EXECUTIVE SUMMARY
REPORT OF THE ADVISORY PANEL TO DEFAC ON POTENTIAL FISCAL CONTROLS AND BUDGET SMOOTHING MECHANISMS

1.0 Executive Summary

The State of Delaware has an extended history of maintaining strict adherence to fiscal controls adopted in the late 1970s and early 1990s. This discipline has enabled the State to annually balance its budget and has earned Delaware AAA ratings from each of the major bond rating agencies.

Over the past decade, however, Delaware's yearly budgetary debates and periodic deficits have become a source of both growing concern and intensified political discord. Moreover, the State's structural imbalance between revenue and expenditure growth has become a topic of frequent discussion, prompting the creation of a Revenue Advisory Council (Council) under the Delaware Economic and Financial Advisory Council (DEFAC) to study and report on such issues during the 2015 fiscal year.

The earlier Council's work suggested reforms to Delaware's tax systems designed to alleviate volatility, improve responsiveness to economic growth, and foster economic development. The Council also recommended that the proposed revenue reforms be taken up in combination with new fiscal controls and a budget smoothing fund that would further reduce annual budget volatility and address the typical boom and bust of economic cycles. Additional study and design of these mechanisms was recommended for a future body.

Recognizing the earlier Council's work, the 149th General Assembly approved House Joint Resolution 8 (Resolution). The Resolution created an advisory panel (Panel) under DEFAC to study fiscal controls and budget smoothing mechanisms that could be added to Delaware's current financial framework to better address the State's systemic fiscal difficulties and long-term budget challenges.

The Panel was tasked with drafting a report to be presented to the Governor and the General Assembly that specifically addressed:

a. the State's historic adherence to the 98% appropriation limit and its use of the Budget Reserve Account;
b. the need for reasonable restrictions on the use of budget surpluses, including but not limited to those arising from unforeseen revenue growth or one-time revenues, to control the expansion of expenditures over the long term; and,

c. the benefits of a budget stabilization fund to store excess funds during periods of budget surplus and cover operating deficits during periods of budget deficit.[1]

The Panel was further charged with reviewing the May 2015 Revenue Report of the earlier Council and undertaking such analyses and studies as the Panel considered necessary or appropriate to discharge its duties.

The Panel convened over a period of nine months to review these issues and evaluate potential solutions. Staff from the Department of Finance (DOF) and the Office of the State Treasurer (OST) collaborated with analysts from Pew Charitable Trusts (Pew) to assist in the development of a series of presentations that covered revenue volatility, Rainy Day Funds, case studies of other states with stabilization funds, measuring Delaware's means and needs, stabilization fund use and optimal size, proposed budget smoothing models and analyses, and revenue reform. Staff from the Office of Management and Budget (OMB) and Controller General's Office (CG) provided critical data, input, and assistance throughout this process.

The Panel's recommendations set out below represent the consensus on each respective topic, but are not necessarily the conclusions of each individual Panel member. Taken together, the Panel believes that these recommendations will alleviate the managerial, cyclical, and structural volatility currently exhibited by Delaware's budget framework. The recommendations, however, will not fully resolve these issues, nor will they relieve policymakers from their ongoing obligations to make determinations regarding limited budget resources.

The Panel strongly encourages the Governor and legislators to consider implementation of these recommendations as a "package" for reasons of both political viability and overall efficacy. While each reform can be attempted alone, the Panel considers the politics of such an approach more challenging than their adoption in totality. The Panel also believes that the reforms taken as a whole are greater than the sum of their parts, with each proposal reinforcing and working in harmony with the others.

Finally, it is the Panel's position that implementation of changes to the fiscal controls and budget stabilization mechanisms should be enacted via a combination of constitutional amendment and statutory codification. The historic fiscal reforms of the late 1970s were implemented in this fashion and resulted in decades of adherence to both their spirit and letter. Delaware's opportunity to build on its legacy of fiscal responsibility will be best served by constitutionally and statutorily cementing new reforms in the same manner as its existing budgetary framework.

1) **Redefine the Appropriation Method and Build on Current Fiscal Controls –** The current method of setting the budget appropriation is based on a forecast of

[1] Delaware General Assembly, HJR 8, *Creating an Advisory Panel to the Delaware Economic and Financial Advisory Council to Study Potential Fiscal Controls and Budget Smoothing Mechanisms,* 149th General Assembly, Introduced June 30, 2017. Passed by House and Senate. Signed by Governor August 25, 2017.

future revenues and excess cash and is limited to 98% of such sum. The Panel recommends amending the current method of setting the annual appropriation limit by including a constraint that would restrain growth in appropriations to the operating budget and grant-in-aid funding to the same rate of growth as an economic metric – the "budget benchmark" while also allowing for a minimum level of authorization to the capital budget bill which may not or should not be funded through General Obligation Bonds. [2]

The new constraint would treat amounts above the benchmark as "extraordinary," and would provide for the appropriation of half of such funds only as one-time monies available to meet non-recurring expenditures with the other half being used to fund its budget stabilization fund (see below). Once fully funded, extraordinary funds otherwise required to be appropriated to the stabilization fund would be available for appropriation for any purpose. The Panel further recommends that the benchmark initially be constructed from an index comprised of equal weightings of the 3-year average of: (i) Delaware personal income growth and (ii) Delaware population growth and inflation reflecting the pool of goods and services purchased by government (as represented by the "Implicit Price Deflator for State & Local Government Purchases"). Effectively, the benchmark is designed to approximate a long-run level of sustainable resources and expenditures and provide policymakers with guidance as to the need to make ongoing adjustments to the State's revenue and expenditure portfolios. The Panel recommends that DEFAC be tasked with calculating the benchmark annually and reviewing and making any recommendations to the Governor and General Assembly regarding the construction of the benchmark periodically, but no less frequently than every five (5) years.

2) **Repurpose the Budget Reserve Account into a Budget Stabilization Fund –** Delaware's current Budget Reserve Account (BRA) has never been utilized. The Panel recommends reforming the constitutionally-mandated fund by increasing its size, providing for specific deposit and withdrawal rules, and converting the "rainy day fund" from an inactive savings mechanism into a means for policymakers to smooth cyclical volatility and cushion the impact of significant budget shortfalls. The new Budget Stabilization Fund (BSF) would be seeded with the monies currently held in the BRA with a goal of growing the new reserve account to 10% of gross General Fund Revenues (twice the size of the current BRA). Withdrawals from the BSF would be allowed if an operating deficit exceeds the 2% set-aside from the 98% rule or when growth in the 98% appropriations limit falls short of the growth in the budget benchmark. Withdrawals would be limited to the lesser of half of the shortfall or half of the

[2] Over the course of the last decade, roughly $40 million on average has been authorized annually in the capital budget bill for recurring expenditures that are not appropriately funded through General Obligation Bonds. To ensure such amounts are not bonded and that sufficient resources exist to meet such ongoing needs, the Panel recommends that the benchmark be applied to a base that is composed of operating funds, grant-in-aid monies, and a minimum amount of cash to the capital budget that is either fixed based on its historical average or limited to an amount not to exceed 1% of the operating budget.

BSF. Finally, the BSF would have a "floor" of 3% (compared to the current 5% BRA) with withdrawals resulting in a balance below that level subject to the same constitutionally-mandated three-fifths supermajority vote of both houses of the General Assembly that is now required for withdrawals from the BRA. At this level of funding, the BSF would provide Delaware with sufficient liquidity to weather most historical downturns with minimal or no expenditure cuts and/or revenue enhancements. Even in the most extreme cases, expenditure cuts and/or revenue enhancements would be more moderate than required under current budget rules. As a consequence, the BSF not only serves to alleviate the toughest of budget decisions, but also provides counter-cyclical fiscal policy that should mitigate the severity and/or length of economic contractions.

3) **Reform the Personal Income Tax to Broaden the Tax Base –** The Panel supports the reforms to Delaware's personal income tax (PIT) set out in the earlier Council's May 2015 Report that were designed to improve the portfolio's responsiveness to economic growth without increasing revenue volatility or reducing competitiveness. While certain of the Council's recommendations with respect to the corporate franchise tax, corporate income tax and estate tax have been adopted, other recommendations, most notably with respect to Delaware's single largest source of revenue, the PIT have yet to be addressed.[3] The Panel "seconds" the Council's recommendations to broaden the base of the PIT via the elimination of itemized deductions, the consolidation of certain age-based tax preferences, and the introduction of a relatively high "means-test" for age-based tax preferences. Additional revenues from these reforms would be used dollar-for-dollar in the first year of implementation to lower marginal tax rates including meaningfully reducing Delaware's highest marginal tax rate (currently 6.6% for taxable income above $60,000). In subsequent years, PIT growth would be both greater and more certain, better tracking Delaware's economy and generating significant additional revenues over current DEFAC forecasts (as demonstrated under sample scenarios set out in the full report). These reforms build upon recent federal tax reforms that lowered marginal tax rates and eliminated, reduced, or phased-out certain tax preferences in order to simplify and improve fairness in the tax code. While additional PIT revenues would constitute amounts removed from private sector allocation decisions, the Panel believes that lower marginal rates and improved counter-cyclical public sector fiscal policy allow for this portion of revenue portfolio growth without harming, and potentially enhancing, Delaware's economic competitiveness when made in conjunction with the Panel's other recommended reforms.

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[3] The Panel also recognizes that changes were made to escheat, the third largest source of revenues for Delaware, but these were outside of the mandate of the previous Council and therefore not a part of the report. Similarly, the Panel recognizes that the 2015 Report recommended a change to provide for equal quarterly payments of corporate income taxes that has not been adopted and could be part of a package contributing to revenue neutrality or pursued separately.