DRAFT MINUTES of the
DELAWARE BENCHMARK EVALUATION AND REVIEW PANEL

Buena Vista – March 20, 2023

Attendance:

Member	Present
M. Houghton	Y
J. Bullock	Y
C. Cade	Y*
B. Carson	N
C. Davis	Y*
L. Davis Burnham	Y
R. Geisenberger	Y

Member	Present
D. Gillan	Y
R. Jones	N
T. Paradee	N
B. Pettyjohn	Y
E. Ratledge	Y
D. Short	Y

Members in Attendance:
Members Absent:

Others Present: * C. Stewart (for C. Cade), * J. Seemans (for C. Davis), A. Aka, B. DiVirgilio, R. Goldsmith, J. Heller, M. Marlin, D. Roose

Opening Business: Mr. Houghton called the meeting to order at 10:00 a.m.

Alternative Benchmark Calculations: Mr. Roose reviewed the intention of the budget benchmark under Executive Order 21, 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." He also reviewed the calculation of the budget benchmark index—an equally-weighted three-year average of growth in total personal income and the sum of population growth and inflation, as measured by the implicit price deflator for state and local government purchases.

He then reviewed key details of total personal income and its components, including wages and salaries, which are roughly half of Delaware's total personal income, and transfer payments, which are income for which no services are performed. He noted that capital gains are not included in total personal income as they are not related to current production.

During the pandemic, transfer payments jumped from roughly 20% of total personal income from 2010 to 2019 to 23.5% in 2020 and 25.5% in 2022—wages and salaries increased 1.3% and 3.7% in 2020 and 2021, while transfer payments increased 19.2% and 15.5%. Questions had been raised whether transfer payments distorted total personal income during this time, and perhaps the budget benchmark. A suggestion had been made at the prior meeting to replace total personal income with wage and salary income in the benchmark index to avoid that distortion. Mr. Roose presented a slide demonstrating that a wage-only benchmark would have been lower through the pandemic, but now as transfer payments are receding as a share of personal income, a wage-only benchmark would be slightly higher. Tying it back to the intent of the benchmark, he said the question is what measure of personal income best approximates a long-run level of sustainable resources. As not all personal income is taxable, particularly transfer payments, and capital gains, which are taxed, are not included in personal income (and data lags several years), there may be no perfect measure.

Mr. Ratledge agreed that it depends what exactly the index is intended to measure. He noted that the transfer payment surge did indicate something about aggregate demand, and that if cash to Delaware was the question, total personal income may be appropriate. But wage and salary income is better for reflecting current conditions, and if wage and salary income is strong the other components (especially transfer payments) may not be as strong.

Ms. Davis Burnham asked about the difference between 401(k) contributions and distributions, as well as Roth contributions. Mr. Roose restated that not all income is taxable, so that the change in personal income does not necessarily measure the change in tax revenue (including the increasing use of Roth retirement accounts). He was uncertain whether distributions are counted as income from current production or not.

Mr. Short asked whether the index could have been directly adjusted for the transfer payment distortion. Mr. Roose responded that despite the distortions, revenue continued to be collected and expenditures continued to be made, and that the benchmark is a three-year average, which attenuates some of the concern. Mr. Geisenberger noted that it's not always clear, especially in the moment, what is an abnormality and what is not.

Mr. Gillan asked where the three-year average came from. Mr. Geisenberger responded that it stemmed from the previous panel's discussion about weighing long-term stability relative to capturing the effect of changing economic conditions, and that three years reflected a satisfactory tradeoff between the two. If we had a ten year average, the benchmark would not be at a relatively high 6.1% this year. Mr. Gillan asked if the most recent year could be more highly weighted; Mr. Geisenberger said it could be weighted however the panel desired.

After the discussion of personal income, Mr. Roose turned to inflation. He discussed the differences between the Consumer Price Index and the State and Local Government Purchases Implicit Price Deflator. The former is roughly 1/3 each services, shelter, and goods, while the latter is over 70% wages with another 25% for other services. The CPI is composed of a fixed basket of goods which is adjusted annually, while the deflator is a dynamic measure that changes each quarter capturing all state and local government spending. Generally, the deflator has increased more rapidly over the past four decades, which indicates that the budget benchmark index would generally be lower if the CPI were the inflation measure used.

At the previous meeting concern was raised about the index' construction not allowing enough responsiveness to quick-onset, very high inflation, and whether increasing the weight of the inflation component in the index would be an appropriate response. Mr. Roose showed that a double-weighting of inflation would always result in a higher index. Mr. Geisenberger asked how a Social Security increase would be reflected in the index. Mr. Roose responded that it would come in through total personal income, not through the inflation component. But, in response to a follow-up, since 70% of government spending is wages, inflation-driven wage increases would result in a higher index through the income component.

Mr. Roose suggested another alternative approach would be to triple-weight just the latest year's inflation measure. Generally, this approach would have resulted in a slight variation from the current benchmark calculation, but in May and December 2022 would have resulted in a one percentage point and nearly two percentage point higher index. But, when inflation slows, it would result in a larger deceleration in the index. In addition, such an index would reduce the budget-smoothing impact of the process, which, though not an explicit charge of the previous panel, was clearly an implicit goal of the process. Increasing the responsiveness of the index, through any measure, would reduce the budget-smoothing impact of the benchmark process, which may or may not be acceptable. An equally important question is whether this would be more or less sustainable over the long term—no reason to think no. Again, there are tradeoffs involved in any changes from the current construction. Mr. Geisenberger noted that there were some states that use inflation plus population for budget growth; the current formula is a slight variation by adding personal income, which is also inflation-driven to a degree, but personal income takes other things into account.

To sum up the inflation discussion, Mr. Roose asked how frequently will we see circumstances in the future like the current ones, and do we need to consider accounting for things like rapid surges in inflation if they won't repeat? In addition, the benchmark process has only been in place five years during a period of unique circumstances—is that enough time to evaluate the effects? And does the benchmark process unnecessarily restrict appropriations in times of high inflation? The several alternative benchmark calculations were compared to the official calculation from FY 17 to FY 22, showing the CPI alternative was lower and less volatile, while the double-weighted deflator was higher and more volatile. Similarly growth in the benchmark appropriation from FY 20 to FY 24 was shown under the alternatives.

Mr. Geisenberger noted that the benchmark has not been strictly observed since its implementation; the result is, under the Governor's Recommended Budget (GRB), spending of roughly $150 million more in FY 24 than otherwise would have been the case, but that the process has helped restrain spending growth over the period. Mr. Roose referred to a graph presented at the prior meeting showing the sawtooth pattern of expenditures in the 2010s as a possible counter-factual—budgets may have been significantly higher now, with sizable cutbacks likely required in the near future. Mr. Geisenberger pointed out that the 19% revenue growth would certainly have led to spending increases, and we would have been better off with any of the alternative benchmark index calculations than none at all. Mr. Houghton said if there needs to be an adjustment to accommodate inflation, we can do that through the current process. He prefers the base or less, rather than more available now. If there are negotiations to spend more above the base, it will work itself out. Mr. Ratledge said revenues are an ultimate constraint on the entire process, and are also heavily influenced by inflation, and he would not be favorable towards more heavily weighting inflation. Though he would prefer a wage and salary component, we can live with what we have now, and don't need to embed inflation in the economy through increasing the weight on inflation.

Mr. Bullock said the benchmark has worked relatively well, and it has had the disciplining effect on spending that we thought it would. We can try to further perfect the process, but it may be about as good as it can get. Mr. Houghton reiterated that the process can be revisited, and we don't necessarily have to wait five years. It seems to have worked well for all stakeholders. The challenge is to structure it more formally so it would last beyond this administration.

Mr. Short noted that with budget shortfalls of hundreds of millions of dollars during the Markell administration and at the start of the Carney administration, budget discussions were difficult. Mr. Ratledge noted there have been structural changes in the economy that will need to be unwound, and we are better off leaving the benchmark unchanged to see what will happen. Mr. Roose said the current structure does reasonably well, and that none of the alternatives appear to represent significant improvement. The mandatory revisiting is very important, especially given the small sample size during unique economic circumstances.

Mr. Roose discussed a sample bill that would codify the current process, adding deposit and withdrawal rules (which don't exist under EO 21) to the Budget Stabilization Fund (BSF), which does as much as possible without a constitutional amendment. Mr. Geisenberger said this binds the GRB or requires an explanation for a deviation from the benchmark process, but does not bind the General Assembly in any way other than officially creating a BSF in statute and make clear that the General Assembly has to vote to withdraw funds. It is wholly consistent with what this Governor has done in putting together his budgets. It is not as constraining as the rules proposed by the prior panel, because we have found those provisions may be overly constrictive—the current approach provides a lot of flexibility. Mr. Houghton noted that this statutory process would provide public accountability for a future administration that may not have bought in to the benchmark process.

Mr. Geisenberger explained the budget process leading to the "tentative bill," or GRB. Mr. Roose said the draft legislation would require that the report accompanying the GRB state the balance of the Budget Reserve Account (BRA), the Budget Stabilization Fund, and the 2% set aside, and would prevent the GRB from exceeding the benchmark appropriation except in certain cases. Mr. Geisenberger mentioned the current report is not required to reference any reserve balances, or recommendations related thereto. The legislation codifies the calculation of the benchmark index and benchmark appropriation, and requires DEFAC to review the index and recommend any changes to Governor and General Assembly every four years. The legislation also codifies the establishment of the BSF, adds deposit and withdrawal rules—essentially from previous panel's recommendations—and requires that the GRB specify how extraordinary revenues will be used between the BSF, one-time spending and debt reduction unless the BSF is at 5% of revenues, in which case they can be used for any purpose. Mr. Geisenberger noted that this provision allows more flexibility than original panel's recommendations. The GRB may propose withdrawing from BSF in budget year if the benchmark appropriation is less than the 98% limit.

Mr. Geisenberger stressed again that these provisions only apply to the GRB, not actions of the legislature. The proposed bill provides that no deposits may be proposed by the GRB that would bring the balance of the BSF above 7% of revenues; if greater than 5%, half must go to one-time spending and the remainder can be used for any purpose, including operating spending. The GRB may not proposed withdrawing more than half the balance of the BSF in any fiscal year. Again, all provisions are binding only on the Governor and GRB, not any action of the General Assembly.

Mr. Geisenberger stated that the combined balance of the BRA, BSF and 2% could reach 12%. With the constitutional amendment proposed by the previous panel, it would have merged the BSF and BRA, with 7% available with simple majority and 3% requiring a supermajority, because the 7% should provide funding to get through 90% of revenue shortfalls. Because the funds were not combined, 7% is thought to be necessary for the BSF. The General Assembly can go higher if they so desire. There was discussion between Mr. Houghton, Mr. Geisenberger, and Mr. Ratledge about the BRA and the fact that its only purpose, given the difficulty of using it, is a credit enhancement vehicle, and between several members about the fact that a recession could wipe out the BSF and at the same time, expensive new programs were being proposed in the General Assembly that, if enacted, would put further pressure on the State's fiscal picture.

Mr. Roose discussed a draft constitutional amendment—distinct from the amendment proposed by the previous panel—that excludes the BSF from unencumbered funds, clarifies when appropriations can exceed the 98% limit, and when appropriations can be made from the BRA.

There was no public comment.

Minutes of the prior meeting were approved.

The meeting was adjourned at 11:20.