

# **DEFAC Advisory Panel on Fiscal Controls and Budget Smoothing**

March 2<sup>nd</sup>, 2018



# Managing Budget Volatility

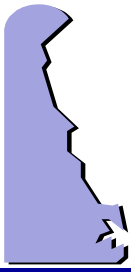
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- Revenue Portfolio Reform
  - Detailed analysis from recent council
  - Reduced volatility may also harm adequacy
- Fiscal Controls
  - Restraints to keep budget growth in-line with historical measures
- Budget Smoothing Fund
  - An additional option for keeping budget growth more linear in the face of volatility.

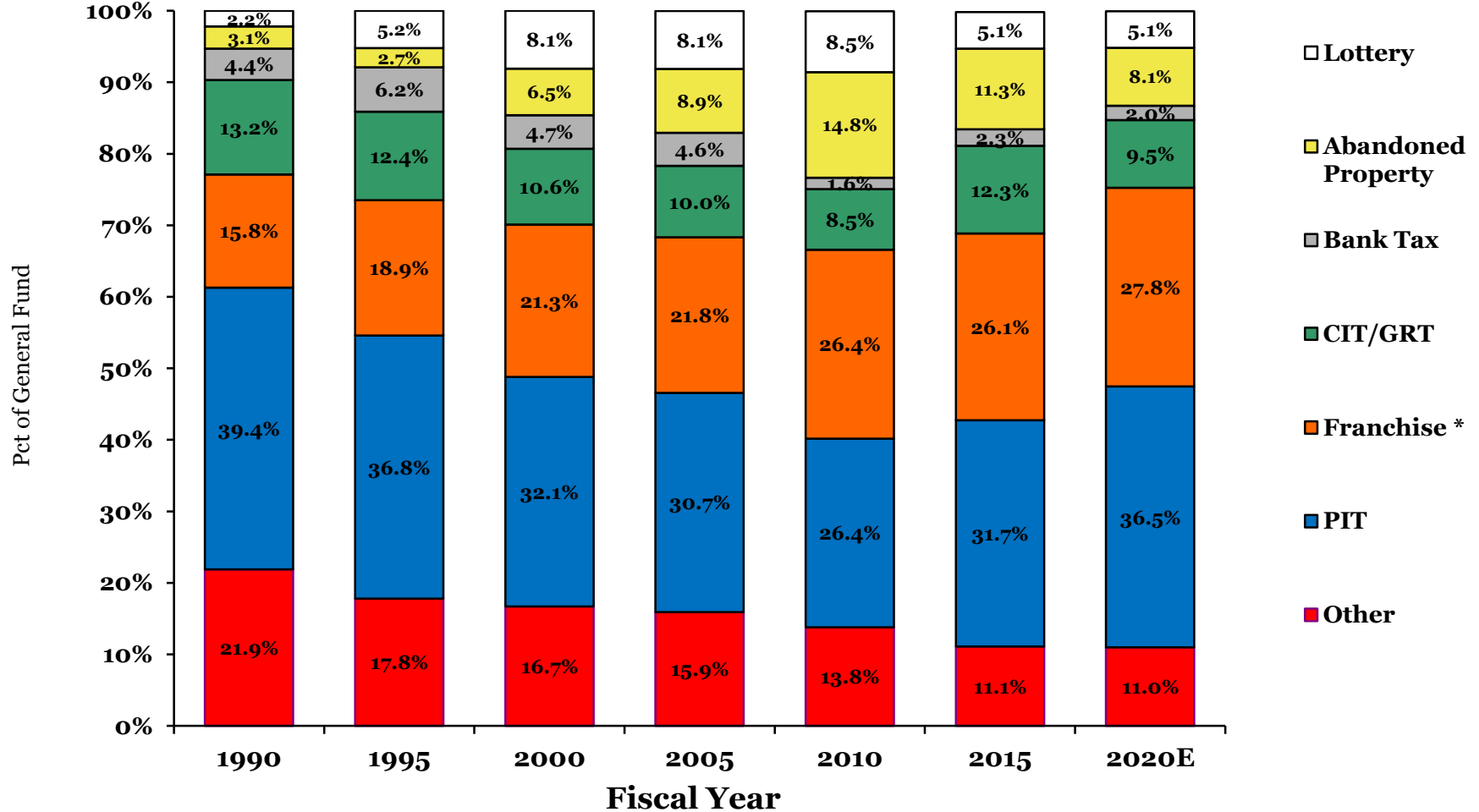


# 2015 Revenue Report on Volatility

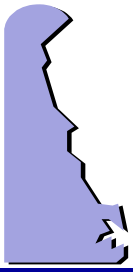
- The Revenue Report acknowledged the history of fluctuating revenues from Bank Franchise Taxation, Lottery, and Abandoned Property deeming:
  - “such one-time revenue sources that peak and wane as an unsustainable formula for long-term fiscal health and discipline.”
- The Report’s Framework “takes a dim view of excessive reliance on volatile, potentially unreliable, and outsourced bases of revenues.”
- The Revenue Report ranked policy measures as follows:
  - “Adequacy and Stability”
  - “Economic Competitiveness”
  - “Fairness, Simplicity, and Neutrality”



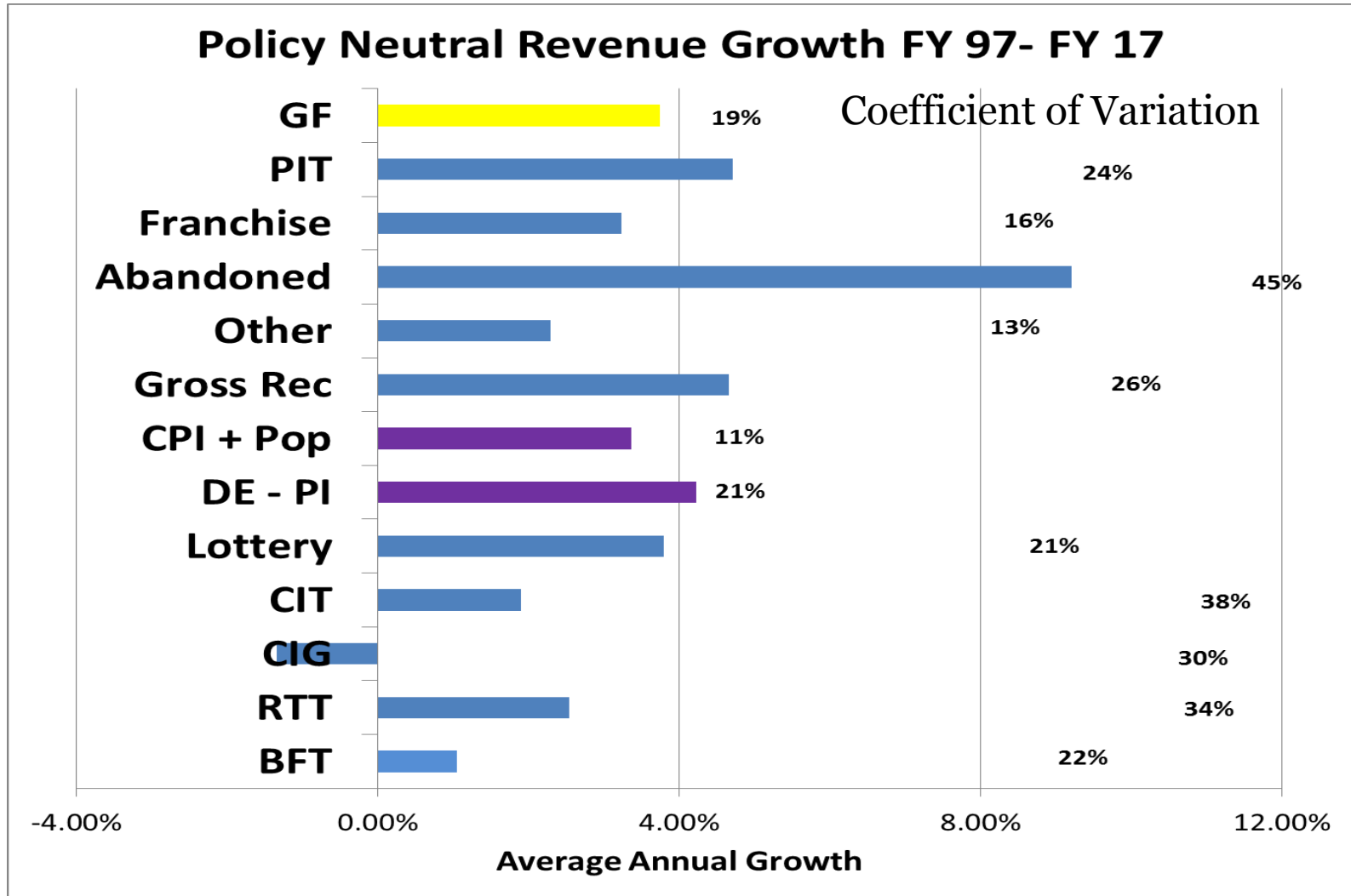
# Changing Revenue Composition

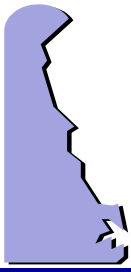


\* 2000 forward Franchise figures include LP/LLC, Entity fee, and UCC collections.



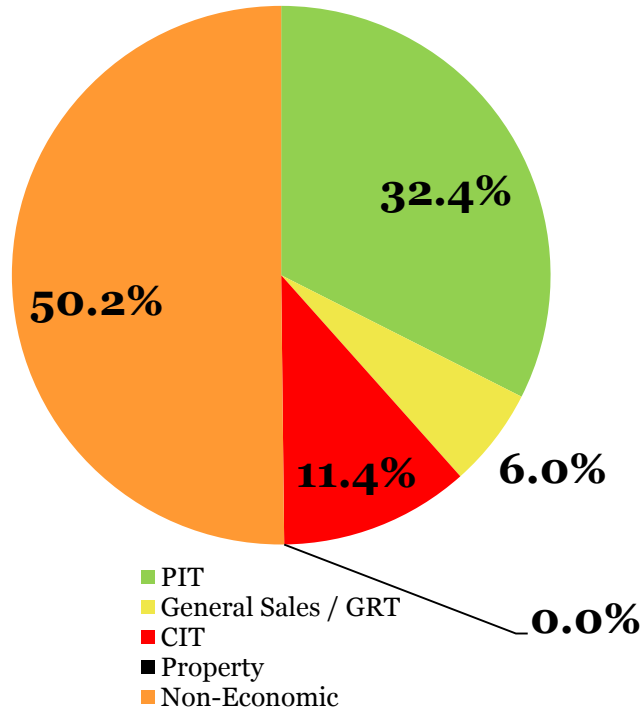
# Economic Correlations and Volatility



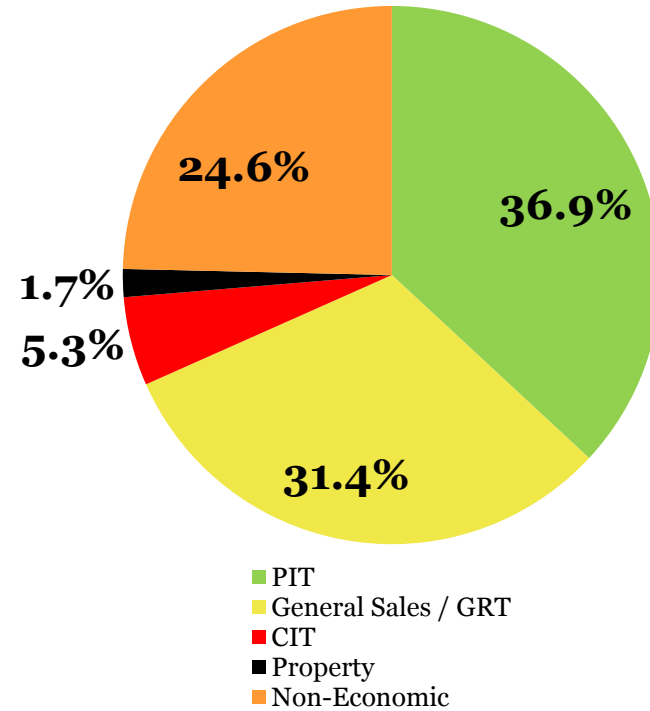


# A Unique Revenue Portfolio

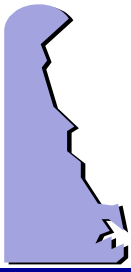
## Delaware



## United States



Source: U.S. Census Bureau, 2015 State Government Finances (adjusted)



# 2015 Advisory Panel Recommendations on Revenue Reform

## Completed and Continuing

- ✓ Apportion more weight on the CIT's Sales Factor
- ✓ Make periodic changes to the Corporate Franchise when prudent
- ✓ Repeal Delaware's Estate Tax

## Outstanding

- Eliminate Itemized Deductions
- Conform Age-Based Tax Preferences
- Offset CIT cuts with GRT Increases
- Normalize revenue payment schedule



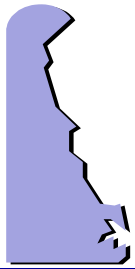
# All taxes have two parts...

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1. Tax Base – that which is subject to tax
  - Income, sales, property value
2. Rate – the share of the base owed
  - Marginal, effective
  - Progressive, regressive

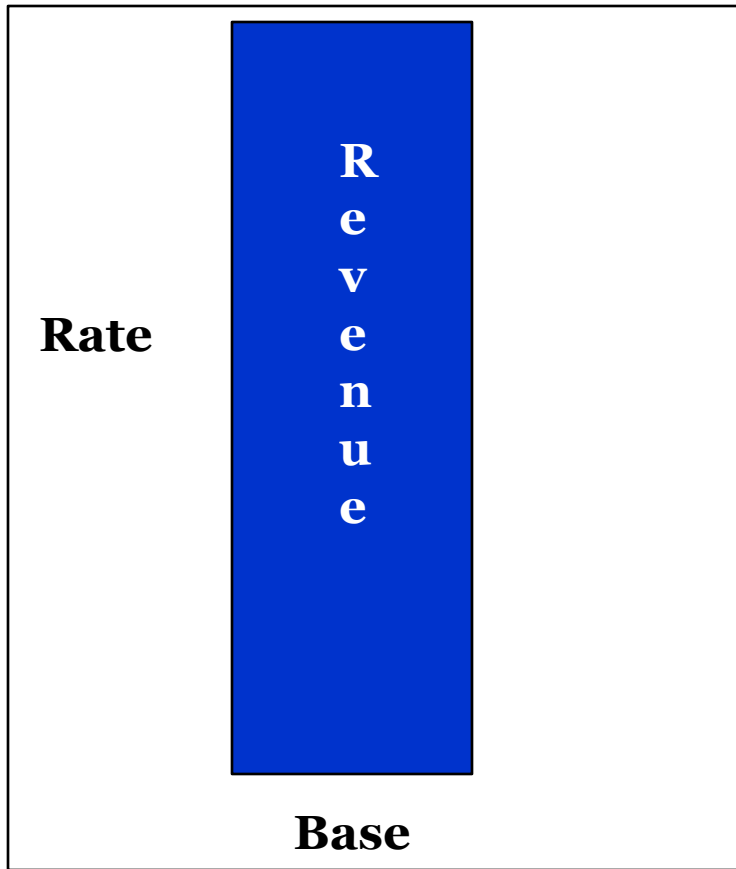
- Where do non-tax revenues fit?



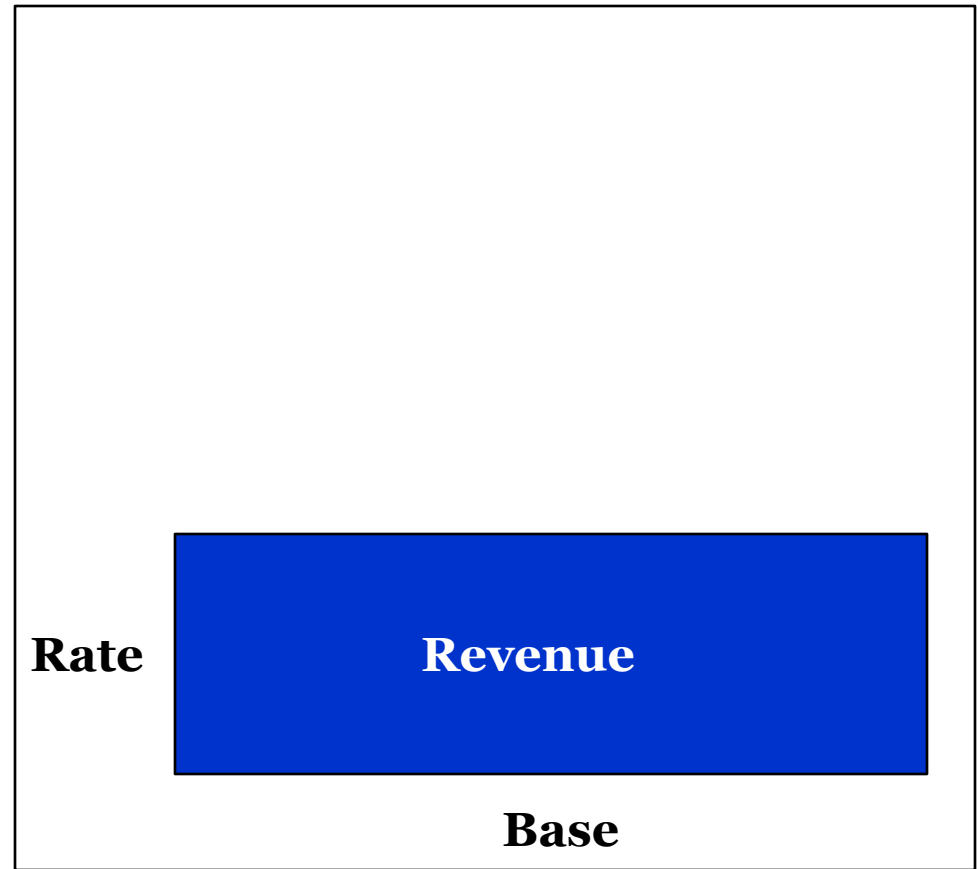


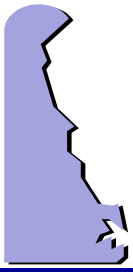
# Broad Base, Low Rate & Stability

**Narrow Base + High Rate**



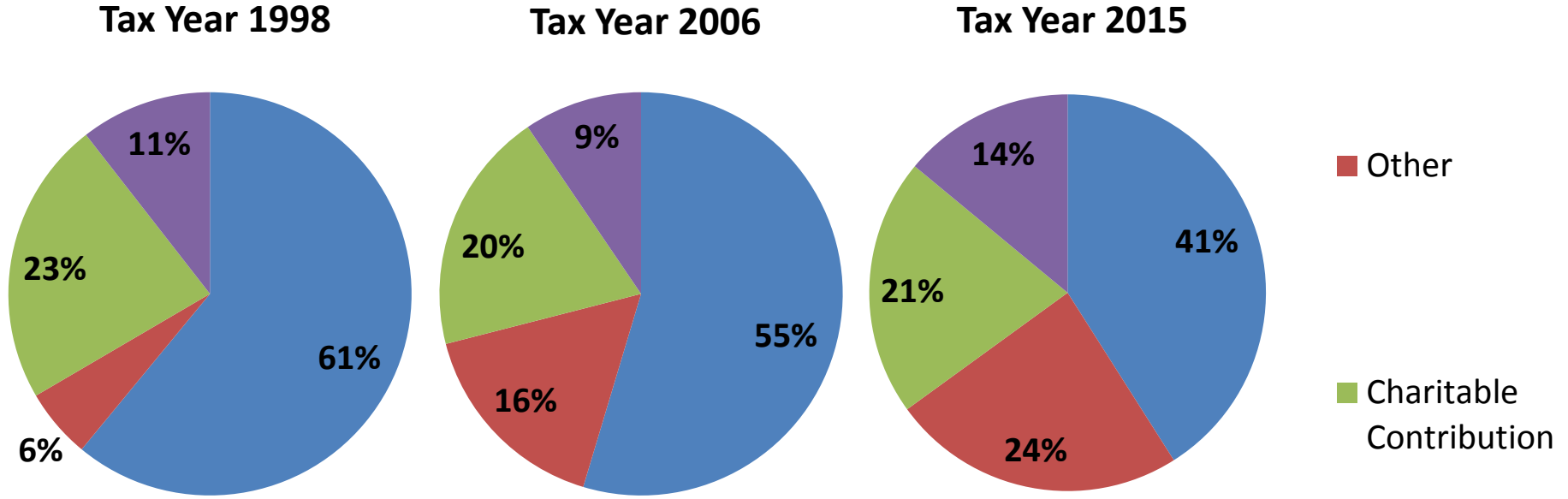
**Broad Base + Low Rate**





# Itemization Narrows Tax Base

What are Delawareans Itemizing?



Other includes unreimbursed employee expenses, medical, gambling losses, tax preparation fees, and casualty losses



# PIT Base Broadening Options: Itemized Deductions

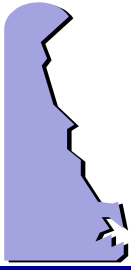
- Note: DEFAC FY20 PIT Estimate: \$1,527m
- Repeal Itemized Deductions in Delaware (\$180-190m, roughly 12%)
  - In 2015 42% of tax returns involve itemized deductions.
  - Reduce state rewards for existing behavior.
- Cap or Means-Test Itemized Deductions
  - Effectively eliminate some deductions and tax subsidies.
  - Still provide tax subsidy based on behavioral choices.
- Offset some of the changes with increased standard deductions, increased personal credit, or rate changes



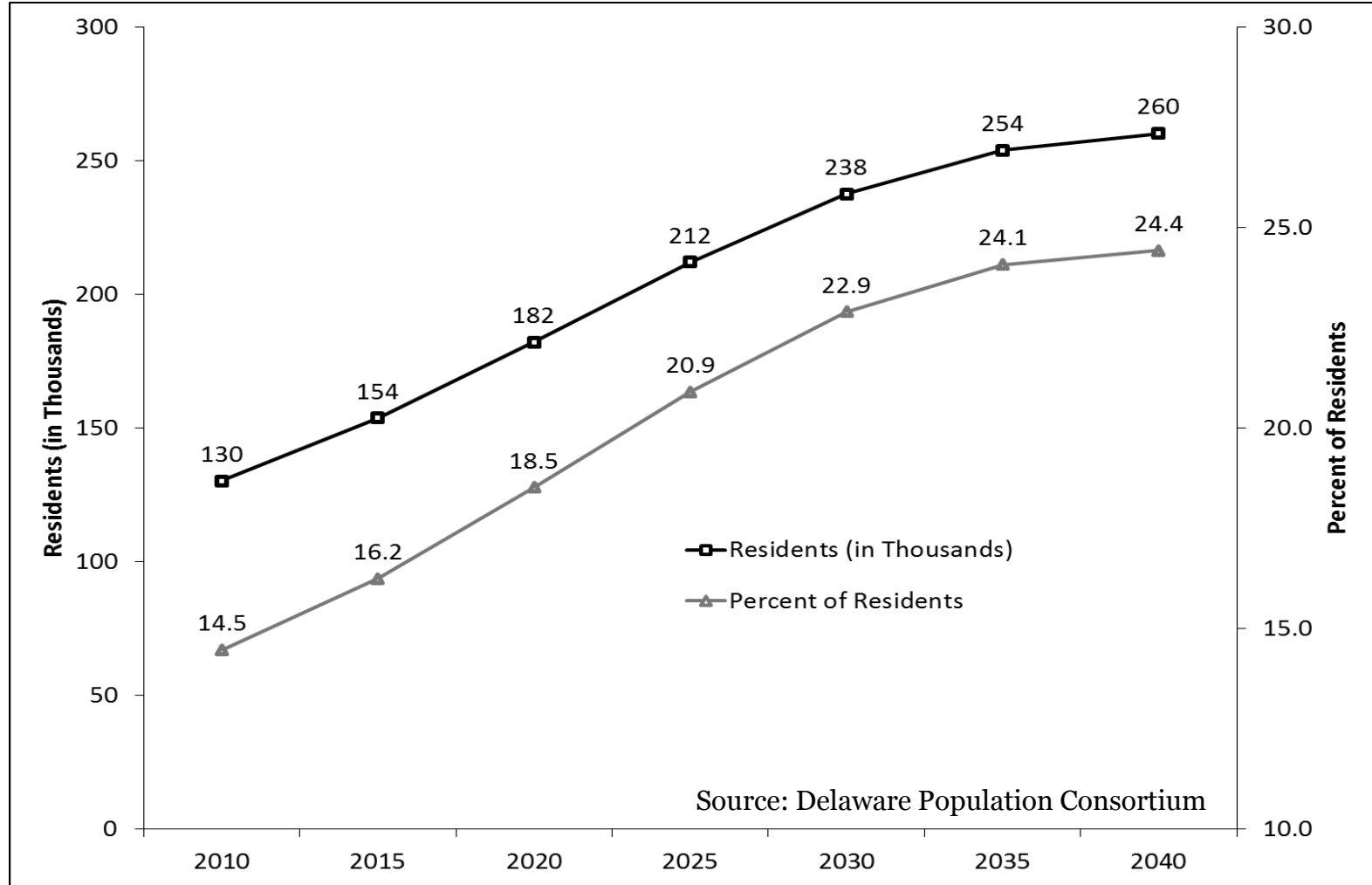
# Age-Based Tax Preferences

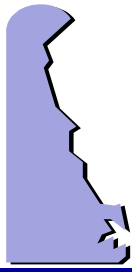
## Narrow the Tax Base

- Delaware's Tax Preferences for Retirement Income
  - \$12,500 in “Retirement income” is tax-exempt for those 60 and over.
  - \$2,000 in “Retirement income” is tax-exempt for those younger than 60.
  - Social Security income is excluded from Delaware definitions of AGI.
  - Taxpayers 65 years of age (or blind) who do not itemize are entitled to an additional \$2,500 standard deduction.
  - Taxpayers 60 years of age or more receive an additional personal credit of \$110.



# Residents Age 65 and Over

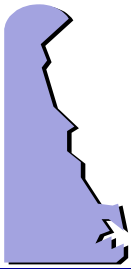




# Demographic Pressure

## Negative Revenue Impact (millions)

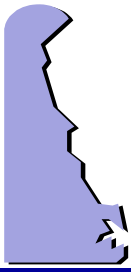
	Fiscal 2007	Fiscal 2017
<b>Income Tax Provisions</b>		
Retirement Income Exclusion (Age 60+, \$12,500 per individual)	\$36.0	\$64.0
Social Security (Exclusion of federally taxable portion)	\$21.2	\$64.7
Additional Standard Deduction (Age 65+ \$2,500)	\$2.9	\$5.1
Additional Personal Credit (Age 60+ \$110)	\$6.9	\$12.3
<b>Elder School Tax Subsidy</b>	\$13.9	\$24.1
<b>Total</b>	<u>\$80.9</u>	<u>\$170.2</u>



# Incrementalism & Unintended Consequences

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

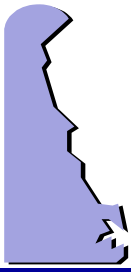
	<u>Working-Age Family of Four</u>		<u>Retired Couple</u>	
	<u>First Spouse</u>	<u>Second Spouse</u>	<u>First Spouse</u>	<u>Second Spouse</u>
Wages	\$40,000	\$40,000	\$0	\$0
Retirement Income	-	-	26,000	26,000
Social Security	-	-	14,000	14,000
Total Income	\$40,000	\$40,000	\$40,000	\$40,000
Exclusions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



# PIT Base Broadening Options: Age-Based Tax Preferences

- Means-test “retirement income”
  - For example, single exemption capped at \$17,500;
  - Phased out over a total income range (excluding Social Security) from \$60,000 to \$110,000 ( Approximately \$30m or 2.0%)
    - Reduces preference towards particular retirement sources for those with a greater ability to pay.
- Change eligibility for extra personal credit from 60 to 65 (Approximately \$4m or 0.3%)
- Change eligibility for “retirement” exclusion from 60 to 65 (\$18.5m or 1.2%)
  - Acknowledges changes to working life and lifespan.
  - Simplifies the tax codes treatment and definition of retirement age.



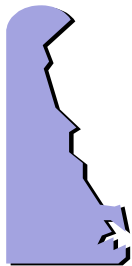


# Excerpt of 2015 Advisory Panel Base Broadening Proposal

## Example of Revenue Neutral Approach

(Millions)

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



# 2018 Update on Base Broadening

## For Illustrative Purposes Only

Reform	Senior Tax Breaks below	Amt	Age
1	Retirement Income Exemption	\$12,500	60
2	Extra Standard Deduction	\$2,500	65
3	Extra Personal Credit	\$110	60

Create a Means-tested Exemption For "Retirement Income".

Means Test is on AGI plus specified **bold addbacks**. Phased out over variable income thresholds.

Itemized Deduction is repealed.

December/September DEFAC Growth Forecast	1.8%	2.2%	2.5%	3.2%
	<u>FY 2019</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>
Phase-outs for Retirement Exemptions	<i>New General Fund Growth Rate</i>			
Non-Joint \$60,000 - \$110,000	1.8%	3.6%	3.0%	3.3%
Joint \$110,000 - \$160,000	<b>CURRENT</b>	<b>Above</b>	<b>ALTERNATIVE</b>	
Retirement Exemption:	<b>0.00%</b>	<b>\$0</b>	<b>0.00%</b>	
\$17,500 for Individuals	<b>2.20%</b>	<b>\$2,000</b>	<b>2.10%</b>	
\$22,500 for Joint	<b>3.90%</b>	<b>\$5,000</b>	<b>3.70%</b>	
Eligibility age 65 with grandfather	<b>4.80%</b>	<b>\$10,000</b>	<b>4.60%</b>	
Means Test includes " <b>Retirement Income</b> "	<b>5.20%</b>	<b>\$20,000</b>	<b>5.00%</b>	
	<b>5.55%</b>	<b>\$25,000</b>	<b>5.20%</b>	
Alternative Tax Table ----->	<b>6.60%</b>	<b>\$60,000</b>	<b>5.98%</b>	
	<b>6.60%</b>	<b>\$150,000</b>	<b>5.98%</b>	
	<b>\$ (0.5)</b>	<b>\$ 61.4</b>	<b>\$ 81.5</b>	<b>\$ 88.5</b>