increasing PIT revenues by broadening the tax base achieves placing more weight on Delaware's most responsive tax without diminishing the desirable characteristics discussed above.

Specifically, base broadening would involve curtailing or removing itemized deductions and changing Delaware's generous treatment of retirement income to make the definition of Delaware's tax base closer to the economic definition of "personal income." In practice, the higher the standard deduction, the more itemization occurs near the top of the income distribution and grows in line with economic growth. As a result, PIT responsiveness is weakened by tax expenditures that favor those who are most likely to be enjoying the rewards of an economic expansion. Additionally, elderly tax preferences—especially those that are triggered at age 60 in Delaware—often result in exempting income earned by individuals in lifetime peak income years. The example below in Table 2 demonstrates how elderly tax preferences currently change the tax liability of two households with otherwise similar economic circumstances.

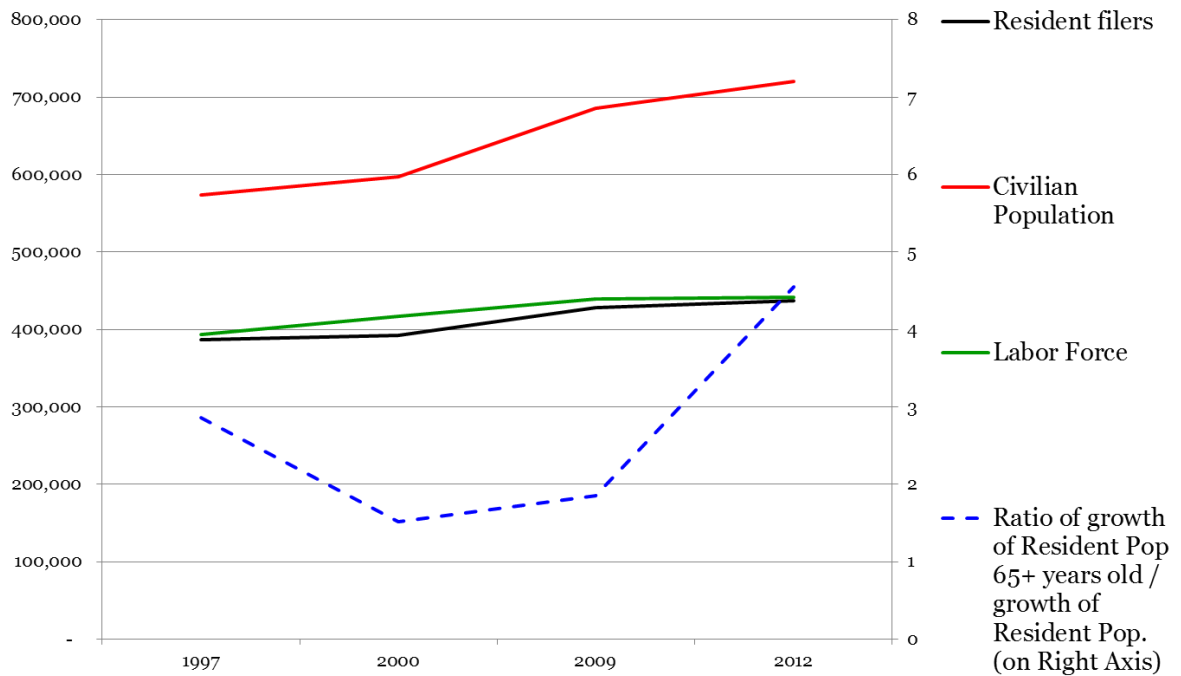
Table 2.

<b>Personal Income Tax Liability Comparison: Two \$80,000 Income Households</b>				
	<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	-	-	<u>14,000</u>	<u>14,000</u>
Total Income	\$40,000	\$40,000	\$40,000	\$40,000
Exclusions				
Retirement Income (Age 60+)	-	-	(12,500)	(12,500)
Social Security (Age 62+)	-	-	<u>(14,000)</u>	<u>(14,000)</u>
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
<b>Total Household Liability</b>	<b><u>\$2,616</u></b>		<b><u>\$0</u></b>	

**Volatility:** While the PIT has one of the largest absolute volatility measures, these large swings are actually relatively small when one considers the size of Delaware's PIT. Considering these types of adjustments, Delaware's PIT is one of the more consistent revenue streams. However, adding weight to the PIT via rate increases instead of base broadening would increase Delaware's revenue generation from the tail of the revenue distribution. This portion of the distribution is inhabited largely by relatively volatile categories of income, such as business income and capital gains.

Broadening the tax base by reducing elderly tax expenditures is an example of base broadening that can both increase responsiveness and reduce volatility. Since 2006, Delaware's total labor force and the number of resident PIT filers have been relatively flat while the civilian population has continued to grow. This trend represents strong growth in retirement-aged population in Delaware and is likely to continue, as recent growth in residents age 65 and over has been more than four times that of Delaware's population growth as a whole (Chart 1).<sup>11</sup> Because pensions and retirement incomes typically are stable, incorporating a larger portion of these income sources within the tax base would augment the PIT's portfolio position without increasing volatility.

Chart 1.



**Competition:** In terms of relative tax competitiveness, Delaware's PIT's top marginal rate of 6.6% is the 19<sup>th</sup> highest rate and slightly above the national

<sup>11</sup> Source: U.S. Census Bureau: American Community Survey Web Address: [http://www.census.gov/acs/www/about\\_the\\_survey/american\\_community\\_survey/](http://www.census.gov/acs/www/about_the_survey/american_community_survey/), U.S. Census Bureau: USA Counties Database Web Address: <http://censtats.census.gov/usa/usa.shtml>



median of 6.0% for all states that tax personal income. However, there is great variety in personal income tax structures related to the allowance of itemized deductions and the use of progressive or flat rates. Compared to states with similar structural elements (e.g., progressive rates coupled with itemized deductions), Delaware's top marginal rate of 6.6% is a touch below the median top marginal rate of 6.7%. Broadening Delaware's PIT base in a revenue-neutral manner would likely require marginal rate cuts that would move Delaware closer to the national average in terms of top marginal rates.

Given the PIT's status as the leader of Delaware's revenue portfolio, it is of the utmost importance that the tax base employed is defined broadly in an attempt to mirror the source of the PIT's strength: personal income growth. The Council finds that reducing the divide between the PIT base and Delaware personal income will allow this revenue source to be more economically responsive and more competitive without increasing volatility. This should enable Delaware to reduce reliance on several taxes that act poorly (according to the Council's criteria) and enable increased significance for portfolio taxes that are better suited for supporting roles in a scheme built around responsiveness and consistency.

## CORPORATE FRANCHISE TAXES AND FEES

Historical Performance								
Responsiveness								
	<i>Growth Rate</i>	<b>2.74%</b>	<i>Elasticity</i>	<b>.50</b>	<i>Sharpe Ratio</i>	<b>-.158</b>	<i>Forecast Elasticity</i>	<b>.59</b>
Volatility								
	<i>Negative Years</i>	<b>4</b>	<i>Standard Deviation</i>	<b>98.9m</b>	<i>Coefficient of Variation</i>	<b>13.79m</b>		

Revenues from the State's Corporate Franchise have exhibited consistent, long-term growth over time. These revenues—which include corporate franchise taxes, LLC/LP annual taxes and related filing fees—have increased from \$525 million in FY 2000 to a projected \$1,028 million in FY 2015 (a total increase of 96%, or 4.6% per year). This revenue source is consistent and flexible, though not always responsive to the larger economy. The unique nature of Delaware's Corporate Franchise requires special consideration regarding economic competitiveness.

**Responsiveness:** While the Corporate Franchise has grown during the period of consideration, much of this growth is the result of price increases (totaling \$302 million) intended to keep revenues on pace with inflation. Of all legal entities incorporated in Delaware, 95% have their principal location in other U.S. states or overseas. Revenues tend to follow national economic and market trends rather than local business or population trends. As such, the Corporate Franchise Taxes and Fees are less responsive to Delaware personal income growth than are other portfolio revenues. This lack of economic responsiveness is largely offset by Delaware's success in maintaining and growing its market share of incorporations, the level of controlled flexibility Delaware has in enacting rate increases, and the superlative consistency demonstrated by this large revenue source.

**Volatility:** The Corporate Franchise is one of the least volatile of the considered revenues according to any of the measures presented. The \$180,000 cap on franchise taxes (which applies mostly to large corporations listed on public exchanges) represents a fairly stable portion of the tax base and reduces the volatility that would otherwise occur without a cap in place. However, since 90% of corporate franchise taxes come from just 9,300 of the largest franchise taxpayers—many of them publicly traded entities—revenues tend to be sensitive to major movements in stock market, merger, and IPO activity. This volatility, which occurs with major market downturns and upticks, has been somewhat ameliorated in recent years through successful efforts to increase the various fees and the flat minimum franchise taxes and LLC taxes paid by a broad and growing base of more than one million legal entities.

**Competition:** Delaware's Corporate Franchise Taxes and Fees exist in a unique competitive position unlike that of many other revenue sources discussed by the Council. More than 1.1 million legal entities are incorporated in Delaware, including 65% of Fortune 500 companies, 55% of U.S. companies listed on the major stock exchanges, and many of the nation's largest privately-held and venture-capital backed firms. Companies can incorporate in any jurisdiction, but they choose to incorporate in Delaware for access to the State's modern and flexible corporate laws, highly regarded Courts, and world-class incorporation services. While incorporation-related revenues account for less than 1% of total state revenues in most states, in Delaware they account for more than 25% of State general fund revenues. Unlike a tax, the State is charging a fee for service that a customer, who has alternatives, is willing to pay. Delaware's formation and dissolution fees are competitive with other states. However, corporate

franchise tax rates and annual alternative entity tax rates are at or near the high end of the market.

History has shown that the market has accepted periodic rate increases in Corporate Franchise Taxes and Fees, provided such increases reasonably reflect the value of incorporating in Delaware as perceived by legal entities and their managers, owners, and advisors. Given the market nature of this revenue stream—and in light of the consistent, flexible history of Corporate Franchise Taxes and Fees—the Council finds it optimal for Corporate Franchise Revenue to continue the current regime of brand management in order to expand Delaware’s market share. It should be Delaware’s goal to solidify the Corporate Franchise’s role alongside the PIT as one of two consistent, competitive, primary revenue sources.

## THE CORPORATE INCOME TAX

Historical Performance								
<b>Responsiveness</b>								
	<i>Growth Rate</i>	<b>4.86%</b>	<i>Elasticity</i>	<b>.94</b>	<i>Sharpe Ratio</i>	<b>.006</b>	<i>Forecast Elasticity</i>	<b>1.16</b>
<b>Volatility</b>								
	<i>Negative Years</i>	<b>7</b>	<i>Standard Deviation</i>	<b>39.2m</b>	<i>Coefficient of Variation</i>	<b>33.7m</b>		

Due to the nature of corporate incomes, Delaware's situation as a small state, and some structural elements in the Delaware Code, Corporate Income Tax (CIT) revenues are extremely volatile while providing moderate responsiveness to economic growth. Yet this responsiveness is often the result of payments wholly disconnected from economic activity in the current or most recently completed tax year. Exacerbating concerns around the CIT, structural changes to state-level corporate income tax statutes nationally have left Delaware with a relatively antiquated CIT structure. Moreover, Delaware's narrow base of payers has forced the state to adopt a top rate of 8.7%, nearly a third higher than the U.S. median and among the top ten highest rates in the country.<sup>12</sup> While measures of responsiveness and volatility show the CIT provides an average return over the long run, competitiveness concerns and limited upside potential suggest that a reduced role for CIT in the portfolio is optimal.

**Responsiveness:** The CIT appears to be an economically responsive tax, both historically and in forecasts. Yet the level of responsiveness observed is often not directly connected to the past year's economic performance. Large final and audit payments, as well as refund claims, are regularly the result of economic activity from many years prior. As such, many of the best and worst CIT years are the result of inaccurate tax liability forecasts and estimates by large

<sup>12</sup> Based on analysis of state statutes provided by Thomson Reuters: Checkpoint. Median calculation excludes states that do not impose a tax on corporate income.

taxpayers, as opposed to being the result of strong economic growth among Delaware companies.

**Volatility:** Because of the large final payments, audit payments, and refunds, Delaware's CIT is extremely volatile year to year. While the CIT is partially volatile because business income is volatile, Delaware's quarterly estimated payment schedule magnifies the effects of volatile corporate incomes. Delaware currently requires 70% of the estimated payments for the CIT to be submitted in the first half of the calendar year. This framework requires businesses to pay the lion's share of their tax liability based on relatively uncertain annual profit estimates, which in turn can cause serious budgetary concerns at the end of Delaware's fiscal year.

Furthermore, Delaware's small geographic size results in relatively fewer large taxpayers in the State. Just 50 companies account for nearly three-quarters of Delaware's CIT revenue. This amplifies volatility, as there are fewer opportunities for countervailing shifts that could smooth out CIT revenues. Attracting more businesses to Delaware would likely help to reduce volatility by increasing the number of corporate payers and the possibility that a revenue loss from one corporation is balanced by gains from another corporation.

**Competition:** Judging by national legislative trends, Delaware's current CIT statute appears to be out of favor. Delaware is one of nine states that apportion the profits of multi-state firms equally based on the state's share of the firm's national sales, property, and payroll. Most states have moved towards an apportionment structure that weighs sales more heavily. A large minority of states has moved to apportioning based on sales alone (Table 3). As a result, business expansion in Delaware has a higher effective tax cost than does

expansion in other states, and new facilities and employees increase Delaware tax liability disproportionately (Table 4). All of Delaware's regional neighbors have moved towards more heavily weighting sales in their corporate income tax apportionment formulas. Compounding the disincentives caused by its traditional apportionment formula, Delaware's CIT rate and burden are high relative to other states. The median corporate income tax rate is 6.5% among all states and 7.0% in all states that levy such a tax, while Delaware's CIT rate is 8.7%.

Table 3.

### Historical Snapshot of State Apportionment Weights

	1978	1982	1996	2002	2014
<b>Equal Weight</b>	44	34	24	11	9
<b>Heavier Sales</b>	0	8	15	27	14
<b>Single Sales</b>	1	2	5	5	22

Table 4.

<b>Before DE Expansion</b>						<b>Expand in Delaware</b>							
	<u>Property</u>		<u>Payroll</u>		<u>Sales</u>		<u>Property</u>		<u>Payroll</u>		<u>Sales</u>		
<b>Delaware</b>	<b>\$20</b>	+	<b>\$20</b>	+	<b>\$5</b>	<b>Delaware</b>	<b>\$30</b>	+	<b>\$30</b>	+	<b>\$5</b>		
<b>U.S.</b>	<b>100</b>		<b>100</b>		<b>100</b>	<b>U.S.</b>	<b>110</b>		<b>110</b>		<b>110</b>		
	= $\frac{\quad}{3}$						= $\frac{\quad}{3}$						
	<b>20%</b>	+	<b>20%</b>	+	<b>5%</b>		<b>27%</b>	+	<b>27%</b>	+	<b>5%</b>		
	= $\frac{\quad}{3}$						= $\frac{\quad}{3}$						
	= $\frac{45\%}{3}$						= $\frac{59\%}{3}$						
					<b>15%</b>						<b>20%</b>		
<b>U.S. Income (millions)</b>						<b>\$50.00</b>	<b>U.S. Income (millions)</b>						<b>\$50.00</b>
<b>Apportioned to Delaware</b>						<b>\$7.50</b>	<b>Apportioned to Delaware</b>						<b>\$9.83</b>
<b>Delaware Tax at 8.7%</b>						<b>\$0.65</b>	<b>Delaware Tax at 8.7%</b>						<b>\$0.86</b>

**Result: DE CIT increases by \$206,000 or 32%.**

The combination of a high rate and an antiquated apportionment structure makes business expansion in Delaware less attractive, which in turn could lead Delaware towards a less diverse business landscape. This reduced business diversification exacerbates the challenges of volatility. A tax with inherent and structural volatility and an uncompetitive structure stacks up poorly against the Council's assessment criteria. Changes to the Delaware Code that curtail self-inflicted disadvantages would improve the fit of the CIT within Delaware's revenue portfolio. The CIT could still play the role of revenue hero in a good year for corporate income, but it is not reliable enough to warrant its current weight within Delaware's portfolio.



## THE GROSS RECEIPTS TAX

Historical Performance								
<b>Responsiveness</b>								
	<i>Growth Rate</i>	<b>5.44%</b>	<i>Elasticity</i>	<b>1.16</b>	<i>Sharpe Ratio</i>	<b>.029</b>	<i>Forecast Elasticity</i>	<b>1.01</b>
<b>Volatility</b>								
	<i>Negative Years</i>	<b>3</b>	<i>Standard Deviation</i>	<b>42.8m</b>	<i>Coefficient of Variation</i>	<b>26.6m</b>		

In terms of consistency, there is no tax currently within Delaware’s revenue portfolio that can match the Gross Receipts Tax (GRT). In recent history, the GRT has been Delaware’s most recession-proof revenue source. It has experienced the fewest years of negative growth and boasts strong responsiveness to personal income growth, especially when adjusted for volatility. The GRT base is broadly defined; among major sectors, only agriculture, insurance, and banking are excluded from the tax base. Compared to other receipts-based taxes nationally, Delaware’s GRT has very few tax-rate preferences for specific industries. Moreover, rates on the GRT range from a low of 0.0945% to a high of 1.9914%, minimizing GRT’s negative effect on growth and efficiency. These elements combine to make the GRT a prime candidate for increased importance within a twice-broadened tax portfolio focused on responsiveness and stability.

**Responsiveness:** As a currently broad-based tax on business receipts, the GRT is strongly responsive to economic growth. This responsiveness is greatly related to the GRT’s broad base, as much of personal income is devoted to consumption of goods and services. To reduce any undue burden potentially faced by small businesses, the GRT has a large monthly exemption of \$100,000. This exemption means that roughly 10% of licensed businesses provide almost all GRT revenues. Thus the GRT is broadly based but skewed towards large businesses.

Beyond this exemption, there are a few business categories—for example supermarket retail and manufacturers—that face reduced tax rates to accommodate for high-receipt, small-profit business models. Only one industry—agriculture—is completely exempt from Delaware business taxes, like the GRT, while insurance and banking are exempt because they face industry-specific taxes on their equivalents to receipts. The Council considered tax simplifications that would have rolled some business licenses with preferred rates into higher tax rate categories, but the Council found that responsiveness benefits were likely not worth the potential damage to firms employing slim-margin business models.

**Volatility:** The broad base of transactions within the GRT also leads to a consistent revenue source. Like other economic activity, business transactions are still depressed during recessions. Unlike incomes, however, which may decline as entities dig into their savings, consumer transactions typically continue to grow, albeit more slowly. This means GRT declines are relatively rare, even in negative economic periods. Additionally, the comprehensive definition of the GRT base ensures that structural changes in Delaware’s industrial composition and consumer preferences do not dramatically change GRT revenues.

**Competition:** There are a few competitive concerns worth mentioning with regard to the GRT. First, the GRT cascades with each transaction across a production process. This effect could drastically increase the effective tax burden on a final product, depending on the number of transactions involved in the acquisition of inputs. The problem of cascading scales with absolute tax rates, however, and Delaware’s GRT is quite low, at 0.4% for the average transaction. Furthermore, Delaware’s small size means that many input transactions likely occur outside Delaware’s borders, occluding many tax cascade situations.

The GRT is also a relatively unique tax across the American business landscape. As a result, many businesses and research groups have a difficult time categorizing the GRT within competitiveness rankings and cost-accounting structures. This difficulty is largely a result of the tax's legal incidence upon businesses. While it is likely that the share of effective taxpayers is similar to that of a retail sales tax—with businesses collecting a tax that is partially passed to consumers through price increases—the accounting optic of paying a tax on receipts can raise some competitive concerns.

While the GRT is extremely top heavy, it also is a remarkably stable tax. This is a consequence of (1) the tax base having relatively few industry-specific exemptions and preferences, and (2) retail sales having a relative resistance to national economic volatility. Combined with robust responsiveness, this consistency makes the GRT well suited to a stable, supporting role within Delaware's revenue portfolio. The GRT is the kind of supporting tax within Delaware's portfolio that provides consistent, average production, which in turn allows other taxes to respond to current economic conditions. As a consequence, the Council believes that Delaware stands to benefit by relying more on the GRT if dependence on the CIT is diminished.

## BANK FRANCHISE TAX

Historical Performance								
<b>Responsiveness</b>								
	<i>Growth Rate</i>	<b>2.32%</b>	<i>Elasticity</i>	<b>.12</b>	<i>Sharpe Ratio</i>	<b>-.097</b>	<i>Forecast Elasticity</i>	<b>.20</b>
<b>Volatility</b>								
	<i>Negative Years</i>	<b>9</b>	<i>Standard Deviation</i>	<b>25.0m</b>	<i>Coefficient of Variation</i>	<b>24.3m</b>		

Recent history shows the Bank Franchise Tax (BFT) to be a fairly consistent—though declining—revenue stream. However, these measurements should be interpreted cautiously, as the period under consideration includes the growth and bursting of an anomalous financial bubble. The Financial Center Development Act (FCDA) introduced many of the structural elements that define the BFT today. This origin contributes to the BFT’s uniqueness, both nationally and within Delaware. As a result of the BFT, Delaware banks are exempt from Gross Receipts and Corporate Income Taxes. The Council assessed the BFT with great care, given the potential competitive impacts of any changes since the BFT is credited with preserving jobs and enticing banks to locate in Delaware.

**Responsiveness:** The BFT has demonstrated minimal historical responsiveness and is not expected to be more responsive in the future. Some tax elements—including a multiplier intended to exempt bank income that results from interest on federal security holdings—are substantially affected by the high levels of inflation that existed around the time of enactment. Inflation has also created some unintended bracket creep into the more regressive areas of the BFT structure.

**Volatility:** As a small part of Delaware’s revenue portfolio, the BFT evidences relatively low volatility. These relative measures obscure the up-and-down

nature of the BFT during the financial crisis, but are consistent with the predictable—even if declining—trend in more normal economic circumstances. Outside of historically rare financial circumstances, the BFT provides a uniform stream of revenues.

**Competition:** Assessing the BFT’s competitive position is difficult. It is one of only two regressive banking taxes nationally, includes an alternative formula, and is based on regulatory call reports rather than income. However, the BFT does act as a complex economic development tool that has stimulated Delaware’s economy by drawing and maintaining banking industry jobs.

While the BFT is a consistent revenue stream that looks appealing based on the Council’s goal to reduce volatility, the BFT’s current structure is thought to be paramount to attracting and keeping banking jobs in Delaware. While some elements could be adjusted to increase responsiveness, the Council’s focus on the competitive aspects of the BFT trumped these concerns. The Council considered the BFT with great respect for the competitive sensitivity of Delaware’s financial sector jobs and found little need for change other than to address potential taxpayer concerns. The BFT’s current structure is crowd pleasing—if unresponsive—making the BFT’s consistent, small revenue contributions an acceptable value proposition.

## LOTTERY

Historical Performance <sup>13</sup>								
Responsiveness								
	<i>Growth Rate</i>	NA	<i>Elasticity</i>	NA	<i>Sharpe Ratio</i>	NA	<i>Forecast Elasticity</i>	NA
Volatility								
	<i>Negative Years</i>	NA	<i>Standard Deviation</i>	NA	<i>Coefficient of Variation</i>	NA		

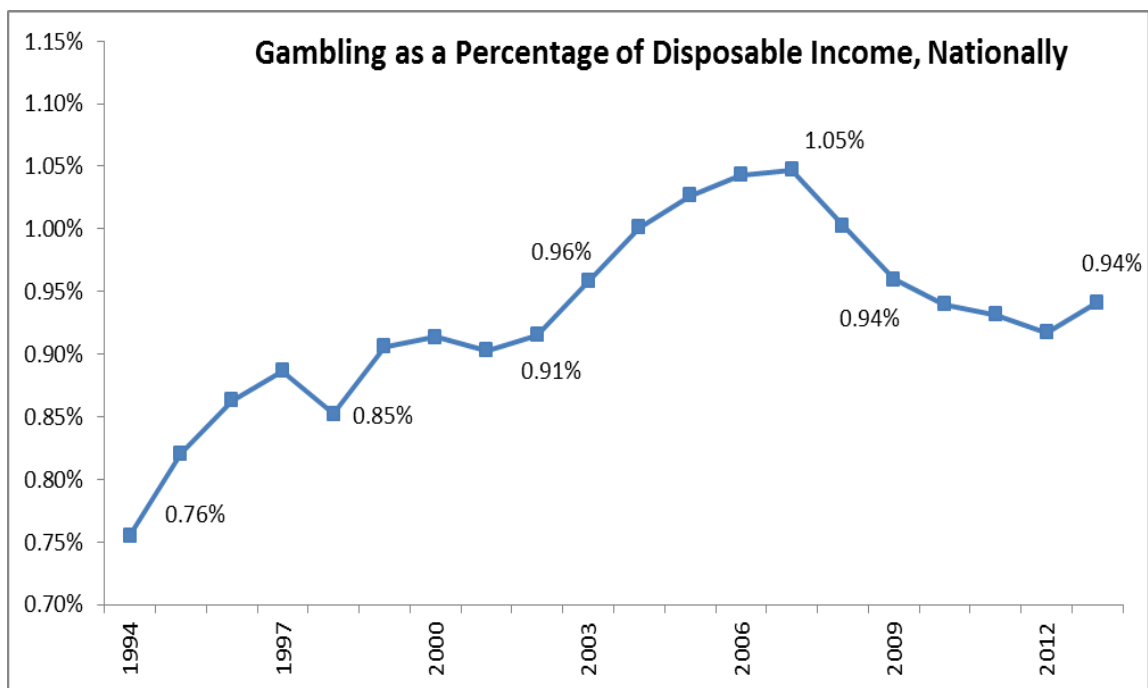
Out of respect for the work of the Lottery and Gaming Study Commission, the Council will avoid making recommendations concerning this revenue source. It is important to acknowledge, however, that the Council is aware of the Lottery's revenue history and attributes. Delaware's Lottery is in the process of becoming a "role player" within Delaware's revenue portfolio. After providing meaningful revenue growth in the late 1990s and the first decade of the new millennium, Lottery revenues have been hampered by an eroding first-mover advantage, shifting consumer preferences, and regulatory constraints. While the Lottery was once an economically responsive though volatile revenue source, the circumstances and trends presented to the Council suggest that the significance of this revenue source will not rebound and could dwindle further in the future.

**Responsiveness:** Lottery revenue had initially been strongly responsive to economic events when Delaware was one of a few states in the region garnering Lottery revenues. After the initial authorization of video lottery in Delaware, revenues grew annually, peaking as a share of the revenue portfolio at 9.5% in FY 2002. Today and extending into the future, casino revenues are unlikely to exceed 5% of Delaware's revenue portfolio, and traditional lottery one-quarter as

<sup>13</sup> The number of market based shocks to lottery revenues and the frequency of legislative changes in the lottery's revenue history make assessing responsiveness and volatility performance upon the measures in this table ponderous and add potential inaccuracies. The charts and tables provide some assessment of lottery revenues responsiveness and volatility in lieu of the measures provided for other revenue streams.

much. Efforts to expand the selection of games offered and changes to the distribution of revenues have slowed but not stopped declining revenues for the State since that time. Since 2007, spending on gaming as a share of disposable income has declined nationally; gaming is a shrinking revenue pie shared by more participants (Chart 2)<sup>14</sup>. The wave of regional competition that accompanied declining consumer preferences for gaming has disconnected Delaware's gaming revenues from economic events in the short term. Table 5 distinguishes Lottery revenue declines attributable to changing consumer preferences from those attributable to regional competition. Only once the regional gaming market stabilizes will an accurate assessment of the Lottery's responsiveness be possible.

**Chart 2.**



<sup>14</sup> Source: Bureau of Economic Analysis: Table 2.1 Personal Income and Its Disposition., Bureau of Economic Analysis: Table 2.4.5 Personal Consumption Expenditures by Type of Product Web Address: <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1>

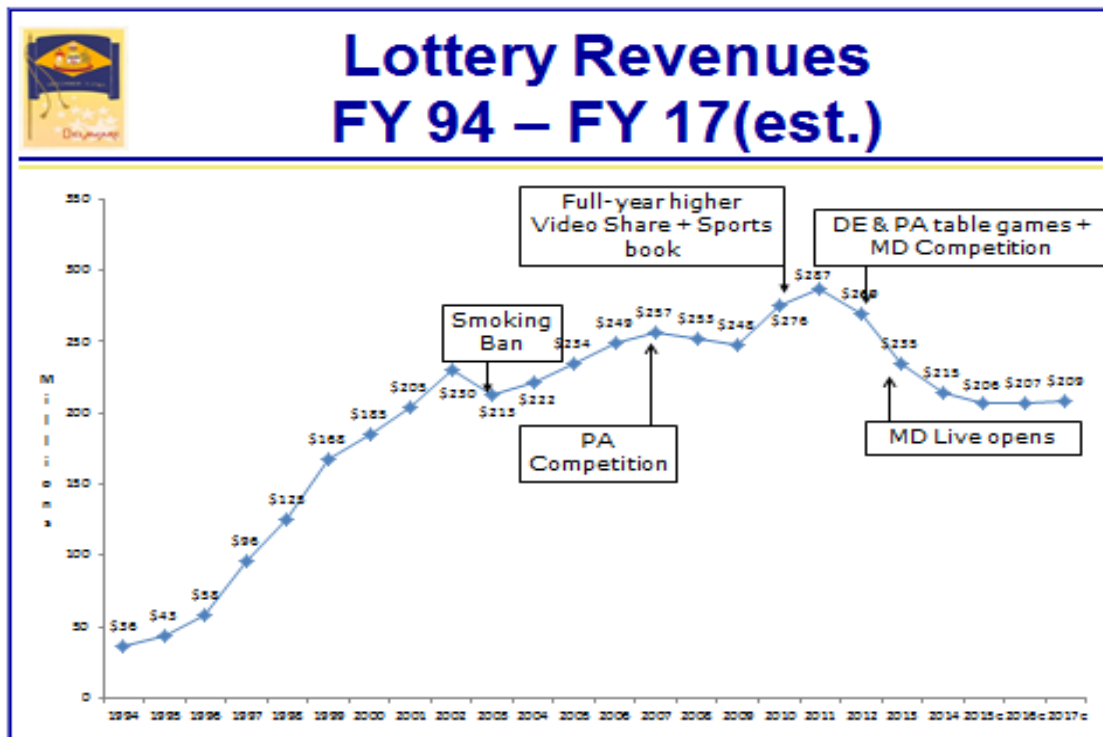
Table 5.

A	Actual FY 13 net proceeds	\$396m
B	Net proceeds without increased competition	\$668m
C	Net proceeds without increased competition or national changes in consumer behavior	\$760m
D	Decrease in net proceeds due to changes in consumer behavior (C-B)/(C-A)	25%
E	Decrease in net proceeds due to increased competition (1-D)	75%

**Volatility:** The history of the Lottery as a revenue source shows a steep incline and a steep decline, but one which occurs in a smooth manner as opposed to generating revenues in fits and starts (see Chart 3). Predicting the direction of this smooth revenue generation depends on an assessment of market saturation and the market competitiveness of Delaware's casinos as opposed to any particular policy agenda. Swings in Lottery revenues will depend largely on when the casino market stabilizes and how well Delaware's casinos are able to function given the characteristics of this new market equilibrium.



Chart 3.



Many of Delaware's gaming products were adopted ostensibly as a means of supporting Delaware's horse racing industry. Current regulatory requirements prohibit an establishment from offering many products without being attached to a horseracing venue. These requirements are essential to attempts to keep Delaware's horseracing purses regionally competitive, but they also impose additional overhead costs on Delaware's casinos. The Lottery and Gaming Study Commission recently submitted recommendations intended to stabilize and balance the economic impact of declining revenues between the State, casinos, and the horse racing industry. For the Council's purposes it is worth noting that those recommendations would even further reduce General Fund revenues derived from the Lottery.

**Competition:** The decline of the Lottery is the result of an explosion in regional market competition combined with changing national preferences for gaming.

Unlike tax competition, the Lottery competes for a consumer base through the market efforts of licensed casinos and by regulating and allowing a wide variety of gaming products. At the height of Delaware Lottery's prominence, regional competition was largely in Atlantic City, an hour or more from any of Delaware's borders and even farther for many regional customers. Since 2004, Pennsylvania and Maryland have combined to add ten casinos closer to Delaware's borders than is Atlantic City. This regional competition is the most significant cause of the Lottery's decline as a revenue source.

There is no indication that Lottery revenues will return to peak performance in the future. The FY 2015 projection for Lottery revenues is only a little over 5% of Delaware's General Fund. The Council's various recommendations were made with clear knowledge that the importance of the Lottery's supporting role within Delaware's revenue portfolio will likely continue to wane.

## ABANDONED PROPERTY

Historical Performance								
<b>Responsiveness</b>								
	<i>Growth Rate</i>	<b>13.4%</b>	<i>Elasticity</i>	<b>2.44</b>	<i>Sharpe Ratio</i>	<b>.171</b>	<i>Forecast Elasticity</i>	<b>-.17</b>
<b>Volatility</b>								
	<i>Negative Years</i>	<b>4</b>	<i>Standard Deviation</i>	<b>152.9</b>	<i>Coefficient of Variation</i>	<b>54.6</b>		

The Council also avoided making recommendations concerning this revenue source, respecting both the work of the Unclaimed Property Taskforce and the fact that Abandoned Property revenues are not directly tied to the economy or tax policy in the same manner as other portfolio revenues. Abandoned Property boasts an 11.4% annual growth since 1990 and nearly \$1 billion in surplus revenue above 2008's baseline Abandoned Property. These facts make it clear to the Council how consequential Abandoned Property revenue has been for Delaware's revenue portfolio. Because of Delaware's unique legal position, Abandoned Property is likely to remain an important revenue portfolio member. However, recent historic growth rates are likely unsustainable, particularly on the enforcement side, suggesting Delaware would be prudent to scale back modestly reliance on this revenue source in the future.

**Responsiveness:** The amount of Abandoned Property generated in any given year is disconnected from economic growth because it must lie dormant for a time before being turned over to the State and because Abandoned Property is related to accounting practices rather than economic circumstance. While Abandoned Property is an exceptional outlier in Delaware's revenue portfolio history, there are reasons to be concerned that this revenue source will be unsustainable in the long term. Technological advances in record keeping may reduce the amount of Abandoned Property in existence, and current legal

disputes regarding Delaware's use of estimation where sufficient records are unavailable threatens the share of Abandoned Property revenue that comes as a result of audit enforcement.

**Volatility:** As the preferred state of incorporation for many large companies in the United States, Delaware receives an inordinate amount of Abandoned Property as a result of the secondary sourcing rule. This rule, which is derived from federal case law, states that Abandoned Property without a known name and address must be turned over to the state of incorporation. This framework acts as a consumer protection against a property holder's attempts to obscure possession of an owner's property. While the validation of the secondary sourcing rule precipitated recent positive volatility in Abandoned Property revenues, the Council acknowledges that the current Abandoned Property compliance rate seems relatively low given the universe of holders incorporated in Delaware.

While the secondary rule explains the size of Delaware's Abandoned Property expansion, the revenue source is extremely volatile and faces even greater uncertainty going forward. Abandoned Property volatility is tied to a lack of economic variables available for forecasting filings. Moreover, a portion of Abandoned Property depends upon the timing of security sales in the stock market, and an above average share of revenues comes from enforcement activity. Admitting the risk of volatility legislatively, Delaware has attempted to cap the General Fund portion of Abandoned Property revenues. However, it has proven difficult to identify the cap that optimally balances (1) the need to exclude unsustainable revenue growth from the base for expenditure expansion against (2) the quantifiable size of the Abandoned Property universe.

**Competition:** To the extent that the bulk of Delaware’s Abandoned Property is the result of the secondary priority rule, Abandoned Property’s competitive position depends largely on the same factors that enable Delaware to continue to be competitive in the market for incorporations. The same concerns surrounding legal disputes regarding Delaware’s use of estimation should be mentioned in terms of Abandoned Property’s competitive position. The Council defers to the recommendations of the Unclaimed Property Taskforce on issues of how to ensure Abandoned Property remains a competitively predictable revenue source.

The Unclaimed Property Taskforce has submitted recommendations to the General Assembly in hopes of improving the fairness, efficiency, and predictability of Delaware’s Abandoned Property laws for holders. The General Assembly has enacted some of these recommendations and is considering others. These recommendations also attempt to stabilize the revenue source in the future. Even the best-case outcome suggests that Abandoned Property revenues are likely to decline in the long term. The Council has made other revenue recommendations with full awareness that one of Delaware’s recent revenue stars is possibly facing some regression towards a meaningful but smaller—and hopefully more consistent—level of revenue generation. Efforts to rebalance Delaware’s revenue portfolio are a proactive attempt to adjust for a future where Abandoned Property plays a smaller role.

## ESTATE TAX

Historical Performance <sup>15</sup>								
Responsiveness								
	<i>Growth Rate</i>	NA	<i>Elasticity</i>	NA	<i>Sharpe Ratio</i>	NA	<i>Forecast Elasticity</i>	NA
Volatility								
	<i>Negative Years</i>	NA	<i>Standard Deviation</i>	NA	<i>Coefficient of Variation</i>	NA		

Unlike many of the other taxes discussed in these findings, the estate tax has been a very small portion of Delaware’s revenue portfolio in recent years. Last year’s collections totaled only \$1.3 million, or 0.04% of the overall portfolio. The Council chiefly discussed this revenue source as it relates to wealthy households’ incentives to retain Delaware residency and whether the Estate Tax changes those incentives—and whether it costs Delaware Personal Income Tax revenue as a result.

**Responsiveness:** The Estate Tax is largely disconnected from economic factors, as accumulation of an estate depends on lifetime economic performance rather than annual trends. Recent changes to federal estate tax brackets—automatically incorporated by Delaware statute— have reduced the revenue generating capabilities of Delaware’s Estate Tax.

**Volatility:** Because there are no economic variables which correlate with Estate Tax revenues and the Estate Tax hits only very large estates, revenues are very unpredictable. This volatility is only truly reduced by tax avoidance of especially large estates, which may move to states with no estate taxation. This reduced volatility through avoidance comes at a cost to the responsiveness and consistency of the Personal Income Tax.

<sup>15</sup> The Estate Tax’s relatively small size and relationship with federal statute that has changed often in the period of analysis prohibited measurement of this revenue source’s historical responsiveness and volatility.

**Competition:** Only nineteen states have some form of asset transfer tax.

However, all of Delaware's bordering neighbors and many of the states from which individuals typically migrate to Delaware also have asset transfer taxes.

While research suggests that tax incentives are fairly low on the list of reasons individuals migrate from one state to another, the revenue generated by the Estate Tax is so small that the movement of a small share of very high income taxpayers might reduce Personal Income Tax by more than total Estate Tax revenues. Concerns about federal filing threshold adjustments further reducing revenues and the potential for federal repeal of the estate tax unexpectedly evaporating what little revenue is generated were also voiced by the Council. Overall, the Estate Tax is a small, volatile source of tax revenue whose roles in an optimal revenue portfolio is directly related to its influence on other more important streams of revenue. For these reasons, the Council recommends the elimination of the Estate Tax.

## STATE PROPERTY TAXATION

The Council briefly discussed Delaware's lack of reliance on property taxes. Delaware has no statewide property tax and ranks as the 44th state in property tax revenues measured against median home value. As Delaware has long eschewed any retail sales tax, the current lack of a statewide property tax leaves few meaningful bases for Delaware to tax outside of personal income. The Council discussed both the addition of a state-level Property Tax to Delaware's revenue portfolio as well as the shifting of some large source of expenditures (such as education or transportation spending) to the county level. In the former case, it was noted that state-level revenues already account for 80% of total state and local revenues (compared to a national average of only 54%). This led the Council to discuss briefly the latter concept, whereby counties would enjoy more of the authority for policy as well as the responsibility for funding same. The timeliness of the discussion of Delaware's system of education funding was noted in this context.

In terms of the Council's evaluation criteria, a Property Tax could be a relatively strong revenue source, but depending on its specifics it might also have negative impacts on volatility and competitiveness. Whether at the state or local level, the Council agreed that a Property Tax would require a uniform tax base with rolling reassessment similar to that of Maryland. The substantial cost of such an initiative would have to be borne upfront, but could be shared by the State and counties. Purely from the perspective of optimal portfolio construction, the Council noted that a meaningful Property Tax would generate responsive, stable revenues that could compensate for the reduction or elimination of other, less reliable sources of revenue.

**Responsiveness:** A broad based Property Tax covering residential properties—both resident domiciles and non-resident vacation homes—as well as business properties (whether commercial, industrial, farm, or utilities) would grow in



proportion with school-age population and infrastructure needs. Such a tax is economically responsive and can be well correlated with ordinary cost increases, but it is sensitive to tax expenditures for the poor or the elderly. This responsiveness requires updated valuations of Delaware property and thus depends entirely on statewide reassessments. From 2004 to 2014, property values in Delaware grew at an average rate of approximately 4.1% per year. This means a direct tax on property values would have grown slightly faster than Delaware personal income (3.7%) over this period.

**Volatility:** Property taxes are generally stable so long as they are broadly based. As an asset tax, a Property Tax may raise ability-to-pay concerns when market-level volatility causes tax bills to stay constant or even to rise despite slow or declining income growth. This could make a Property Tax an asset in terms of volatility, but a Property Tax may not measure as well on standards the Council was not asked to consider.

**Competition:** Delaware's current local Property Tax is one of the lowest in the nation, generating 6% of all state and local revenues. On average 12% of all state and local revenues in the United States are generated by property taxes.<sup>16</sup> While increased reliance on a Property Tax would certainly reduce Delaware's property tax competitiveness, rates could be set at a level that keeps Delaware's Property Taxation below the national average.

In a revenue-neutral case, a state-level Property Tax would be used to pay for further competitive improvements in other taxes. The recommendation of increased reliance on a revenue stream that is largely responsive, consistent, and could be made relatively competitive fits in well with the Council's mandate. Owing to Delaware's historic and

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<sup>16</sup> Source: U.S. Census Bureau: 2012 Census of Governments: State and Local Finances by Level of Government and by State: 2012. Web Address: <https://www.census.gov/govs/local/>

unique opposition to a retail sales tax, increased reliance on property taxes might be the only meaningful revenue source available to play a significant role in Delaware's revenue portfolio. However, given so many topics of concern, the Council could not properly consider such a large analytical proposal in the time allotted.

## SECTION II. RECOMMENDATIONS

### GENERAL

The following recommendations represent the Council's consensus vision for constructing an optimal tax portfolio for Delaware. It should be noted that, while the Council reached consensus on many issues, the Council did not achieve unanimity on all issues. Consequently, each recommendation might not receive the endorsement of all members of the Council. The Council recognizes that some of its recommendations represent significant changes to the rules that guide businesses and individuals in making financial decisions at the margin. Many of the recommendations are intended as medium- and long-term solutions to Delaware's structural revenue problems. As such, some of these recommendations will include explanatory excerpts concerning how to best phase-in tax changes thought to substantially affect legitimate tax-planning efforts of individuals and businesses alike. In other cases, the Council's longer-term recommendations constitute the outlines of a framework, the particulars of which will require policymakers to engage in a more thorough examination of related issues.

As previously noted, the Council's specific mandate involves providing a road map to collecting revenue in an economically responsive, consistent, and competitive manner. The Council was mindful that the Council's work and recommendations are advisory to the General Assembly's decision-making authority. In order to align discussion within the framework of the Council's mandate, recommendations were developed with the express provision that budgetary outcomes would be revenue neutral in the short term but provide increased responsiveness in the long term. The Council did not engage in any "dynamic" scoring of its revenue proposals, yet, as per its mandate, the Council believes the recommended changes will encourage growth relative to the status quo. The Council is also aware of other major tax analysis criteria and various considerations

related to state expenditure programs, but the Council expressly avoided discussion of these topics in order to efficiently fulfill the Council's mandate.

The revenue recommendations that follow are organized into three categories: primary sources, secondary sources and tertiary sources. The former two categories ideally would comprise roughly 80% of Delaware's revenues and can be considered "core revenues." Recommendations of the Council focus on these core revenues; tertiary sources were not analyzed in detail, and further analysis of them is warranted. A final section of this Report introduces the concept of fiscal controls that complement the Council's revenue recommendations. This section, like the discussion of tertiary revenue sources, deserves further development and analysis, though it is considered a vital part of this Report.

## **PRIMARY SOURCES**

Primary sources of revenue consist of the Personal Income Tax and the Corporate Franchise Tax (including related entity fees). These two sources presently constitute 50-55% of revenues. The Council would maintain that percentage as a reasonable overall target for the portfolio. Assuming the Council's recommendations are implemented, the blended growth rates for these revenue sources can be expected to meet the projected growth rate of state and local services together with population growth. Combined volatility of these two sources also offers an attractively reliable source of primary revenue. Proposed base-broadening and lowered rates of the PIT coupled with modest reforms and predictable growth targets for the CFT are considered on balance to be pro-growth reforms.

## Personal Income Tax

For the PIT the Council expressly focused on broadening the tax base. Increased top marginal tax rates and new, higher tax brackets were considered as alternative means to increase elasticity, but they were not included as recommendations given that they would increase Delaware's reliance on an even narrower portion of volatile revenues and raise questions relating to economic competitiveness. Instead, base broadening brings the PIT closer to the broadest definition of personal income while limiting Delaware's reliance on volatile incomes such as capital gains and business incomes. For competitive and revenue-neutrality purposes, base broadening should be accompanied by across-the-board PIT rate cuts.

**Eliminate Itemized Deductions:** The Council recommends that Delaware's base broadening begin by eliminating itemized deductions from the PIT. This elimination would more closely align the definition of "taxable income" in Delaware with the economic statistic "personal income." With the exception of the most recent recession, personal income has grown robustly in Delaware. Bringing the PIT more in line with this economic definition will provide more economic responsiveness in Delaware's revenue portfolio.

**Means-Test and Conform Elderly Tax Preferences:** Many government-related programs have acknowledged that Americans increasingly are living and working longer. Coupling this trend with an awareness of the inordinate demographic size of the aging Baby Boomer generation leads the Council to recommend the unification of Delaware's elderly tax-preference age-triggers at 65. The Council recommends this change be enacted via annually increasing the trigger-age by one year until the trigger-age reaches 65. Phasing-in these changes accommodates the legitimate tax-planning decisions of those who are

reaching the original trigger-age during the implementation of the tax law change.

Additionally, the Council recommends means-testing Delaware's elderly tax preferences. In order to means-test, the Council recommends replacing the current piecemeal system with a catch-all retirement income exemption. This exemption should be designed such that, at the very least, a taxpayer's maximum possible Social Security income is exempt. While there are certainly exceptions, the national trend is for elderly populations to have higher average incomes and lower poverty rates than the average household. Many retirees have stable, consistent streams of personal income, while those older citizens who are still working frequently are experiencing their lifetime income peaks. The combined effect of unifying age-triggers and means-testing most of Delaware's elderly tax preferences would (1) increase elasticity by taxing peak income more heavily and (2) enhance stability by including the consistent income earned by retirees in Delaware's tax base. Means-testing would ensure Delaware is not garnering this revenue at the expense of individuals with a low ability to pay.

**Decrease Marginal Tax Rates:** The use of a broader PIT base should improve the PIT's responsiveness and stability and enable Delaware to lower the top marginal rate to something closer to the national median of 6.0%. As top marginal tax rates typically headline any discussion of PIT competition, the Council recommends scaling back all tax rates in order to balance out the fiscal effect in the first several years of the Council's base broadening recommendations. In doing so, policymakers should be aware that the top marginal tax rate in the three states with similar tax structures to the one recommended by the Council ranges from 6.0% to 6.7%.

**Avoid Adjustments to Nominal Tax Factors Going Forward:** The increased elasticity that would result from the Council’s recommendations is partially a result of replacing an economically responsive deduction with a static deduction. The Council understands the potential political pressure to increase the standard deduction and other nominal tax figures over time, but the Council recommends against such practice. Holding such levels constant through economic cycles ensures that the proposed elasticity gains won by implementing the recommended changes will endure over time.

### **Corporate Franchise Taxes and Fees**

The Committee recognizes that the best way to increase the State’s incorporation revenues is to continue to grow Delaware’s market share. The Committee supports ongoing efforts by State officials and the business and legal community to boost Delaware’s brand awareness, both domestically and globally.

**New Products and Premium Services:** By offering innovative new products and services, the State can both attract new entities and generate more revenue from those already here. Recent success stories include legislation to attract public benefit corporations, permit certificates of validation, and facilitate short-form mergers in two-step transactions. The newly enacted Delaware Rapid Arbitration Act may also help attract businesses to incorporate here. Delaware’s Secretary of State has also successfully developed “premium offerings” such as expedited service and pre-cleared filings. A potential new offering could include a “Good Standing Guarantee Service” that enables pre-payment of LLC annual fees over a 10, 15, or 20 year period at a premium rate.

**Rates:** The Committee recommends that the Secretary of State’s Office closely monitor the State’s franchise tax rates and fee schedule relative to other states and, in consultation with the State’s legal and corporate services community,

continue to make periodic recommendations to the Governor and General Assembly when adjustments may be appropriate. When rate increases are under consideration, the State should explore ways to assign increases to entities that tend to derive the greatest value from being incorporated in Delaware.

## SECONDARY SOURCES

Perhaps the most important recommendations of this Council center on the long-term need to develop a reliable set of secondary revenues sources to complement the state's two primary sources. These secondary sources would ideally compromise as much as 25-35% of revenues in the aggregate, and as much as 8-12% individually. A "three-legged stool of solid and equal parts" may be an overly simplistic description, but conceptually the analogy is accurate. When combined with primary revenues, the total of such "core revenues" would be designed to comprise at least 80% of Delaware's revenue portfolio.

At present, this secondary tier is non-existent. At roughly 15%, Abandoned Property ranks as the third most significant source of revenue for Delaware, with the next greatest sources (Corporate Income Taxes, Gross Receipts Taxes and Lottery revenues) contributing 4-6% each. The Council's recommendations in this area include a reduced reliance on Abandoned Property and CIT over time, coupled with enhanced reliance on GRT and an additional source of revenue to be determined. The most likely candidate to fill this gap is a Property Tax. Development of this third source of revenue and diminished reliance on other sources will require many policy decisions and significant transition time. The Council encourages the debates and discussions in the General Assembly that will be needed to move in this direction and achieve this balance.

### Abandoned Property

As noted above, the Council does not intend to replicate or reconsider any specific conclusions of the Abandoned Property Task Force. Rather, for purposes of this Report,



conclusions and recommendations will focus on the portfolio level. From that perspective, the Council notes both the lack of elasticity and high volatility of this source of revenue. The Council also views the historic growth of this revenue source as an aberration and projects that such growth will level off over time. Still, owing to its close relationship to and dependence on the State's corporation franchise, the Council believes that Abandoned Property can and should remain a meaningful part of Delaware's secondary sources of revenue.

Abandoned Property should be targeted as a smaller percentage of revenues over time. While the long-term growth rate of this revenue source should be derived mostly from "organic" or recurring sources, the short- and medium-term run rates of growth may continue to exceed this level. Volatility of Abandoned Property can be managed at the portfolio level and via the fiscal controls proposed below. So long as enforcement actions are constrained to acceptable market levels and do not diminish the allure of Delaware's status as the default state of incorporation, this source of revenue should not trigger economic growth concerns.

#### **Corporate Income Tax & Gross Receipts Tax**

The Council considered Delaware's business taxes in tandem, noting that from the perspective of the Executive Order's mandate the Gross Receipts Tax has been a more reliable tax than the Corporate Income Tax, with both a broader base and lower rates. The relatively high rate of the CIT was shown to be less competitive than regional peers and 9<sup>th</sup> highest nationwide. While the GRT is unusual and draws critique for its relative novelty, consideration of competitiveness was thought to favor a relatively lighter weighting of the CIT in favor of increased reliance on the GRT.

Outside of shifting the relative reliance on these two revenue sources via rate adjustments, reforms to these taxes are modest in scope with an emphasis on lessening volatility of the CIT and making its apportionment formula more competitive with

regional peers. Base broadening of either tax is difficult, owing to the market structure of firms. Accordingly, the Council's recommendations focus on a modest but meaningful reduction of Delaware's reliance on the CIT and a concurrent increase in reliance on the GRT, with the long-term goal of making the GRT a clear second-tier source of revenue.

**Even Out Quarterly Payments of the CIT:** It is intuitive to revise quarterly CIT payments so that the estimate of corporate income is evenly distributed throughout the year. Such a system would incur a one-time budgetary cost. Despite this one-time cost, the Council recommends evening out quarterly payments, as the current distribution injects self-inflicted volatility into the budgetary process towards the end of each fiscal year. This adjustment should have no effect on responsiveness and little effect on competitiveness, though for smaller CIT payers this would alleviate any potential cash-flow problems caused by making a 50% payment estimated from very little calendar-year data or revenue.

**Apportion More Weight on the CIT's Sales Factor:** While it would be competitively difficult to broaden the CIT's tax base through changes to policy definitions, attracting more business to Delaware would provide industrial diversification. In hopes of hedging against inherent volatility through diversification, the Council recommends doubling the sales-factor weight in Delaware's apportionment formula. If even heavier sales factors are implemented, phasing in the implementation could provide businesses time to plan payroll and property expansions in Delaware while dampening their budgetary costs in the short term.

**Reduce the CIT Tax Rate:** Given that the CIT is volatile and puts Delaware at a competitive disadvantage, the Council recommends lowering the CIT rate and shifting the revenue portfolio's reliance to the GRT. The Council's analysis assumed a reduction in the CIT rate from 8.7% to 7.7%, which would move Delaware from the 9<sup>th</sup> highest tax rate nationally to the 16<sup>th</sup> highest. This reduction would decrease Delaware's CIT rate below that of neighboring Maryland and closer to the national median of 7.0%. More importantly, this reduction would soften the CIT's role in Delaware's overall revenue portfolio.

**Increase the GRT Rate:** It is the Council's general view that, under the constraint of revenue neutrality, GRT rate increases should be made to counter the cost of CIT reliance reductions. This would increase the GRT's relative share of Delaware's revenue generation, and thus reduce revenue volatility, all without damaging economic responsiveness or tax competitiveness. For example, to balance the cost of the CIT recommendations above, GRT rates would have to increase from a weighted average of approximately 0.40% to an average of approximately 0.45%. While this percentage increase is not immaterial, the absolute levels of this tax are unlikely to cause meaningful economic distortion or loss of competitiveness. Crucially, an increased weight on the GRT would also reduce some of the potential disconnect caused by changes to CIT apportionment, as GRT payments fall more heavily on businesses directly enjoying the benefits of Delaware's government services.

### Third Leg of the Stool

The Council noted that over the long term Delaware should develop a third secondary source of revenue to complement Abandoned Property and the GRT. The most logical and complementary source would be the Property Tax. As noted above, Delaware is among the states that rely least on the property tax as a percentage of state and local revenues. A property tax is generally responsive to economic growth, has relatively low volatility, and could be increased while maintaining a competitive advantage (given the level of property taxation among Delaware's regional peers).

The Council's discussion on this topic was limited, due to time and the significant number of policy choices that would need to be made by both state and local officials to effectuate the Council's recommendation. However, there was general agreement that choices to be considered might include relocating spending decisions regarding education or transportation to the county level in tandem with an increased reliance on the property tax bases of the counties to support such spending authority. Policy issues in both education and transportation would have to be considered in any such discussion, but purely from the perspective of constructing a consistent, stable, and competitive revenue portfolio, increased reliance on Delaware's property tax base and elimination of or lessened reliance on other revenue sources would be desirable.

### TERTIARY SOURCES

Excluding the revenue sources already reviewed above, Delaware currently relies on more than a dozen distinct sources for General Fund revenues. None of these revenue sources individually accounts for more than 6% of the portfolio, while several contribute less than 1%. In the aggregate, these sources make up roughly 22% of Delaware's General Fund revenues. They include, among others: Lottery revenues (both casinos and traditional), Bank Franchise Taxes, realty transfer taxes, public utility

taxes, cigarette taxes, insurance premium taxes, lodging taxes, Estate Taxes, hospital and treatment revenues, dividends, and interest.

With the exception of the Bank Franchise Tax, Lottery revenue, and Estate Tax, the wide array of tertiary revenues were not considered individually. This decision was based on both the limited timeframe in which the Council had to work, as well as the generally held view that none of these sources was likely to be able to be developed into a “core revenue” source. If, over time, the Council’s recommendation to pursue a stable five-part core revenue portfolio is adopted, several of these taxes and revenue sources could be phased out commensurately to increase portfolio elasticity, lower volatility, and improve Delaware’s competitive position. In sum, an ideal “bench” of tertiary revenue sources would be both deeper and narrower.

#### **Estate Tax**

The Council recommends repealing Delaware’s Estate Tax. Any projected revenue lost could be made up for with very small adjustments to the above-outlined recommendations for increasing elasticity in the Personal Income Tax. At best, the Estate Tax is a volatile revenue stream; at worst, it is a negative influence on other revenue streams. From the perspectives of revenue consistency, elasticity, and competitiveness, the costs of having an Estate Tax outweigh the benefits.

#### **FISCAL CONTROLS**

The Council recommends combining (1) the broadening of Delaware’s revenue portfolio with (2) budget measures that ensure that portfolio revenue growth in excess of targeted spending growth does not become “baked” into future budget levels or that large or unexpected surpluses are used judiciously. Ideally, consideration should be given to a budgetary smoothing fund independent of the Budgetary Reserve Account that would operate to mitigate overall volatility of the revenue portfolio, storing revenues in “good times” to be drawn down in “bad times.”

Institutional restraints intended to deal with extraordinary revenues should focus on reducing foreseeable future liabilities rather than broadening the size and accessibility of Delaware's current Budgetary Reserve Account. Controlling extraordinary revenues in this manner stands to maintain Delaware's reputation as a fiscally responsible state, mitigate the potential that increased elasticity drives unsustainable expenditure expansions, and help reduce Delaware's future overhead costs.

**Defining Foreseeable Future Liabilities:** An example of such a proposal might require that extraordinary revenues only be appropriated toward: (1) retiring tax supported debt, (2) funding the General Fund portion of the capital budget while reducing tax-supported debt apportionment in the current fiscal year, or (3) contributing to OPEB or the State Employees' Pension Plan. Like Delaware's other institutional restraints, consideration should be given to adopting any new measure as an amendment to the Delaware Constitution.

**Example Extraordinary Revenue Definition:** While policymakers should be diligent in considering all possible definitions of "extraordinary revenue," the Council offers Idaho's current definition as an example of the concept in practice. Idaho defines revenue growth above 4% to be "extraordinary" but caps extraordinary revenues at 1% of the General Fund in a given year. This creates a "donut hole" in revenues during years with unexpected revenue growth. Revenue growth up to 4% is available for appropriation, as is revenue beyond 5% growth in the General Fund. Any revenue growth between 4% and 5% would be restricted for appropriations towards Foreseeable Future Liabilities. A summary of other states' approaches towards such mechanisms is found in Appendix I.

## REVENUE NEUTRAL EXAMPLE PROPOSAL ANALYSIS

The Council developed an example of a revenue-neutral recommendation that includes those elements upon which a general consensus was achieved. Consistent with the Executive Order's directive, the recommendations' goals are to:

1. Increase the revenue system's responsiveness to economic growth;
2. Limit or reduce the revenue system's volatility; and
3. Promote Delaware's economic competitiveness.

The recommendations include the following items:

- **Personal Income Tax**
  - Combine base-broadening with across-the-board rate cuts to achieve a revenue-neutral result
  - Example A:
    - Eliminate Itemized Deductions;
    - Cut rates across-the-board by approximately 9%
  - Example B:
    - Eliminate Itemized Deductions;
    - Cut rates across-the-board by approximately 12.4%
    - Eliminate current senior tax breaks and replace them with a single means-tested exemption
    - Over a five-year period, move the eligibility age for the exemption from 60 to 65
- **Business Taxes**
  - Combine structural changes with rate adjustments to achieve a revenue-neutral result
  - **Corporate Income Tax**
    - Even out the Quarterly Estimated Payment Schedule
    - Update the Apportionment by Double-weighting the Sales Factor
    - Cut the tax rate from 8.7% to 7.7%
  - **Gross Receipts Tax** – Enact an across-the-board rate increase of 12.74%
- **Estate Tax** – Eliminate the tax, and offset lost revenue by using the added out-year growth gained as a result of the Personal Income Tax reforms

A table containing the fiscal implications of this proposal is as follows:

<b>Example of Revenue Neutral Approach</b>						
<b>(Millions)</b>						
<b>Item</b>	<b>FY 2015</b>	<b>FY 2016</b>	<b>FY 2017</b>	<b>FY 2018</b>	<b>FY 2019</b>	<b>FY 2020</b>
<b>Business Taxes</b>						
1	CIT – Even quarterly payments (Timing change only)	\$0.0	(\$20.0)	\$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)
	GRT – 12.73% Across-the-Board Rate Hike (Revenue Neutral FY 17)	\$0.0	\$10.5	\$29.2	\$30.5	\$31.9
	<b>Subtotal – Business Taxes</b>	\$0.0	(\$14.4)	\$0.1	(\$0.1)	(\$0.2)
<b>Personal Income Tax</b>						
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
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	(\$5.4)	\$5.4	\$16.1	\$31.8
4	<b>Estate Tax – Eliminate</b>	\$0.0	(\$1.0)	(\$4.0)	(\$4.0)	(\$4.0)
	<b>Total – Using Personal Income Tax Option 3(a)</b>	\$0.0	(\$22.0)	\$0.4	\$4.1	\$10.8
	<b>Total – Using Personal Income Tax Option 3(b)</b>	\$0.0	(\$20.8)	\$1.5	\$12.1	\$27.6



## APPENDIX I: Fiscal Control Designs

### Summary of Fiscal Controls Designed to Address Surplus Funds

Researchers from the Pew Charitable Trusts have recently studied Rainy Day Funds (RDFs) for all 50 U.S. states. They found that only 12 states have rules that tie Rainy Day deposits to underlying economic or revenue fluctuations: Alaska, Arizona, Hawaii, Idaho, Indiana, Louisiana, Massachusetts, Michigan, Tennessee, Texas, Virginia, and Washington. Of the remaining 38 states, Pew researchers found that 4 do not have an RDF, 21 make use of year-end fiscal balances to guide deposits into their budget stabilization funds, 5 use forecast errors, and 8 make deposits on an ad-hoc basis or based on static requirements. A brief discussion of RDF mechanisms (as currently found in several of the states that link deposits to volatility) is as follows:

- Massachusetts:** Massachusetts previously relied on deposits of any surplus funds left over at the end of a fiscal year, but now has two sources of Rainy Day funding. First, any one-time settlement or judgment in excess of \$10 million is deposited into the RDF (Commonwealth Stabilization Fund). After the Great Recession, Massachusetts linked RDF deposits to the volatile capital gains. A separate capital gains tax is levied, and revenue above a threshold (\$1.05 billion in FY 2015) enters Massachusetts's RDF. This threshold grows with the economy. These deposit rules rebuilt Massachusetts's RDF balance, from \$0.67 billion in FY 2010 to approximately \$1.25 billion only 4 years later.
- Washington State:** In 2007, voters approved a ballot measure to create a constitutional emergency reserve account. Under the 2007 reform, 1% of state revenues are deposited into the reserve account. An amendment was approved in 2011, which added a provision that three-quarters of any "extraordinary" growth in state revenue be transferred to the RDF. Extraordinary revenue growth is defined as growth in general state revenues that exceeds the average biennial growth in general state revenues over the prior five biennia by 33.3%. When the Budget Stabilization Account exceeds 10% of general state revenues, the Legislature may appropriate the excess balance to the Education Construction Fund. According to Pew researchers, revenue growth in the state of Washington has not been strong enough in the past few years to trigger deposits based on extraordinary revenues.

- **Virginia:** According to Virginia's statute: *"The General Assembly shall make deposits to the Fund to equal at least fifty percent of the product of the certified tax revenues collected in the most recently ended fiscal year times the difference between the annual percentage increase in the certified tax revenues collected for the most recently ended fiscal year and the average annual percentage increase in the certified tax revenues collected in the six fiscal years immediately preceding the most recently ended fiscal year."* By comparing total tax revenue growth with that of the previous six years and identifying expansion above the longer-term trend, Virginia has been able to make steady deposits to its RDF during years of economic expansions while maintaining budget flexibility during downturns in the business cycle. Between June 1995 and June 2010, annual deposits reached as high as \$490 million. Prior to the Great Recession, regular deposits had led to steady increases in the RDF balance, from less than \$300 million in FY 2003 to almost \$1.2 billion in FY 2007. In the current recovery period, the RDF balance grew from about \$300 million in FYs 2010-12 to more than \$400 million in FY 2013.
- **Idaho:** Idaho funds its RDF with any general fund revenue in excess of 4% growth, up to a maximum of 1% of collections. The balance of the budget stabilization fund was also capped at 5% of total general fund receipts prior to FY 2014. In recent years, Idaho passed "surplus eliminator" legislation, which mandates that any unanticipated surplus in the general fund over \$20 million be transferred to the RDF. In FY 2014 it also raised the RDF cap to 10% of total general fund receipts. Overall, Idaho had a direct statutory transfer of \$25.8 million in FY 2013 and a surplus eliminator end-of-year balance transfer of \$85.4 million. The balance of the state's RDF stood at \$135 million in that year, as opposed to \$109 million in FY 2006.

## APPENDIX II: EXECUTIVE ORDER No. 47

### EXECUTIVE ORDER NUMBER FORTY-SEVEN

TO: HEADS OF ALL STATE DEPARTMENTS AND AGENCIES

RE: THE DELAWARE ECONOMIC & FINANCIAL COUNCIL REVIEW OF STATE REVENUES

WHEREAS, the Delaware Economic & Financial Council (DEFAC) has provided the State of Delaware with objective and expert guidance on state revenues and helped contribute to Delaware's reputation for fiscal prudence; and

WHEREAS, in addition to DEFAC's responsibilities providing revenue and expenditure estimates, DEFAC is responsible for educating the public and policymakers about the financial condition of the State and related issues; and

WHEREAS, the State of Delaware's revenue portfolio continues to show growth, but various members of DEFAC and the public have expressed concerns about the composition of those revenues, including whether Delaware's revenue sources, both individually and as a whole, are sufficiently responsive to growth in the Delaware economy, whether those revenue sources are too volatile, and whether Delaware's revenue portfolio supports the State's economic competitiveness; and

WHEREAS, the State recognized some of these challenges to its revenues in 2008, when a report issued pursuant to Senate Joint Resolution No. 5 of the 144th General Assembly concluded that many of Delaware's revenue sources "have unique properties in terms of their cyclical and, especially, their structural risks"; and

WHEREAS, the State has managed these volatile and cyclical financial challenges in recent years by working to ensure that the State meets the increasing demand for government services in an efficient and effective manner that keeps a close control on costs, while preserving essential services and continuing to invest in education and job growth; and

WHEREAS, our State's tradition of prudent fiscal management requires we re-evaluate whether the State's revenue sources are too volatile and whether they provide a stable foundation for the State's fiscal future, and whether steps might be taken to improve the stability and decrease volatility of those revenues; and

WHEREAS, the General Assembly has in the last two years created separate bodies examining unclaimed property and the State lottery thereby providing policymakers and the public with a fuller understanding of Delaware's chief non-tax revenue sources, but there has been no evaluation of the adequacy and stability of other revenue sources since at least 2008, and

WHEREAS, the Chairpersons of DEFAC and of its principal subcommittees are best positioned to lead a review of the state's revenue sources, along with input from each of the General Assembly's four caucuses, the departments that collect most revenue, the State Treasurer and others with private and public sector experience.

NOW, THEREFORE I, JACK MARKELL, by virtue of the authority vested in me as Governor of the State of Delaware, do hereby DECLARE and ORDER that:

1. The DEFAC Advisory Council on Revenues (the "Council") is hereby created.
2. The Council shall be comprised of 12 members. The Chairperson of DEFAC shall serve as the Chairperson of the Council. The Council shall also be comprised of the Chairperson of the DEFAC Subcommittee on Revenue, the Chairperson of the DEFAC Subcommittee on Expenditures, four members of the General Assembly, the Secretary of Finance, the Secretary of State, the State Treasurer, and two public members with prior service in both government and the private sector, one from each major political party. The President Pro Tempore of the State Senate, the Speaker of the House, the Minority Leader of the Senate, and the Minority Leader of the House shall each appoint a member of their caucus to serve at their pleasure on the Council. The two public members shall be chosen by the Governor and serve at his pleasure.
3. Members of the Council shall receive no compensation, but shall be reimbursed for customary and usual expenses incurred in the performance of their duties. The Council shall adopt public procedures and standards for the conduct of its affairs, consistent with this Order.
4. The Council shall review the General Fund's principal revenue sources, including building upon analysis previously done by the Department of Finance, Office of Management and Budget and Controller General's Office, and undertake such analysis as the Council deems necessary to evaluate those revenue sources.
5. The Council's review of state revenue sources shall consider and evaluate whether Delaware's principal revenue sources are appropriately responsive to economic growth, whether they are too volatile, whether they are economically competitive, and in making such evaluations, note other tax policy issues that the pursuit of these objectives may entail.
6. On or before April 30, 2015, the Council shall report to DEFAC, the Governor, and the General Assembly any findings and any recommendations for alterations to Delaware's revenue portfolio.

7. The Department of Finance shall provide staff support to assist the Council in performing its duties and shall, upon request, provide the Council with reports and data helpful to the Council's ability to perform its assigned duties. All other executive branch state agencies and departments shall cooperate with the Council when requested. The Council may call and rely upon the expertise of individuals and entities outside of its membership for research, advice, support or other functions necessary and appropriate to accomplish its mission.

8. The DEFAC Advisory Council on Revenues shall be terminated on June 30, 2015, if not reconstituted by further executive order.

**APPROVED this 14<sup>th</sup> day of January, 2015**

## APPENDIX III: MEMBERSHIP OF THE DEFAC ADVISORY COUNCIL ON REVENUES

<b>Council Member</b>	<b>Affiliation</b>
Joshua Martin (Chair)	Chairperson of DEFAC
Representative Ruth Briggs King	Appointed by the House Minority Leader
Jeffrey Bullock	Secretary of State
Thomas Cook	Secretary of Finance
Representative Quinn Johnson	Appointed by the Speaker of the House
Glenn Kenton	Former Secretary of State, Appointed by the Governor
Senator Gregory Lavelle	Appointed by the Senate Minority Leader
Ken Lewis	Chairperson, DEFAC Subcommittee on Revenue
Ed Ratledge	Chairperson, DEFAC Subcommittee on Expenditure
Pete Ross	Former Budget Director, Appointed by the Governor
Ken Simpler	State Treasurer
Senator Bryan Townsend	Appointed by the President Pro Tempore of the Senate