Minutes of the Advisory Panel to DEFAC
Buena Vista Conference Center New Castle, DE – March 23, 2018

Attendance:	Chairperson, Mr. Michael Houghton	P	
K. Lewis	A	H. McDowell	P
E. Ratledge	P	Q. Johnson	P
K. Simpler	P	M. Ramone	A
J. Bullock	P	A. DelCollo	P
R. Geisenberger	P	R. Johnson	P
M. Jackson	P	S. Malfitano	P
M. Morton	P	D. Smits	P

Support and Staff Present:
A. Aka, R. Goldsmith, J. Johnstone, B. Peterson, N. Roby, D. Roose, B. Scoglietti, S. Scola, S. Steward

Members of the Public:

B. Doolittle, K. Dwyer, R. Larson, P. Morrill, J. Young

1. Introduction

Chairman Houghton called the meeting to order. Chairman Houghton reminded the Panel of his prior request that staff return with a consensus proposal for the Panel's consideration and the May 1st deadline for producing a preliminary report.

2. Review of Prior Meeting Minutes

Chairman Houghton directed panel members to consider the prior meeting minutes as drafted and postponed final approval of said minutes.

3. Proposed Budget Smoothing Model

Secretary Geisenberger, Representative Johnson, and Chairman Houghton noted the volume of work required from OMB, OST, DoF, and CG's office staff in developing the model to be presented.

Mr. Johnstone presented a proposed budget smoothing model. The presentation covered the detailed mechanisms proposed, analysis of four prospective scenarios, and discussion of policy options surrounding Personal Income Tax reforms. Mr. Johnstone noted that the proposed model addresses concerns raised previously by Panel members by building upon the existing budget architecture, including an objective economic measure, allowing policymakers discretion in how to use funds available for withdrawal, and precluding complete budget smoothing. Mr. Johnstone outlined the budget mechanisms introduced by the model including a Benchmark Appropriation, a definition of “extraordinary funds,” specified uses for “extraordinary funds,” a new Budget Stabilization Fund (BSF) with a higher cap than the BRA, and clearer, more automatic withdrawal rules.

Chairman Houghton asked about the rationale behind allowing some “extraordinary funds” to be spent on one-time projects and using some “extraordinary funds” to fill the BSF.

Mr. Johnstone noted when revenue growth was strong in the past; policymakers had a strong track record of funding one-time projects from revenue generated in good years. The new rules would not remove policymakers’ ability to make prudent investments.

Secretary Geisenberger stated that an alternative consideration, where all “extraordinary funds” are put into the BSF until the cap is met, did not reflect the concerns of OMB or the CG’s office about Delaware’s capital and budgetary needs. The rule proposed is a balance of those two positions.

Chairman Houghton stated that the definition of a “one-time” expenditure is an important consideration in drafting a proposal.

Senator McDowell stated that one-time expenditures have typically been considered lower priority concerns compared with new programmatic expenditures.

Representative Johnson noted that the current bond bill includes some portion of expenditures that are not one-time in nature.

Secretary Geisenberger stated that “extraordinary funds” are available for “one-time” use only, but that policymakers are not required to use them. He noted further that the cap of 10% chosen in this model was based on a Pew analysis that suggested a 10% cap would cover 80 to 90% of recessionary scenarios.

Director Jackson noted that this cap was also intended to provide as much flexibility as possible for policymakers in determining whether funds were best used to solve a shortfall in the in-year budget or the out-year budget.

Senator McDowell stated that current budget mechanisms set aside around $400 million in any given year as funds available to offset shortfalls.

Treasurer Simpler noted that the current budget architecture lacks a guiding principle to determine whether funds available in one year are extraordinary or expected. He stated further an additional intent for the BSF is to reduce budget volatility.

Chairman Houghton asked why the model required a 3/5th majority vote to draw the BSF below 3% of gross revenues.

Mr. Johnstone stated this was proposed to address concerns from rating agencies about the ability to automatically draw the reserve fund to zero.

Secretary Geisenberger noted that this is an amendment of the existing system, but keeps the reserve funds mechanisms similar to those in existence today.

Chairman Houghton asked if there is a sense that bond rating agencies have more tolerance for reserve fund withdrawals than had been previously assumed.

Mr. Johnstone stated that there are several examples of AAA-rated states drawing their reserve funds during recessions without ratings consequences.

Senator McDowell stated that saving 10% might severely constrain the State's choices and might prohibit the State from acting more like a business in response to available opportunities.

Treasurer Simpler noted that many state agencies find it disruptive to be so constrained by year to year variations in their budgets and that this volatility prevents them from engaging in long-term planning.

Mr. Johnstone presented four prospective simulations comparing budget results between the proposed budget smoothing mechanisms and the current rules. The simulation scenarios assumed a variety of five year periods in the past twenty years with the intent of capturing the extremes of recent revenue history. Mr. Johnstone noted that total spending must be reduced in order to fill the new BSF, but that the modeling presented assumes that the reduction in spending would come out of cash to the bond bill. Where reduction might actually occur would be up to policymakers.

Secretary Geisenberger noted that the BSF would greatly reduce the dramatic nature of appropriation cuts necessary to balance the budget during a recession.

Mr. Johnstone stated that the proposed rules greatly reduce budget volatility and increase the amount available as reserves at the cost of slight reductions in average expenditures.

Director Jackson noted that an adjustment may need to be made to account for items within the bond bill that are ongoing appropriations and this portion of bond bill outlays should be considered when calculating the benchmark budget.

Mr. Johnstone discussed several withdrawal examples, detailing how the budget mechanisms determine when a withdrawal is allowed and how large the withdrawal can be.

Chairman Houghton stated that the BSF would never solve a budget deficit alone, but that the current mechanisms would still be necessary in a reduced capacity.

Secretary Geisenberger noted that the intent was to make life easier without taking away all the difficult decisions. The BSF is intended to remove the incentive to overcompensate in the face of a deficit.

Secretary Bullock noted that taking more out of the BSF is still possible with a 3/5th majority vote.

Mr. Malfitano asked how long would be required to implement the proposed mechanisms.

Secretary Geisenberger stated because constitutional amendments are necessary to implement items with 3/5th majority override mechanisms, implementation would require two consecutive General Assemblies.

Senator McDowell noted that these proposals sound simple in practice, but that the tradeoff required involves denying constituent requests that have been building up over the last nine years.

Secretary Bullock noted that current year estimates are impacted by anomalies such as state revenue policy, federal revenue policy, and the typical volatility that comes with collecting substantial abandoned property revenues.

Representative Johnson noted that the budget mechanism outlined could be applied to the budget process before the proposal has been fully embedded within Delaware's constitution.

Treasurer Simpler stated that the BSF can effectively act, for the State, the way working capital is used in the business world. That function provides budget negotiators an additional tool for addressing deficits.

Mr. Johnstone noted that having a BSF structure similar to the model just presented would allow the State to act more counter-cyclically and offset expenditure declines seen in the private sector during a recession.

4. Open Discussion

Chairman Houghton asked if modeling had been done varying the level of the cap and whether there were lower thresholds that would render the BSF ineffective.

Mr. Johnstone answered that modeling a different cap has not been undertaken, but would not require substantial effort.

Secretary Bullock asked if the scenarios ever reached the 10% cap.

Mr. Johnstone answered that the third scenario with repeated years of high revenue growth quickly reaches the 10% cap.

Treasurer Simpler stated that the staff involved settled on the 10% cap as a means of covering 90% of recession scenarios based on the outcomes of Pew's Minnesota-method optimal fund-size analysis and Moody's state reserve stress testing.

Secretary Bullock asked if reserves would have been increased in post-Great Recession years.

Mr. Johnstone stated that case 1 is a sample of years from the most recent recovery and the results show reduced budget volatility and greatly increased reserves.

Senator DelCollo noted that the scenarios also assume the revenue portfolio we have currently and that putting in place budget architecture as was proposed might enable easier discussions around revenue restructuring.

Chairman Houghton asked if there was agreement among panel members that changes to budget mechanism must be implemented alongside revenue reform.

Secretary Geisenberger stated that Delaware has a structural spending concern and a structural revenue concern and that the budget smoothing mechanism only addresses the spending concern.

Treasurer Simpler concurred and noted that the benchmark appropriation acts as a fiscal control, but also as an indicator of when our revenues are not performing as well as our economy.

Senator McDowell noted that the State bears costs that in many other states would be borne by local government. This has led to Delaware local governments having close to the lowest taxes in the country. Senator McDowell requested that if a proposal such as the one being discussed is to go into effect, the State should ensure it is used as a tool to enact programs with long-term cost saving potential.

Treasurer Simpler noted that Census data shows Delaware to be in the top quartile of per capita spending when you aggregate state and local expenditures. Treasurer Simpler agreed with Senator McDowell that investing in value is important and noted that the churning deficit/surplus cycle in the current budget process distracts from policymakers' ability to spend time assessing the value propositions offered by various policy options.

Secretary Geisenberger noted that a 3/4th majority is required to assume the costs of a non-profit, and that it's possible a similar vote threshold should be applied when the State assumes local government costs.

Senator DelCollo noted that the current structure does allow the State to wield significant policy control not seen in more balkanized structures.

Mr. Ratledge stated that the current procedure keeps revenues and expenditures in tandem fairly well aside from the case of deficit years. He noted that measurement items in the benchmark may be inflated by the assumptions used in the modeling. This is especially a problem as population and personal income growth are likely to stagnate in the future.

Secretary Geisenberger asked if transfer payments should be a portion of the benchmark calculation and noted that there have been in-depth discussions among staff about which inflation measure to include in the benchmark.

Senator McDowell stated that community associations and constituents will not look kindly upon the State holding large surpluses for long periods.

Chairman Houghton stated panel members should take some time to consider this presentation. Chairman Houghton encouraged members to raise their substantive and technical issues with staff and engage in discussion where necessary. The goal is to offer a recommendation in May, whether that is a specific proposal or a merely statement of principles.

Senator DelCollo stated that he is in favor of implementing a benchmark alongside revenue reform.

Chairman Houghton noted that the key for enacting such a bargain will be determining a reasonable revenue increase to go along with budget constraints. Chairman Houghton asked Senator DelCollo if he felt adopting such a bargain this year is achievable.

Senator DelCollo stated that the specific procedure used to ensure both fiscal controls and revenue reform are implemented would determine the likelihood of a bargain being enacted.

Mr. Johnstone presented two examples of base-broadening Personal Income Tax reform that are revenue neutral in the first fiscal year and increase net revenues in out-years. These examples rely on repealing itemized deductions and means-testing age-based tax preferences to generate out-year revenue while lowering marginal rates.

Treasurer Simpler clarified that the examples are an attempt to interpret the recommendations of the 2015 DEFAC Advisory Council on Revenue.

Secretary Geisenberger noted that the new retirement exemption, proposed to replace the three existing preferences, would be worth the same amount to individuals below the means-test threshold as those existing preferences.

Chairman Houghton asked for more detail on how lowering rates alongside a broader base will generate more revenue growth.

Mr. Johnstone noted that itemization alone reduces the tax base about 11-12% and that applying a tax rate to income which was previously tax exempt would allow reduced rates of taxation on all currently taxed income. Mr. Johnstone stated that taxable income would grow faster than previously forecast, and this would produce out year revenue gains.

Representative Johnson noted that the total effect in the first fiscal year would be $0, but that individuals may experience increases or decreases to tax liability depending on their particular circumstances.

Secretary Geisenberger noted that the second scenario is more progressive in terms of which taxpayers bear the burden of the tax increase.

Treasurer Simpler stated that the first scenario adheres closest to the specifications recommended by the Advisory Council on Revenue.

Mr. Ratledge stated that the cost of the age-based exemptions will grow significantly over the next few decades.

Chairman Houghton noted that it may not be the purview of this panel to determine the tax policy specifics around the composition of rate cuts used to net out the revenue gained.

Senator DelCollo stated that the panel's recommendation should follow the format taken by the 2015 Advisory Council and leave the specific policy details for policymakers to decide.

Representative Johnson stated that policymakers are elected to make difficult decisions as servants of the citizens of Delaware. He noted that constituents want the State to act more like a business and that a business sets aside reserves in a similar fashion to this broad proposal.

Secretary Geisenberger stated that staff would attempt to provide, at minimum, an executive summary at the next meeting.

5. Public Comment

Mr. Doolittle, an advocate for children, discussed his own modeling of a budget smoothing reserve focused on treating unencumbered funds variance and revenue variance separately. The greatest concern with treating these two variances in aggregate is that a combined model might hide budget problems in the short-term if the two variance types generate offsetting effects.

Mr. Young, a member of the public, stated that he is bitterly disappointed that the efforts of the Advisory Panel on Revenues have seen so little movement and that paying attention to the recommendations of that report would be a major step forward for Delaware's budget process. Mr. Young stated that budget smoothing is fine if it's imperative for getting the critical revenue reform enacted. Mr. Young thanked the panel for their effort and asked that members prepare a simple message to help the public understand the final proposal.

6. Adjournment