Analytics

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RE: The futility of raising taxes

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Previous research by the CRI has shown that despite many major changes in tax rates and regulations over the past 20 years, Delaware state tax revenue has consistently hovered around 5.5% of gross state output. The bottom line is that citizens and businesses are creative and find ways to limit the total government takes out of their pockets.

With regard to alternative tax sources, CRI has already demonstrated that there is a statistically significant inverse relationship between Delaware's top personal income tax rate and inflation-adjusted personal income tax revenue over the last 35 years.

State cigarette and gross receipts tax revenues for the first half of the current fiscal year (July 1, 2010 through December, 2010) confirm this avoidance behavior. During this six month period, according to DEFAC, employment has finally started to grow again in Delaware, wage and salary income is up 2.1% and personal income has risen 3.4%. However, despite a 39% increase in the cigarette tax rate and an 8% increase in the gross receipts tax rate, revenue for both is down on a year over year basis. And the revenue is down 4 to 8% when adjusted for the rise in personal income.

What is going on?

The cigarette tax rate in Delaware was raised to $1.60 per pack. This competes well with Pennsylvania ($1.60), Maryland ($2.00), and New Jersey ($2.70). It does not compete well, however, with the tax per pack in nearby Virginia ($0.50), West Virginia ($0.55), and North Carolina ($0.45). A recent study by the Mackinaw Center documents that both casual and commercial cigarette smuggling rises as the cigarette tax rate rises. Internet sales have strengthened this relationship.

The increase in Delaware's cigarette tax rate will modestly discourage smoking among young people. It will also, however, discourage smuggling *out of the state*. Delaware is a net exporter of cigarettes. According to Mackinaw, in 2009 Delaware was second largest cigarette exporting state in the nation, exporting 29% of its cigarette consumption. Virginia was first, exporting 56% of its consumption. Obviously, the 39% tax hike for 2010 will reduce Delaware cigarette sales to out of state customers and is the major factor behind the lagging cigarette tax revenues.

The main reason for the decline in gross receipts tax revenues despite the hike in the rate is that Delaware retail trade activity is well below its 2007 peak and is just showing signs of reaching a turning point. The greater concern with regard to the gross receipts tax is in effects on the price competitiveness of Delaware businesses and long term economic growth.

The gross receipts tax does provide the illusion that Delaware does not have a sales tax, and this stealth tax does significantly boost Delaware retail activity. The down side of the gross receipts tax is that it applies to the complete product or service life cycle…being levied on intermediate business-to-business purchases of supplies, raw materials and equipment. This pyramid effect results in many Delaware businesses having to charge higher prices and Delaware businesses being encouraged to buy from lower price out-of-state suppliers. And, obviously, the gross receipts tax penalizes low margin business relative to large margin business.

It is not surprising that only a handful of states still apply a gross receipts tax. Before any future increases in the gross receipts tax rate, the state should evaluate the full long term impacts of the tax on Delaware employment and income growth.

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