Report on the Use of Fiscal Controls and Budget Smoothing Mechanisms in Delaware

Advisory Panel to the

Delaware Economic and Financial Advisory Council

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Acknowledgements
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I. Introduction and 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:

- the State's historic adherence to the 98% appropriation limit and its use of the Budget Reserve Account;
- 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,
- 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]

[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.

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 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 the 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 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

[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.

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.

[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.

II. Context and Guiding Principles

The Panel's discussions began with the broadest definitions of budgetary mechanisms available to address volatility through (1) fiscal controls, (2) stabilization funds, and (3) base-broadening revenue reforms. Over the course of the panel's deliberations, discussion moved from broad definitions and multistate comparisons to a narrow consideration of specific policies framed within Delaware's unique budgetary context.

The Panel specifically acknowledged and made liberal use of research and recommendations provided by each of Pew and the earlier Council. In the latter case, much of the revenue reform recommendations made by the Panel are drawn from the work of the Council. Moreover, just as the Council agreed to take no view on the current or desired amount of revenues and spending, the Panel also agreed to take no view as to the level of the budget and instead focused its work on addressing the problems associated with managing a sustainable growth trend.

The Panel also drew on the work of Pew in helping states apply fact-based solutions to a wide range of fiscal policy areas, including the development and use of rainy day funds. Pew staff provided objective context concerning policy options while also offering an outsider's view of Delaware's history of budgeting practices and reserve fund usage.[4] This perspective highlighted Delaware's uniquely conservative position, when compared to other AAA-rated peers, as a state that has never drawn upon its BRA.

Drawing on the foregoing resources and a substantial body of data produced by the DOF, OMB, CG and OST, the Panel developed a set of guiding principles that ultimately shaped its specific recommendations. Those principles are as follows:

- **Objective Sustainability**–the budget process should make explicit reference to and be guided by outside measures to determine an overall level of budgetary growth that is consistent with Delaware's recent economic and demographic trends;
- **Structural Progress**–Delaware's existing budget mechanisms and current tax structure should be the framework for reform in order to capitalize on the State's culture of savings and history of fiscal rule-following;
- **Budgetary Flexibility**–extraordinary revenues should be put to a variety of uses that emphasize one-time expenditures and saving for budget contractions but which allow for operating fund growth so long as savings rules are being followed and reserves are employed as policymakers deem prudent;
- **Enhanced Credit Worthiness**–the State currently has a AAA-rating with the three major credit rating agencies, a position which should be strengthened by the recommendations.

The following research and analyses address major policy considerations related to the requirements contained in HJR 8 within the foregoing framework and consistent with the Panel's agreed-upon principles.

[4] Much of the discussion in this report references four reports prepared by Pew, noted in Appendix B.

III. Research on Budget Mechanisms and Fiscal Controls

Factors that contribute to budgetary disruptions range from those largely outside of policy control, such as the national economy and demographic trends, to those wholly determined by policy choices, such as the composition of a revenue portfolio or the quality and scope of government service provision. It is not uncommon for states to experience one or a combination of these factors at any given time.

The goal of policymakers is to ensure the continuous provision of necessary services across volatile budgetary conditions. Understanding and differentiating among the sources of such volatility is an important step in designing solutions to increase budget stability. Typically, budgetary imbalances can result from one or a combination of three volatility factors:

- **Cyclical** – culmination of the business cycle in an economic recession;
- **Managerial** – missed projections or poor financial management; and,
- **Structural** – enduring imbalance in the size and performance of the revenue or expenditure portfolios.[5]

This section reviews Delaware's historical adherence to budget rules and their policy impact as budgetary mechanisms. The Panel chose a 20-year period for review from FY 1997 to FY 2017 as it incorporates both periods of growth and two economic downturns of varying magnitudes. The second part of this section contrasts Delaware's practices with an analysis of budget mechanisms and fiscal controls adopted by other states. This section concludes with a high-level review of the personal income tax reform recommended by the Council's 2015 Report.

A. Delaware's Historical Budget Mechanisms

Delaware has three primary mechanisms for achieving budgetary stability and balance: (i) the 98 percent appropriation limit (the 98% Limit), (ii) tax and spending policy, and (iii) the budget reserve account or BRA. The first and third mechanisms were added to Delaware's Constitution following a period of major fiscal challenges in the 1970s. As a practical matter, Delaware has balanced the budget from year-to-year by adhering to the 98% Limit and adjusting revenues and expenditures as required; the BRA has never been used to reduce budget deficits.

1. The 98 Percent Appropriation Limit

The 98% Limit is Delaware's version of a balanced budget requirement, limiting appropriations for spending in any year to 98% of the revenues and unencumbered cash forecast for that year. The provision is set forth in Delaware's Constitution as follows:

> "No appropriation, supplemental appropriation, or Budget Act shall cause the aggregate State general fund appropriations enacted for any given fiscal year to exceed 98 percent of the estimate State general fund revenues…"[6]

[5] Yilin Hou. 2006. Public Administration Review. Budgeting for Fiscal Stability Over the Budget Cycle: A Countercyclical Fiscal Policy and the Multiyear Perspective on Budgeting.
[6] Delaware Constitution, Article 8, Section 6 (b).

The remaining 2% of forecasted revenue is not allowed to be appropriated within the year and serves as a cushion against revenue forecast shortfalls and expenditure overruns. However, to the extent there is no such shortfall or overrun, the 2% of revenue collected during the budget year is added to the forecasted revenue for the following year and available for appropriation. The 2% is not set aside or added to the Budget Reserve Account ("BRA") as savings each year. The 98% Limit is therefore best understood as a 100% limitation on future revenues, albeit with a lag that acts as a source of extra budget cushion.

Policymakers have been consistent in adhering to the 98% Limit. Delaware has only appropriated above the 98% Limit eight times since adoption of the amendment to the Constitution, as shown in Figure 1. All eight of the supplemental appropriations were approved to provide sufficient State matching funds for the Medicaid program, generally during or immediately following recessionary periods.

Figure 1: Requested Supplemental Funding Above 98 Percent Appropriation

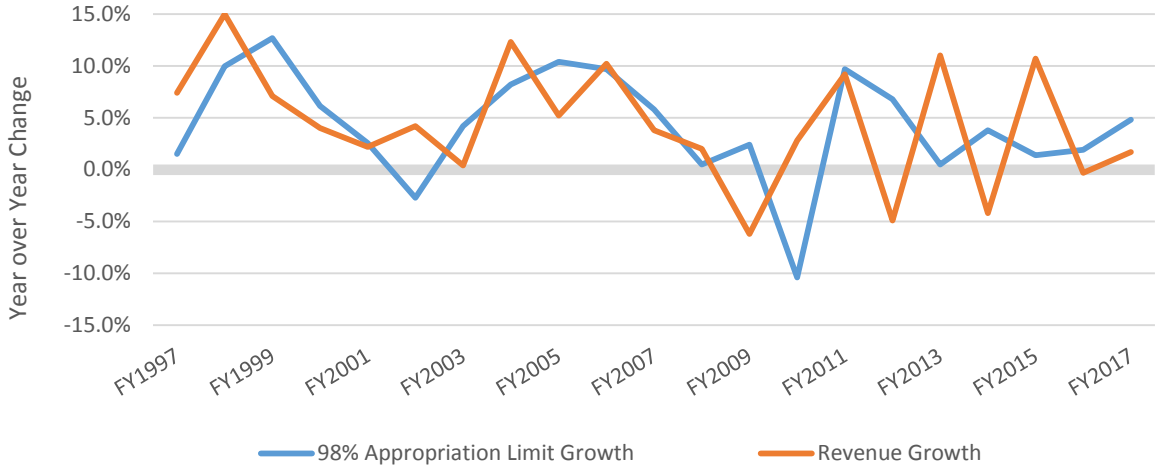
State Fiscal Year	Supplemental Funding	Share of Budget
1981	$9,400,000	1.5%
1982	$11,000,000	1.7%
1983	$640,000	0.1%
1984	$7,167,600	1.0%
1991	$5,700,000	0.5%
1992	$20,000,000	1.6%
1993	$25,830,000	2.0%
1994	$14,051,000	1.0%

Source: Delaware Office of Management and Budget (OMB)

2. Tax and Spending Policy

While Delaware's consistent application of the 98% Limit has demonstrated fiscal discipline, it has also resulted in budgetary variances arising from annual revenue volatility and economic trends over the business cycle. Figure 2 depicts graphically the annual change in the 98% Limit and General Fund revenues since FY 1997. While periods prior to FY 2009 also exhibited some revenue volatility, such variance presented fewer challenges as growth was consistently positive and revenues better tracked the economy. Since the Great Recession, however, revenue volatility has increased while revenue growth has, on several occasions, turned negative and become decoupled from economic growth.

Figure 2: Annual Change in the 98 Percent Appropriation Limit and Revenues



Sources: Department of Finance (DOF), Office of the State Treasurer (OST)

Figure 3 (below) sets out the revenue and appropriation growth shown in Figure 2 in a table in the form of annual percentage changes since FY 1997. The figures demonstrate how spending and tax policy have followed revenue portfolio volatility and business cycles.

Between FY 1997 and FY 2003, Delaware experienced significant growth in revenues resulting from strong employment and capital gains. In response, policymakers elected to enact large tax cuts. After the dotcom bubble burst, Delaware, like many states, raised taxes. Revenues from the Corporate Franchise, Cigarette, and Limited Liability Company taxes were increased by a total of $248.5 million for FY 2004 and FY 2005. However, these increases were not large enough to offset prior year tax cuts.

The Great Recession required a general shift in tax policy towards revenue enhancement. The revenue decline in FY 2009 prompted increases in the Personal Income Tax Gross Receipts Tax, Corporate Franchise Tax, Business Entity Fees, and other smaller miscellaneous taxes. Expenditures were also reduced during the Great Recession, with budget growth turning negative in FY 2010 (including a temporary reduction of employee pay by 2.5 percent that was subsequently restored in FY 2011).

Reversions have also played a more prominent role in budget policy following the recent economic downturn. These are amounts appropriated in a previous fiscal year that were unspent and reclaimed for appropriation. As a budgetary tool, reversions allow for periods of in-year contraction to be mitigated by effectively repurposing such amounts for new appropriations and/or to ensure adequate cash balances. Such use is highlighted in Figure 3 in the challenging years of 2009 and 2014. While reversions are an appropriate means of culling unused appropriations on a regular and consistent basis (see FY 1997 – 2007), their facility for addressing budget shortfalls over extended periods of slower growth is finite, as the amount of unspent appropriations that can be eliminated diminishes.

Figure 3: Changes in Revenue, the 98 Percent Limit, Taxes and Reversions

Fiscal Year	Revenue Growth	98 Percent Limit Growth	Budget Year Tax Policy Effects ($mm)	Sum Total of Tax Changes ($mm)	Reversions ($mm)
1997	7.4%	1.5%	-70.4	-70.4	23.4
1998	15.0%	10.0%	-43.4	-83.8	29.9
1999	7.1%	12.7%	-68.2	-134.0	19.4
2000	4.0%	6.1%	-193.8	-264.0	15.0
2001	2.2%	2.6%	-120.6	-335.4	N/A
2002	4.2%	-2.7%	-20.0	-355.8	N/A
2003	0.4%	4.2%	-10.0	-367.4	39.3
2004	12.3%	8.2%	133.6	-246.8	29.8
2005	5.2%	10.4%	114.9	-290.0	15.4
2006	10.2%	9.7%	-46.7	-334.1	12.8
2007	3.8%	5.8%	-97.1	-399.1	12.0
2008	2.0%	0.5%	18.1	-354.4	90.6
2009	-6.2%	4.2%	174.9	-241.3	247.0
2010	2.8%	-10.4%	359.4	-25.3	49.3
2011	9.2%	9.7%	288.0	40.9	41.9
2012	-4.9%	6.8%	-204.2	-218.6	75.3
2013	11.0%	0.5%	-130.5	-133.0	50.5
2014	-4.2%	3.8%	-74.8	-150.7	111.3
2015	10.7%	1.4%	22.4	-73.4	39.6
2016	-0.3%	1.9%	51.5	-77.3	57.5
2017	1.7%	4.8%	-10.7	-127.0	39.6

Note: "Budget Year Tax Policy Effects" shows the estimated revenue impact from fiscal notes, which generally only extend for a three-year period, at the time legislation was enacted; "Sum Total of Tax Changes" shows the ongoing impact, including the effects of growth, phase-ins and sunsets. Accordingly, the "Sum Total of Tax Changes" is not a running total of "Budget Year Tax Policy Effects."
Sources: OMB, DOF, OST

Figure 3 also includes both the annual and cumulative value of tax law changes included in the revenue growth figures. This data demonstrates that while tax cuts have outpaced tax increases, the net effect over a 21-year period is negligible, amounting to decreases that average roughly $6 million per annum. Revenue growth (or lack thereof) is better explained by other policy choices, notably, greater reliance on less reliable sources of revenue and a hollowing of revenue bases. These same trends, what the earlier Council described as a "double narrowing" of the revenue portfolio, have also resulted in greater revenue variability.

3. Budget Reserve Account (BRA)

In theory, Delaware's third means of budgetary planning consists of a "Rainy Day Fund," currently holding reserves of $231.6 million. While the rules for depositing to the fund have been applied to consistently maintain its balance at or above 5% of gross General Fund Revenue, competing or inconsistent rationales for its application have prevented its use.

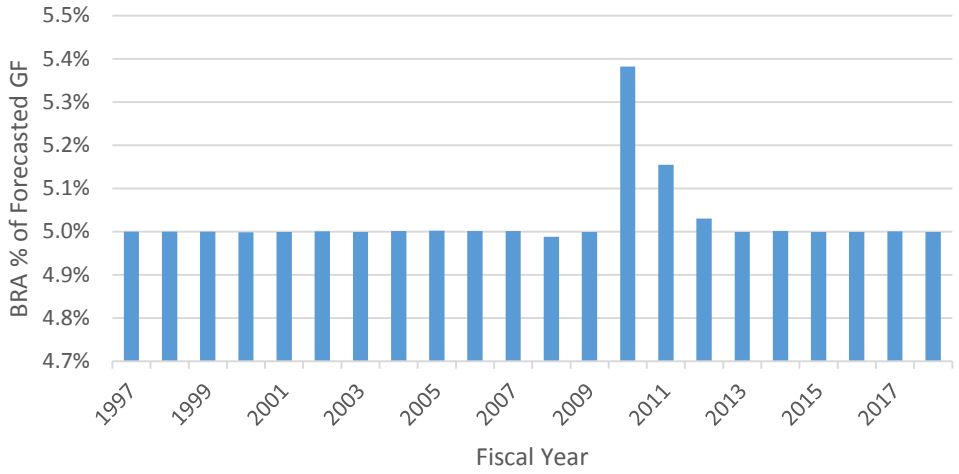
According to the Constitution, the BRA can be drawn upon as follows:

> "…The General Assembly by three-fifths vote of the members elected to each House may appropriate from the Budget Reserve Account such additional sums as may be necessary to fund any unanticipated deficit in any given fiscal year or to provide funds required as a result of any revenue reduction enacted by the General Assembly."[7]

The intended use of the BRA, enacted in 1979, has long divided policymakers. Over time there have been calls to cap and/or appropriate funds from the BRA, but it has never been drawn upon. Some see it as a credit enhancement device to support Delaware's bond ratings and argue the fund cannot be used without jeopardizing credit ratings. Others point to the ambiguous nature of the withdrawal rule as a basis for failing to use the fund. They question the nature of an "unanticipated deficit" given that revenues and expenditures for any budget year are forecast several years in advance and are further estimated six times per annum by DEFAC.

Figure 4 provides the historical balance of the BRA as a percentage of estimated General Fund revenues from FY 1997 through FY 2017. With the exception of the period between FY 2010 and FY 2012, the balance has been maintained at the 5 percent threshold using annual deposits of unencumbered cash. Delaware did not deposit into the BRA in those three years as total revenues fell below FY 2009 levels, driving the unchanged balance of the fund over 5 percent. As there is no mechanism for withdrawal besides the three-fifths vote and because legislative intent for the use of the BRA is unclear, the balances in the BRA have remained untouched.

Figure 4: Historical Percentage of BRA to Estimated General Fund Revenues



Sources: OMB, DOF, OST

[7] Delaware Constitution, Article 8, Section 6 (d).

B. Multistate Analysis on Budget Mechanisms and Fiscal Controls

Since 2014, Pew has worked with several states to develop their rainy day funds into a tool that can help manage the business cycle. Pew has issued a series of reports that identify several best practices for building better rainy day funds. The reports emphasize that states should:

- Study how sensitive their revenues are to economic volatility;
- Identify concrete BRA objectives and an appropriate savings target (size);
- Link deposits to economic or revenue growth; and,
- Establish withdrawal conditions that encourage use during periods of fiscal stress.

Pew staff presented on each of the four elements emphasized in their reports, and worked with Delaware staff to refine their analysis to include Delaware-specific information for comparisons to other AAA-rated states.

1. Revenue Volatility

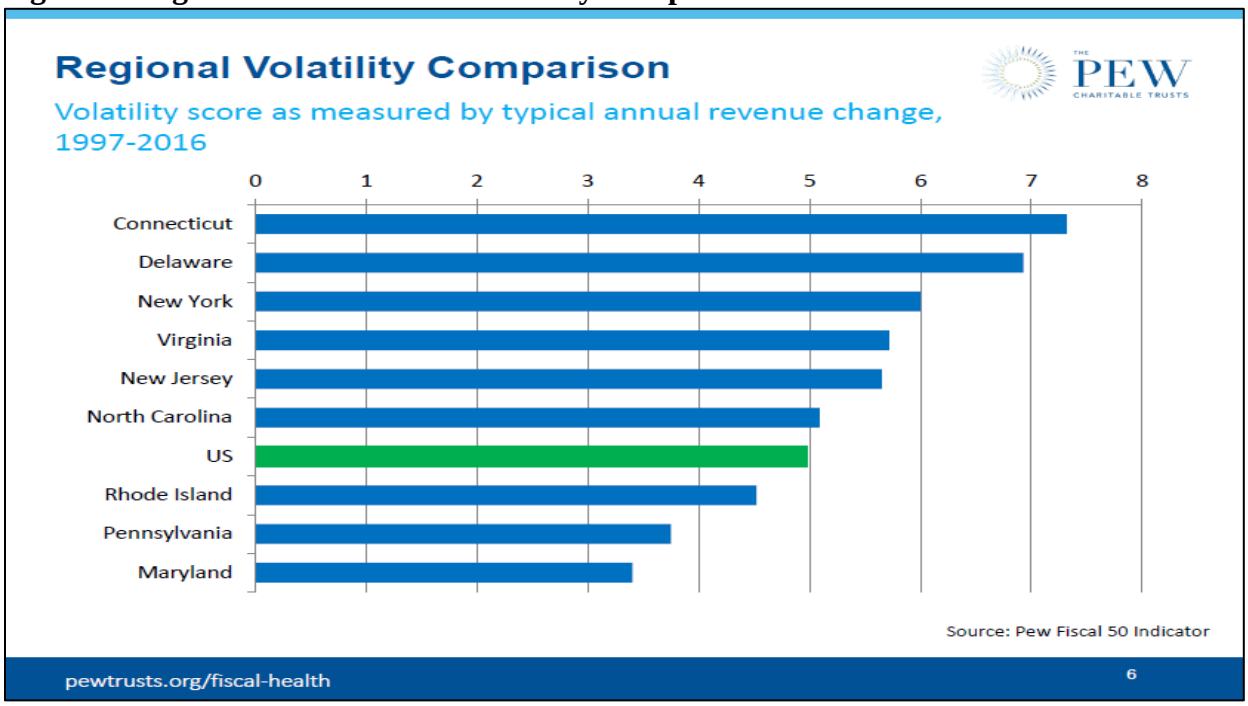
Revenue volatility can most easily be defined as the yearly fluctuations in revenue collection and is not inherently bad if effectively managed. When revenue growth is strong, states can use this good fortune to improve infrastructure, pay down debt, or set money aside to buffer against leaner years ahead. States can struggle, however, when strong revenue growth that is above sustainable levels is built into base budgets.

Moreover, when revenue growth is weak, or when revenues actually decline, states are faced with difficult decisions. They can either raise taxes to increase revenues, cut services to reduce expenditures, borrow from other funds, use contingency funds such as a budget reserve, or a combination thereof. In the years since the Great Recession, Delaware has done all of the above with the exception of using the budget reserve.

To the extent that the frequency or severity of budgetary responses to revenue volatility detracts or distracts from strategic planning and performance-based budgetary decisions, revenue volatility can be an impediment to sound fiscal management. As shown in Figure 5, Delaware is well outside the norm with regards to revenue volatility.[8] Delaware revenues rank as the 12th most volatile nationally, and the second most volatile in the region, with annual revenue changes that are 170 basis points higher than the national average.

[8] For more detail on the sources of Delaware's revenue volatility see the May 2015 Report of the DEFAC Advisory Council on Revenues.

Figure 5: Regional State Revenue Volatility Comparison



Source: Pew Charitable Trusts

2. Budget Reserve Accounts

BRAs have become a widely known and commonly understood tool for state government budgeting; 48 states now have one, including Delaware. The primary function of a BRA is to aid in managing budget disruptions. A secondary function is credit enhancement, as the maintenance and use of a BRA to manage budgetary disruptions is viewed favorably by credit rating agencies.

For decades it was thought that a BRA should represent approximately five percent of general fund revenues or expenditures, and Delaware has always followed that rule of thumb.[9] Since the turn of the millennia, research has indicated that the five percent rule (as a fixed metric) is relatively inadequate to cover potential budget imbalances.[10] [11] [12] Instead, a better approach is to target the BRA fund size to match a state's volatility experience.

One method for determining the optimal size of a BRA that has received praise from credit rating agencies was developed by the state of Minnesota. Since 2014, Minnesota has assessed the maximum size or cap of its BRA based on statistical analysis. Essentially, historical revenue

[9] Philip G. Joyce. 2001. Public Budgeting & Finance. What's So Magical about Five Percent? A Nationwide Look at Factors that Influence the Optimal Size of State Rainy Day Funds.
[10] Joyce. 2001. What's So Magical about Five Percent?
[11] The Pew Charitable Trusts. July 2014. Building State Rainy Day Funds: Policies to Harness Revenue Volatility, Stabilize Budgets and Strengthen Reserves.
[12] Kenneth A. Kriz. January 2015. Local Government Budget Stabilization: Explorations and Evidence. Is There an Optimal Size of Fiscal Reserves for Local Governments?

performance is used to determine how much revenue would need to be set aside to address a range of revenue downturns. Pew recommended the Minnesota Model for measuring a prudent cap for Delaware's BRA. (The results of Pew's analysis are presented in Section IV.A.2.)

3. Deposit Rules

Deposit rules define when revenues are deposited into a BRA, and how much. Delaware's deposit rule has always been based on excess funds at the end of a given fiscal year. For many years, this was the most common way for states to capture deposits. Conventional wisdom was to build the budget first and then set any surplus aside in reserves. During the Great Recession, the policy of "budget first and save later" exacerbated the resulting cyclical imbalance, partly because weak surplus deposit rules enabled the repeated use of one-time revenue to satisfy the ongoing expenses of many states.

The Great Recession caused many states to change the way they think about budgeting,[13] which has led to more volatility-based deposit rules. Such rules require deposits into a BRA when revenue or economic growth is above average. When the economy weakens, states are able to use these funds to maintain continuity of services and reduce the necessity or severity of tax increases. This prioritizes saving first, and prevents states from building one-time revenues into the base budget. Figure 6 demonstrates the change in states' deposit rules since the Great Recession.

Figure 6: Deposit Mechanisms Pre- and Post-Great Recession

Deposit Rule Mechanisms Prior to 2007		Deposit Rule Mechanisms Post-2007	
Savings Mechanism	**Number of States**	**Savings Mechanism**	**Number of States**
Surplus	23	Surplus	16
Forecast Error	5	Forecast Error	4
Fixed Amount	6	Fixed Amount	4
Volatility	9	Volatility	20

Source: Pew Charitable Trusts

Volatility-based deposit rules also make the most sense if the explicit purpose of the fund is to serve as a countercyclical fiscal tool. However, they are not a "set it and forget it" solution as tax bases and underlying economic conditions frequently fluctuate. Pew makes the following recommendations regarding volatility-based systems:

- Tie BRA deposits to observed volatility. Deposit rules linked directly to extraordinary or unexpected growth make saving a consistent, reliable practice in good times.
- Require regular studies to identify specific drivers of volatility and present appropriate policy solutions.

[13]Dan White, Bernard Yaros, and Brittany Merollo. October 2017. Moody's Analytics Stress Testing States.

4. Withdrawal Rules

Having and depositing into a BRA is an important first step to fiscal prudence; however, using the BRA when appropriate is the only way to manage budget imbalances with reserve accounts. That is not to say that funds should be used whenever and however the Governor or Legislature determine. For example, solving a structural mismatch between revenues and expenditures with reserves may address a budget shortfall in the short-term, but will only exacerbate the problem in the long-term.

Withdrawal rules for fund use should encourage the exercise of fiscal restraint and provide guidance on whether deficits are structural or have some other cause. Typically, acceptable rules for fund use fall into one of the following: to solve a non-structural budget gap, to correct a forecast error, to stabilize revenue or economic downturns, and to resolve other non-economic events (e.g. natural disasters, legal settlements, etc.).[14]

Historically, state policymakers have expressed concern that withdrawals from their BRA may negatively affect credit ratings. The concerns have merit as "depletion of financial reserves" is listed as a factor that could lead to a downgrade by Moody's.[15] However, Pew's research indicates that a withdrawal is unlikely to result in a credit downgrade, provided it is in accordance with well-defined rules.

Between 2000 and 2016, 7 of the 12 current AAA-rated states not only made withdrawals but withdrew their reserves down to 1% or less. The only state to receive a downgrade was North Carolina in 2002, from only one of the credit rating agencies. Interestingly, Indiana received a credit upgrade in 2010, the same year reserves were exhausted. It is evident that the context for the depletion of financial reserves and subsequent rebuilding of reserves is critical in ratings decisions, and that such agencies look favorably on well-constructed BRAs that allow for regular, clearly defined use. Pew recommends the following:

- Design rainy day funds with clear, objective goals that policymakers can refer to regardless of changes in governors, legislatures, and business cycles;
- Structure rainy day funds to be in line with the economy, so that deposits, withdrawals, and savings targets are informed by revenue volatility and the business cycle; and,
- Base the decision to tap rainy day funds on the state's fiscal situation, withdrawing money as appropriate during budget crises but resuming deposits when economic and fiscal conditions improve.

C. Review of May 2015 Revenue Report

The May 2015 Report of the Council outlined several recommendations to counter accumulated revenue policy choices that have decreased the reliability, responsiveness to economic growth,

[14] The Pew Charitable Trusts. April 2017. When to Use State Rainy Day Funds: Withdrawal Policies to Mitigate Volatility and Promote Structurally Balanced Budgets.

[15] Moody's Investors Service. January 25, 2018. *Moody's Assigns Aaa to Delaware G.O. Bonds; Outlook Stable.* https://www.moodys.com/research/Moodys-Assigns-Aaa-to-Delaware-GO-Bonds-Outlook-Stable--PR_904439350.

and capacity to foster economic development of Delaware's revenue portfolio. Some of these recommendations have been implemented, but suggested reforms to the State's largest revenue source, the Personal Income Tax, have not.

The personal income tax reforms recommended by the Panel follow the proposals of the 2015 Council. Those proposals focused on broadening the tax base and lowering marginal rates. Broadening the tax base entailed eliminating itemized deductions. It also entailed means-testing of the additional Personal Credit for taxpayers 60 and above, the $12,500 retirement income exclusion for taxpayers 60 and above, and the extra $2,500 standard deduction for taxpayers 65 and above. Marginal rates were to be reduced pro-rata by an amount equivalent to the revenue generated via base-broadening. While the first year of the proposal should be roughly revenue-neutral, base-broadening would provide stronger growth and greater tax revenue in the out-years.

For additional information on proposed PIT reforms and other recommendations regarding Delaware's revenue portfolio, the Panel recommends individuals read and become familiar with the Council's 2015 report.[16]

[16] DEFAC Advisory Council on Revenues, May 2015.
https://finance.delaware.gov/publications/defac/DEFAC_Advisory_Council_on_Revenue-Final_Report.pdf

IV. Findings, Proposal and Application

After reviewing Delaware's existing budget framework, best practices of peer states, and Pew's recommendations, the Panel broadly agreed that some combination of new fiscal controls, enhancements to the BRA , and revenue reform would improve on Delaware's capacity to effect prudent budgetary planning and enhance the State's reputation for sound fiscal management. The broad recommendations adopted by the Panel are summarized in the Introduction and Executive Summary of this Report and are more fully detailed below.

To assess the effect of the proposed reforms, the Panel modeled the recommendations and compared the outcomes to those produced with the current budget framework. In each scenario, the proposed reforms produced overall superior outcomes.

A. Findings and Proposal

The proposal developed by the Panel consists of a set of fiscal controls defining the use of extraordinary revenues for supplemental and one-time appropriations, a new Budget Stabilization Fund (BSF) with well-defined deposit and withdrawal rules, and Personal Income Tax reform in line with the recommendations provided by the Council's May 2015 Revenue Report.

1. Fiscal Controls

The Panel's proposed fiscal controls marry the best practices adopted by other states with the distinct qualities of Delaware's revenue and expenditure portfolios. Many states have acknowledged the disconnect between current budgeting practices, including balanced budget requirements, and regional economic cycles. As a result, several states have recently established fiscal controls that provide objectivity as well as structural and budgetary flexibility. The Panel adopted the same approach when developing its recommendations.

The Panel recommends the following fiscal controls:

- Create a "Budget Benchmark (BBM)" using a three-year rolling average of economic indicators that provides an objective and stable measure of sustainable budgetary growth.
- The BBM should consist of economic indicators that reflect both the means and needs of the State. The proposal calls for a 50/50 mix of Delaware Personal Income growth, and a summation of the Implicit Price Deflator for State and Local Government Purchases and Delaware population growth.
- Regularly review and test the blend of economic indicators in the BBM to ensure objectivity and stability through the economic cycle.
- Define "extraordinary revenues" as the extent to which the 98% Limit is greater than the BBM Limit (as defined below).
- A 3/5 General Assembly vote would be required to adopt and subsequently change the BBM and its component economic and demographic indicators.

Under this construct, the BBM represents an overall indicator of the performance of Delaware's economy, a restraint on budget growth during extraordinary revenue years, and a reflection of the efficacy of the State's revenue portfolio given current economic conditions.

The BBM is applied in conjunction with the State's existing budgeting practices and calculated in addition to the current 98% Limit. Whereas the 98% Limit is based on forecasted revenues and unencumbered cash, the BBM applies the growth in the economic indicators to the prior year's operating budget and Grant-in-Aid appropriation, plus recurring expenditures included in the bond bill (not to exceed one percent of the operating budget). The resulting BBM appropriation limit (the "BBM Limit") acts to identify and constrain the use of extraordinary revenues that would otherwise be available for appropriation as determined by the 98% Limit.

Supplemental appropriations for one-time expenditures, beyond the 1% defined above, should not be included within the BBM Limit. These appropriations are based on one-time revenues that are not expected to continue year-over-year. As such they should not be dedicated to recurring expenditures that will continue to grow in the future. To include supplemental appropriations in the base would undermine the intent of the fiscal control.

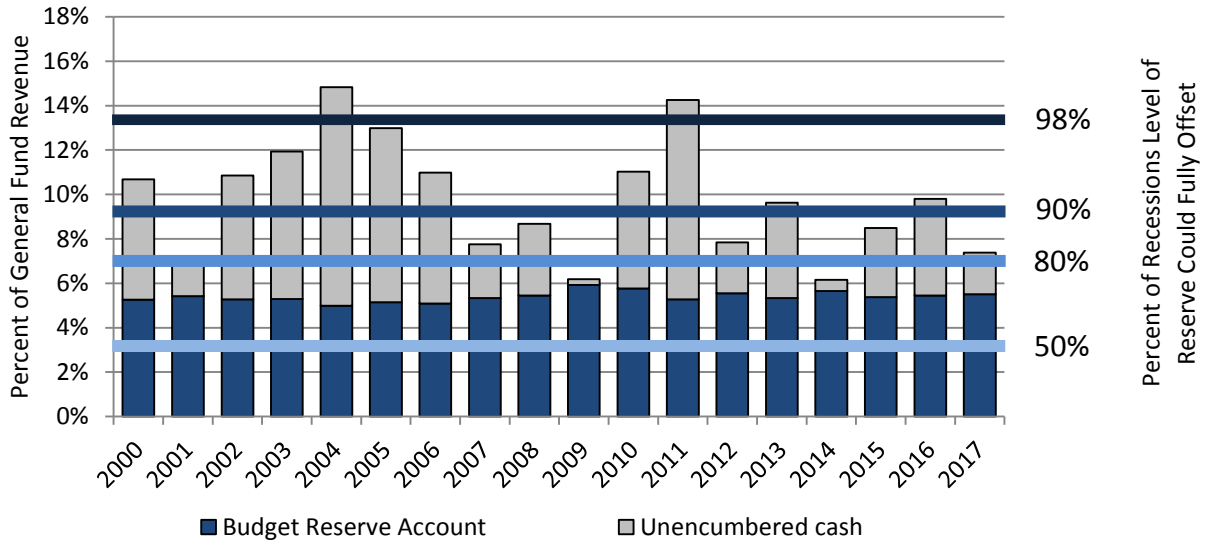
2. Budget Stabilization Fund

The Panel proposes repurposing the current "inactive" BRA into an active Budget Stabilization Fund (BSF). The proposal is based on the recognition that Delaware's volatile revenue portfolio requires better tools to manage annual variations. In addition, Delaware's historic maintenance of the BRA as an inert account to support credit enhancement no longer appears consistent with practices recently developed by other states, including those with AAA ratings, to better manage for consistency and sustainability over an economic cycle. Achieving such purposes requires a fund of greater size with well-defined deposit and withdrawal rules.

Pew presented an overview of optimal size targets for a Delaware BSF based on a replication of the Minnesota "optimal size" model. The analysis deconstructed the revenue portfolio into four revenue streams—individual income taxes, franchise taxes, abandoned property, and all other revenue—from 1990 through 2017 to show the percentage of the general fund revenues that Delaware would need to have in reserve in order to weather downturns of varying sizes and durations. Pew found that Delaware would need reserves equal to 3.9 percent of revenues to cover 50 percent of potential downturns, which would include mild recessions. Comparably, they found that Delaware would need reserves of 9.6 percent to cover 90 percent of potential downturns—enough to mitigate a severe recession. This analysis thus provides a potential floor and ceiling for a BSF that could withstand a mild to severe recession.

Figure 7 (below) compares Delaware's historic reserve levels, including both the BRA and unencumbered cash, to the amount the State would need in order to cover a downturn at the various levels. However, as previously mentioned, Delaware has not used its BRA to offset revenue downturns and unencumbered cash has historically been appropriated except for a 2% cushion. Figure 7 nonetheless demonstrates that doubling the reserve balance to 10% is not as daunting a task as one might initially think so long as constructs are put in place to set such cash aside.

Figure 7: Comparing Delaware's Current Reserves to Optimal Savings Target



Sources: DOF, Pew Charitable Trusts

The Panel recommends:

- Using the current $231.6 million BRA balance to provide initial funding for the BSF; and
- Raising the funding cap for the BSF from the BRA's 5 percent of gross estimated General Fund revenues to 10 percent (based on the intent to partly offset 90% of recession scenarios).

Delaware stands out as the only state with a AAA rating that did not use its BRA during the Great Recession, despite the fact that the Delaware revenue portfolio ranks as among the most volatile. As discussed above, the principal reasons cited for the maintenance of a BRA that goes unused are three-fold: (i) concern that use would trigger a ratings downgrade, (ii) lack of clear statutory rationale, and (iii) the difficulty of obtaining a 3/5 vote of each chamber of the General Assembly.

Research by Pew and examination of the many states that have effected changes to their BRAs since the Great Recession, suggests a new BSF with well-defined deposit and withdrawal rules that do not require super-majority action would not jeopardize Delaware's credit rating so long as the fund is not used to remedy structural imbalances and is instead actively used to collect and disburse funds over periods of fluctuating revenue and economic cycles.

The Panel recommends the following BSF deposit and withdrawal rules:

- Deposit Rules
  - Appropriate half of extraordinary revenues to the BSF until the 10 percent cap is reached.

- The other half of extraordinary revenues would only be available for appropriation to cover one-time, non-recurring expenditures.
- Once the 10 percent cap in the BSF is reached, the half of extraordinary funds otherwise deposited would be available for appropriation for any use as determined by the General Assembly.

- Withdrawal Rules:
  - In the event the 98% Limit is less than the BBM Limit, the BSF could be drawn upon to reduce the difference.
    - i. Half of the shortfall could come from the BSF provided it did not exceed half of the BSF balance.
    - ii. The remaining portion of the shortfall would need to be addressed through other means, presumably fiscal policy in the form of revenue enhancements and/or spending reductions.
  - In the event a current year operating deficit is greater than the 2% set-aside generated by the 98% rule, the BSF may be drawn upon to reduce the difference.
    - i. Half of the shortfall could come from the BSF provided it did not exceed half of the BSF balance.
    - ii. The remaining portion of the shortfall would need to be addressed through other means, presumably fiscal policy in the form of revenue enhancements and/or spending reductions.
  - Unlike the current BRA, withdrawals from the BSF that follow the withdrawal rules would be subject to the normal majority vote requirement of the current budget process.
  - A 3/5 General Assembly vote would be necessary for a withdrawal from the BSF that brings the balance below three percent of estimated gross General Fund revenues or to bypass any of the above deposit or withdrawal rules.

3. Revenue Reform

Following the suggestions of the earlier Council, the Panel recommends reforms to Delaware's PIT that reduce the volatility of the tax and enhance its responsiveness to economic growth by eliminating tax expenditures. The "Rate Focus" case prioritizes lowering marginal rates while maintaining the current bracket structure. The "Equity Focus" case emphasizes increased horizontal equity of payers and a greater sharing of the burden on higher incomes.

Both options are revenue neutral in the first year of implementation but generate additional amounts of revenues in subsequent years. The Equity Focus case raises a greater amount of revenue by eliminating additional tax preferences and introducing a higher bracket at $150,000 into the PIT rate structure.

The fiscal impacts on State revenue collections and distributional effects on taxpayers of the foregoing recommendations are set out in Figure 8. (For greater detail on the differences in the two cases presented below see the May 2nd presentation to the Panel.)

Rate Focus Case:

- Reforming existing age-based preferences and replacing them with a single retirement income exemption of $22,500 (joint) or $17,500 (individual);
- Eliminating Federal itemized deductions;
- Means-testing the single retirement income exemption, phasing out along the same ranges of $110,000 - $160,000 (joint) / $60,000 - $110,000 (individual); and
- Moving eligibility for the single retirement income exemption to 65 with a grandfather clause for previous age-based preferences; and,
- Reducing marginal tax rates by amounts equivalent to those generated via base-broadening.

Equity Focus Case: Includes everything in Option 1 with the following additions,

- Adding a new tax bracket for income above $150,000 (leaving intact the remainder of the bracket structure);
- Adding an exclusion for taxable Social Security Income to the Means-Tests, phasing out along the same ranges of $110,000 - $160,000 (joint) / $60,000 - $110,000 (individual); and,
- Providing for four equal installments of estimated Corporate Income Tax payments over the four quarters of the tax year (generating a one-time loss of revenue in the year of implementation).

Figure 8: Fiscal and Distributional Impacts of Each PIT Reform Proposal

Fiscal Impacts ($ in millions)				
Illustration	**FY19**	**FY 20**	**FY 21**	**FY 22**
Rate Focus	(5.8)	40.6	56.4	63.9
Equity Focus	5.5	104.1	114.6	130.3

Distributional Impact				
Quintile	Average TY 20 Change		Share of Change	
	Rate	Equity	Rate	Equity
1	$(5)	$(1)	-1.7%	-0.1%
2	$(6)	$22	-1.7%	2.0%
3	$54	$129	16.3%	11.9%
4	$196	$327	59.8%	30.2%
5	$90	$605	27.3%	55.9%

Source: DOF

B. Application

In order to compare the application of the Panel's recommendations against the current budget framework, four examples of Delaware's recent revenue growth patterns were analyzed. The analysis examines the impacts related to the BBM Limit and BSF under these scenarios based on historical revenue performance and without regard to the revenue reform package separately set out in this report.

Each of the four scenarios analyzed by the Panel uses actual revenue growth from a specific 6-year period as described below. In each case, the resulting revenue growth for the model period (FY2018 – FY2023) is set out in Figure 9 with introduction of the new fiscal controls and BSF in FY2019.

- **Scenario 1 (Whipsaw):** Alternating growth and decline, similar to FY 2011 to 2016;
- **Scenario 2 (Current):** Modest, steady growth, similar to the current forecast for FY 2018 to 2023;
- **Scenario 3 (Boom):** Strong revenue growth, similar to FY 2002 to 2007; and,
- **Scenario 4 (Crisis):** Revenue growth prior to and including the 2008/2009 financial crisis (FY 2005 to 2010).

Figure 9: Revenue Growth under Each Scenario

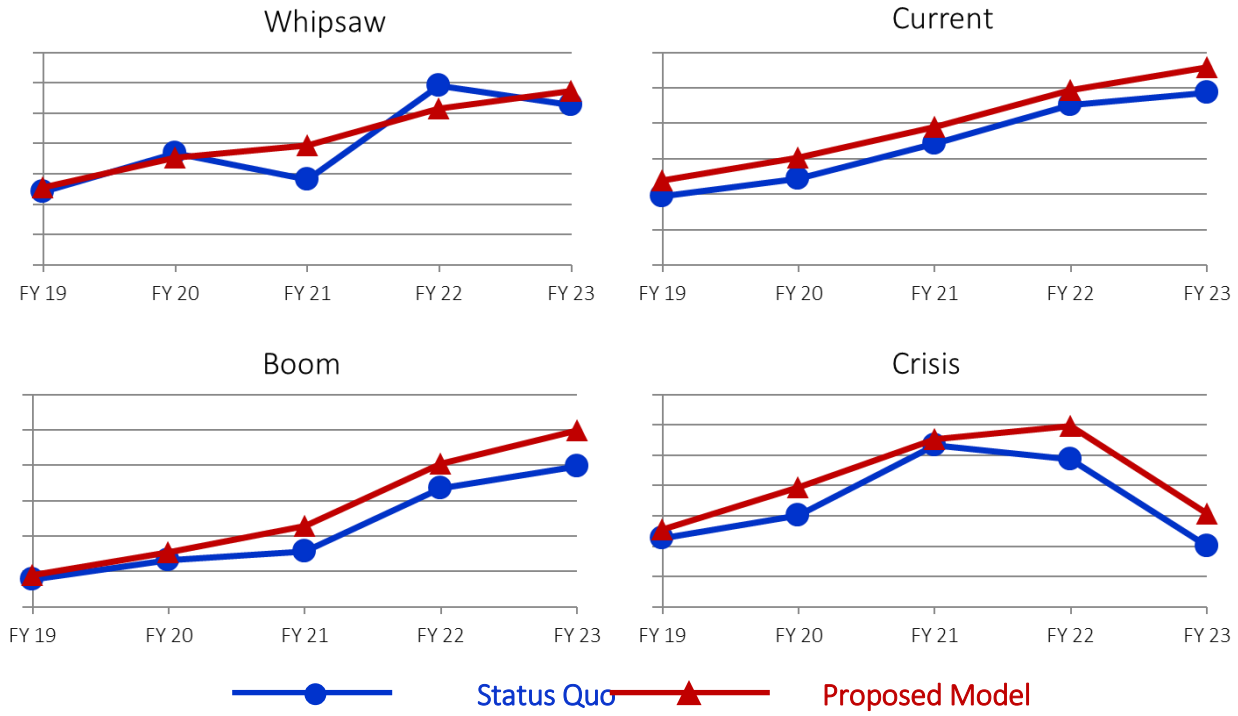
Scenario	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Whipsaw	9.0%	-5.0%	11.0%	-4.0%	11.0%	0.0%
Current	0.0%	8.0%	2.0%	3.0%	3.0%	4.0%
Boom	4.0%	1.0%	12.0%	5.0%	10.0%	4.0%
Crisis	5.0%	10.0%	4.0%	2.0%	-6.0%	-6.0%

Source: DOF, OST

The proposal is compared against the status quo under each scenario. The status quo assumes no change to the current budget structure. Each of the options is analyzed using the following performance metrics: level of spending, volatility, changes in reserve balance, and use of the BSF.

As shown in Figure 10 (below), under each scenario, the proposal provides a smoother budgetary path. Scenario 1 demonstrates that the BBM Limit would successfully smooth the whipsaw nature of revenues to create a moderate glide path for budget growth. Under Scenario 4, the BBM Limit and BSF work well to provide growth through the first year of revenue declines. Although there is a reduction in the budget in the second year of revenue declines, the analysis does not assume policy changes that would likely be made to address the full scope of the multi-year recession. Such changes almost certainly would have been made, particularly given the thoughtful consideration afforded by the use of the BSF to delay the budgetary shock associated with the loss of revenues.

Figure 10: Level of Spending, Status Quo vs. Proposal for Each Scenario



Source: DOF

Figure 11 shows the overall volatility of the budget. The coefficient of variation, an absolute comparative value of variance between data series, is used to measure the volatility of the options in each scenario. Essentially, the higher the number the more volatile the expected outcome will be in comparison to the alternative. In nearly every scenario the proposal experiences half the level of volatility expected under the status quo.

Figure 11: Aggregate Budget Volatility, Status Quo vs. Proposal for Each Scenario

Scenario	Status Quo (+/-)		Proposal(+/-)	
	Total	Operating	Total	Operating
Whipsaw	183	191	65	29
Current	54	47	20	20
Boom	68	74	70	46
Crisis	1,314	1,332	463	452

Source: DOF

When considering the impact on spending, a smoother growth in appropriation and lower volatility does not mean that average spending will be significantly reduced. Figure 12 demonstrates the average operating budget would remain relatively unchanged in the whipsaw and current scenarios. The value of the proposal in those scenarios is a smoothing to the average that prevents high growth in the base budget in one year and cuts to programs or tax hikes in the next. The counter-cyclicality of the proposal is demonstrated in the boom and recession scenarios. The proposal would reduce average operating budget growth in the boom to be used during the recessionary periods.

Figure 12: Average Operating Budget Impacts, Status Quo vs. Proposal for Each Scenario ($millions)

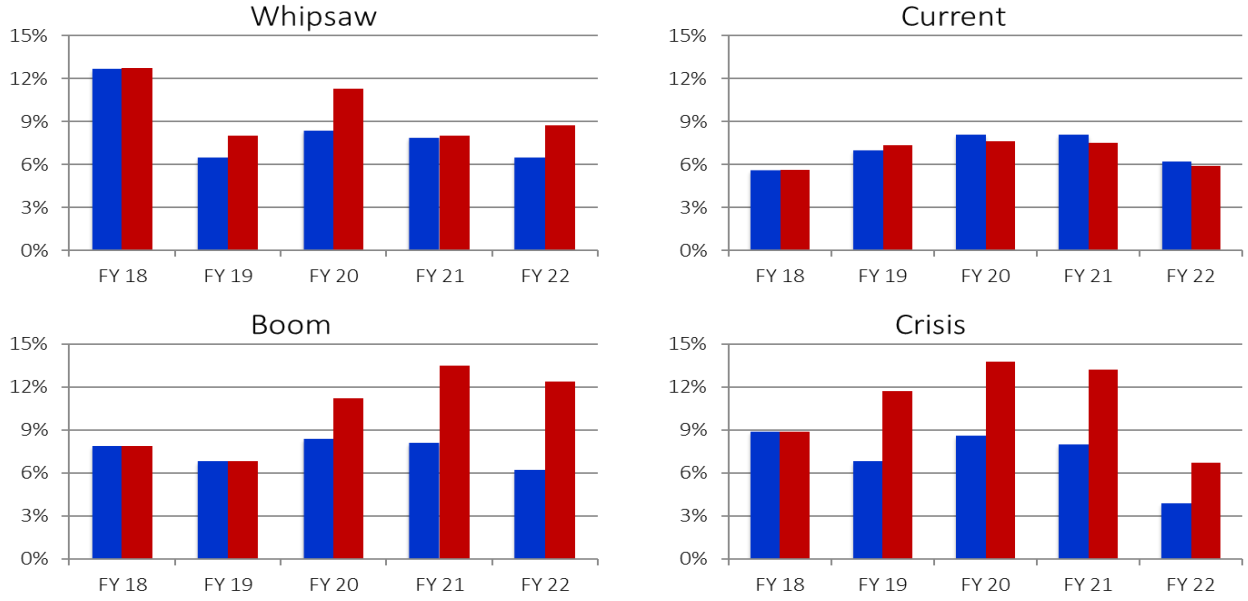
Scenario	Status Quo	Proposal	Difference
Whipsaw	$4,579.0	$4,577.0	-0.01%
Current	$4,502.0	$4,508.0	0.01%
Boom	$4,869.0	$4,815.0	-1.09%
Crisis	$4,606.0	$4,616.0	0.22%

Source: DOF

Unless budget growth parallels change in the economic measure for prolonged periods—as seen in the current scenario—the proposal would generate more reserves. In Figure 13, reserves consist of the BRA/BSF plus unencumbered funds at year end.

Figure 13 shows reserve balances as a percent of gross general fund revenues. Total balances consist of the BRA/BSF amount and unencumbered funds at year-end. Under the current forecast scenario with steady moderate growth, the proposal generates a slightly lower amount of reserves. This is because budget growth parallels growth in the economy, resulting in little availability to capture excess revenue. In each of the other scenarios, the proposal is able to build reserve balances over the period. However, it should be noted that a scenario of steady moderate growth over a 6 year period (as reflected in the state's current forecast) tends to be inconsistent with the volatility observed in practice. Any meaningful increase in actual upside and downside volatility would likely result in a higher amount of reserves.

Figure 13: Reserve Balances as a Percent of Gross General Fund Revenues, Status Quo vs. Proposal for Each Scenario

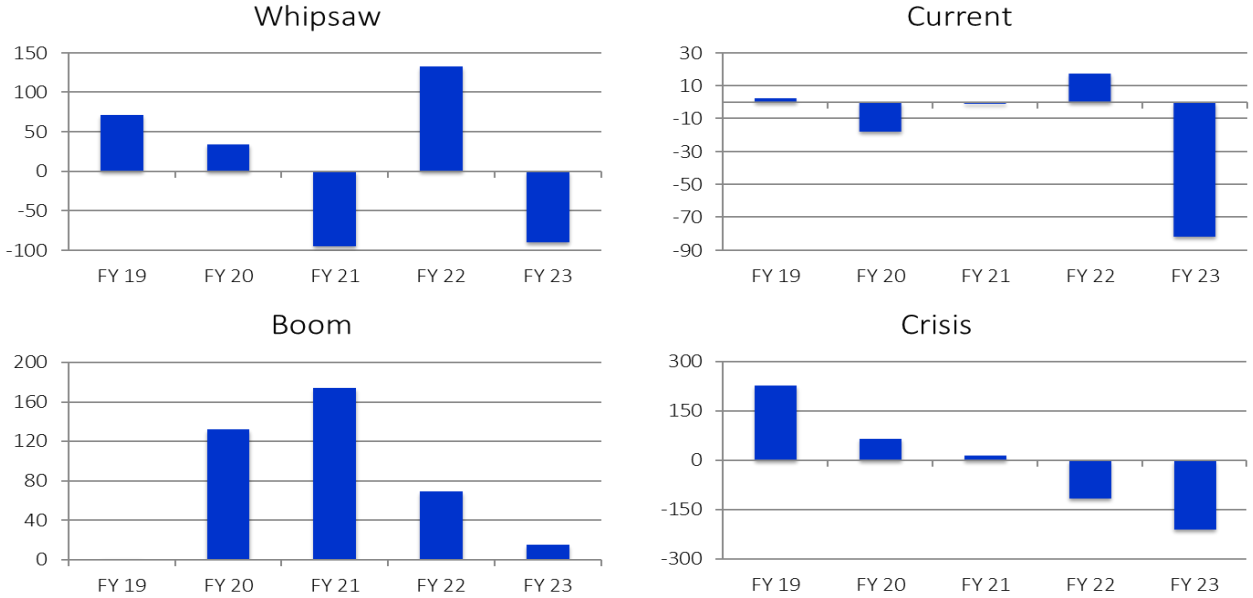


Source: DOF

Status Quo Proposed Model

Building higher reserves is positive but only if those reserves are utilized to offset the budgetary shock associated with a recession. Figure 14 depicts deposits to the BSF as positive bars and withdrawal years as negative bars. Since the status quo has never generated a withdrawal from the BRA, only the proposal is analyzed. Contrary to the history of Delaware's existing BRA, the proposal would have a reserve fund that is regularly used to smooth budget decisions over a multi-year period.

Figure 14: Annual Net Change in BSF Balance, Proposal Only ($millions)



Source: DOF

Overall, the analysis indicates that the proposal would reduce budget volatility, and only marginally affect the average level of spending. Using history as a guide to determine where reductions would be made in total expenditures, the analysis assumes that any reductions would occur within one-time spending to provide for a smoother operating budget. One notable result from the analysis is that during a recession, drawdowns from the BSF would enable Delaware spending to increase rather than decline. In economic theory, this would provide counter-cyclical support to cushion the State's economy during a period of contraction in private sector spending.

V. Conclusion

HJR 8 tasked the Panel with drafting a report to be presented to the Governor and the General Assembly that specifically addressed (i) the State's historic adherence to the 98% Limit and use of the BRA, (ii) the need for restrictions on the use of budget surpluses to control the expansion of expenditures over the long term, and (iii) 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. The Panel was further asked to consider the May 2015 Revenue Report of the earlier Council in undertaking such analyses.

The Panel has prepared this report and put forward its recommendations with specific attention focused on addressing the concerns set out in HJR 8. In that vein, it is the opinion of the Panel that adherence to the State's historic budget framework has been strong in managing annual solvency, but is inadequate to address issues of budget certainty from year-to-year and sustainability over the longer term. PIT reforms suggested by the Panel will mitigate these problems by reducing revenue volatility and improving revenue growth. However, more comprehensive solutions require reasonable constraints on the use of clearly defined extraordinary revenues and a robust budget stabilization fund to provide counter-cyclical funding. The package of reforms set out herein can and will accomplish those goals.

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.

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.

Appendix A – House Joint Resolution 8

SPONSOR: Rep. Q. Johnson & Rep. Schwartzkopf & Rep. Longhurst & Rep. Viola & Sen. McBride & Sen. Henry & Sen. Poore

Sens. Delcollo, Hansen, Lavelle, Pettyjohn, Simpson, Sokola, Townsend

HOUSE OF REPRESENTATIVES

149th GENERAL ASSEMBLY

HOUSE JOINT RESOLUTION NO. 8

CREATING AN ADVISORY PANEL TO THE DELAWARE ECONOMIC AND FINANCIAL ADVISORY COUNCIL TO STUDY POTENTIAL FISCAL CONROLS AND BUDGET SMOOTHING MECHANISMS.

WHEREAS, in recent years, despite less than 3% average annual growth, the growth in the State's budget has exceeded the growth in the state's revenue portfolio;

WHEREAS, State policy makers must ensure that taxpayer dollars are spent in a way that is responsible and that provides maximum value to the citizens of Delaware;

WHEREAS, a number of specific areas such as health care and education costs have been driving the budget's growth in recent years; and

WHEREAS, it is important to put in place a process to ensure that in-depth examinations of cost containment strategies are being conducted and actionable recommendations are being produced in order to progress towards the ultimate goal of slowing the growth of costs.

NOW, THEREFORE:

BE IT RESOLVED by the House of Representatives and the Senate of the 149th General Assembly of the State of Delaware, with the approval of the Governor, that there is hereby created an Advisory Panel to the Delaware Economic and Financial Advisory Council (DEFAC), in order to study potential fiscal controls and budget smoothing mechanisms, and shall be composed of the following members:

1. The Chairperson of DEFAC, who shall serve as the chairperson of the Advisory Panel.

2. The Chairperson of the DEFAC Subcommittee on Revenue.

3. The Chairperson of the DEFAC Subcommittee on Expenditure.

4. The State Treasurer or his or her designee.

5. The Secretary of the Department of State or his or her designee.

6. The Secretary of the Department of Finance or his or her designee.

7. The Director of the Office of Management and Budget or his or her designee.

8. One member appointed by the Speaker of the House of Representatives.

9. One member appointed by the Minority Leader of the House of Representatives.

10. One member appointed by the President Pro Tempore of the Senate.

11. One member appointed by the Minority Leader of the Senate.

12. The Controller General or his or her designee.

13. Three members of the public with prior experience in private and/or public sectors, appointed by the Governor.

BE IT FURTHER RESOLVED that the Advisory Panel shall:

1. Review the May 2015 Revenue Report and any supporting analyses or data and shall undertake such further analyses and studies as the Advisory Panel deems necessary or appropriate to discharge its duties.

2. Call upon and rely on any expertise of individuals outside of its membership, including paid consultants, for research, advice, support, or other functions necessary or appropriate to accomplish its mission. The budget for paid consultants shall not exceed $50,000 of aggregate fees and expenses.

3. Develop a report addressing all of the following:

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.

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.

d. Such other matters as the Advisory Panel deems appropriate.

4. Identify any changes to the Delaware Constitution, the Delaware Code, or any other regulation or law needed to implement the Advisory Panel's recommendations.

BE IT FURTHER RESOLVED that the Advisory Panel shall submit a preliminary report no later than May 1, 2018 to the Governor, the Speaker of the House of Representatives, the President Pro Tempore of the Senate, the Minority Leader of the House of Representatives, and the Minority Leader of the Senate.

BE IT FURTHER RESOLVED that staff support for the Advisory Panel shall be provided by the Department of Finance if necessary.

SYNOPSIS

This Joint Resolution creates an Advisory Panel to the Delaware Economic and Financial Advisory Council (DEFAC) that is tasked with developing a report concerning the State's historic budgeting practices, the need for reasonable restrictions on the use of budget surpluses, the benefits of a budget stabilization fund, and such other matters as the Advisory Panel deems appropriate. A preliminary report shall be submitted to the General Assembly and the Governor no later than May 1, 2018.

Appendix B – Meeting Minutes, Presentations, and Other Materials

Minutes of the six Panel meetings, along with all presentations made to the Panel, can be found at this link:

https://finance.delaware.gov/publications/BudgetSmooth/res8.shtml

Research reports from the Pew Charitable Trusts, which informed the Panel's discussions, can be found at this link:

http://www.pewtrusts.org/en/research-and-analysis/collections/2017/06/rainy-day-funds-best-practices-to-mitigate-revenue-volatility