MINUTES of the
DELAWARE BENCHMARK EVALUATION AND REVIEW PANEL

Remote Event – February 27, 2023

Attendance:

Member	Present
M. Houghton	Yes
J. Bullock	No
C. Cade	Yes
B. Carson	No
C. Davis	Yes
L. Davis-Burnham	Yes
R. Geisenberger	Yes

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

Members in Attendance: 11
Members Absent: 2

Others Present: A. Aka, B. DiVirgilio, R. Goldsmith, K. Knight, M. Marlin, P. Kiefer, Q. Kirkpatrick, D. Roose, R. Scoglietti, J. Seemans, L. Solloway

Opening Business: Mr. Houghton called the meeting to order at 11:00 a.m. He stated that the purpose of the meeting was to reacclimate Panel members with the DEFAC benchmark mechanism. At this meeting the history, components, and results of the benchmark will be discussed. The panel roster is intended to be a mirror of the prior panel, representing the legislature, members of DEFAC, and State officials. The panel is mandated by executive order to revisit the benchmark criteria, evaluate the benchmark process, and make some decisions. No decisions need be made today, he said—the next meeting or two will address potential recommendations and changes.

Mr. Geisenberger reiterated that today's meeting is an orientation to cover the work of the original panel, the charge of this panel, and how the benchmark has worked.

Review of Work of Advisory Panel on Fiscal Controls and Budget Smoothing: Mr. Roose reviewed the work of the 2017 Advisory Panel on Fiscal Controls and Budget Smoothing. Delaware's revenues had always exhibited volatility, he said, but until the Great Recession they generally grew, which made volatility easier to manage. Revenues after the Great Recession showed alternating years of double-digit growth and mid-single digit declines, causing significant issues with budgeting. Mr. Geisenberger said in 2017, when preparing the fiscal year 2018 budget, we were not in a recession but had a massive budget deficit. In the 2008, 2012 and 2014 budgets, we also had problems even though not in recession, causing tax increases and budget cuts—not just one year, but pattern of

years that caused this discussion and the creation of the panel as a response to the $400 million problem in 2017.

Mr. Roose reviewed the State's existing fiscal controls, especially the constitutional 98% appropriations limit and Budget Reserve Account (Rainy Day Fund, or RDF). The RDF is required to be at 5% of gross general fund revenues, requires a 3/5 vote to appropriate only for unanticipated deficits or as a result of statutory revenue reductions, and any withdrawal must be replaced in the following fiscal year. As a result, the RDF has never been used. Mr. Houghton asked what the benefit was, just as a credit enhancement vehicle for bond ratings? Mr. Roose affirmed. Mr. Geisenberger reiterated the problems with the RDF, and said it is essentially unusable.

Mr. Roose discussed extraordinary revenues, such as one-time revenues from settlements and audits or capital gains, or they can also be defined as general fund growth relative to long-term trends. Trend growth will change slowly, but in any given year there can be very significant fluctuations from trend growth. In recent years we've seen a massive surge in corporate income taxes, realty transfer taxes and others—these are not necessarily a one-time event, but cyclical with the economy and other factors.

Mr. Geisenberger mentioned that extraordinary revenues are partly a result of Delaware's tax structure—we don't have a sales tax or State property tax, stable revenue sources that many states have. We have a personal income tax with stable components and capital gains, stable gross receipts tax which is fairly small, not like many states. It's great that we can export revenue, but when it goes down it's a big problem.

Mr. Roose stated that one goal is try to isolate the operating budget from fluctuations caused by extraordinary revenues. The budget reserve account could be used for that purpose, a new budget smoothing account could be created, or we could require extraordinary revenues to be spent on one-time expenditures but not built into operating budget, that would presumably require increasing amounts in future years. The 2017 panel did look at revenue portfolio reform, but changing the revenue structure may reduce economic responsiveness and growth, which could hurt revenue adequacy—sufficient revenues to fund government—a primary goal of tax policy. Additional fiscal controls could be imposed to keep budget growth in line with historical measures and/or a budget smoothing fund, which the RDF is not a sufficient vehicle for.

Mr. Roose said the 2017 panel worked with Pew Charitable Trusts to review rainy day funds and fiscal controls of other states. All presentations and minutes of the Advisory Panel are online; the link will be provided to current members. After a broad review, the panel looked at a handful of states' rules for setting excess funds aside and using them when needed. These rules were modeled with Delaware budget history to see what the effects would have been.

Mr. Geisenberger noted that the Pew Foundation said there is no one answer—each state has developed something that works for their unique revenue structures and political situations. Many states have figured out something that works for them—Alaska, for

example, has a massive budget reserve account because their revenues are based on oil, but they need that massive budget reserve.

Mr. Roose reviewed the recommendations of the 2017 panel, which were provided in the context of building on Delaware's existing fiscal controls. The panel recommended amending the 98% appropriation limit by tying growth in the operating budget to an objective measure of the State's economic growth—the budget benchmark index. The RDF should be converted into a Budget Stabilization Fund (BSF), and the personal income tax base should be broadened. These recommendations would have required both constitutional and statutory changes.

Mr. Geisenberger said that Pew saw no reason at all not to draw from a budget reserve account, so long as there is a plan to automatically restore the funds. Mr. Houghton mentioned that Pew noted, as have we, that a reserve account that is not touched is not helpful.

Mr. Roose then discussed the construction of the budget benchmark index, equal weightings of growth in Delaware personal income and the sum of Delaware population growth and inflation as measured by the implicit price deflator for state and local government purchses. The index provides allowable growth in the operating budget and grants-in-aid,with an additional one percent of the prior year's operating budget if that amount is a supplemental appropriation to the bond bill. Mr. Geisenberger noted that most items in the bond bill can be issued as tax exempt debt, but some things cannot be because they do not have a public benefit, hence the one percent carve-out. The difference between the (unchanged) 98% appropriation limit and benchmark appropriation is extraordinary revenues or shortfall.

Mr. Roose explained that personal income (data from the US Bureau of Economic Analysis, or BEA) was chosen for the benchmark index because it's a measure of ability to support government services and also a measure of demand for government services—as income increases, demand for education, transportation, public safety and other services also rises. The implicit price deflator for state and local government purchases (data also from the BEA) is a measure of inflation specifically for government purchases—as an example of the differences from the consumer price index (CPI), about 60% of the implicit price deflator is wages, which are not a factor in the CPI, while housing is a significant factor in the CPI, but buildings are only a small component of the deflator. Lastly, population (data from the Delaware Population Consortium) is also a measure of demand for government services.

As recommended by panel, the BSF was intended to be used when economic conditions warranted. Withdrawl would require a simple majority vote, not the 3/5 vote required by the RDF. Mr. Geisenberger restated that as a 10% fund, 7% of which could be withdrwawn with a simple majority, and the other 3% with a supermajority. He went on to say that Governor Carney was willing to live within this for purposes of developing his budget, but obviously has no ability to impose it in the final budget. Mr. Houghton asked if there has been any variation from what the Governor has proposed; Mr. Geisenberger

said there definitely has been deviation in terms of the share going to reserves, but there's always been a proposal to increase reserves when possible. We have exceeded the BSF cap, depending how you look at it, but the process has been largely but imperfectly followed. Mr. Geisenberger noted that in the first several years there was a planning account (for the BSF) that held an unappropriated amount, but that was all it was—it carried into next year's unencumbered funds. Starting with the FY 20 budget, there was a specific special fund under epilogue language that the General Assembly has voted on.

Executive Order 21 Benchmark Process: Mr. Roose explained the differences between the 2017 panel's recommendations and Executive Order 21, which largely revolve around the BSF (and no change to the RDF) and lack of withdrawal rules. He walked through the benchmark calculations from the December DEFAC meeting to show how they work, including the index, the benchmark appropriation, extraordinary revenues and the BSF. Mr. Geisenberger noted that the example shows the value of using a three-year average—there were dramatic changes in the one-year snapshot.

Budget Benchmark Results: In discussing the results of the benchmark process Mr. Roose noted the $400 million structural deficit in 2017, and that now there is a $988 million projected surplus—above benchmark growth of $315 million and $102 million of setasides.

Mr. Geisenberger said many have heard the Governor's presentation on the budget, but FY 2016 through 2018 show the tendency to spend into the 98% limit, but the FY 2019 and 2020 extraordinary revenue did not get built into the base budget (although the General Assembly added to the Governor's recommended budget—GRB), and look what happened during COVID when the FY 2021 budget was put together—we would have had to cut the budget, or do dramatic tax increases right in the middle of the pandemic had this mechanism not been put in place. Instead, we were able to draw from the BSF for FY 2021 budget, grow it a little above 2% and not implement significant budget cuts and tax increases. Then we had the discipline in FY 2022 and 2023 not to take extraordinary revenue and put it in base growth. As a result, in FY 2024 the proposed budget is above what we'd expect growth to be from the revenue resolution because we can do it sustainably. The benchmark process has demonstrated itself through good times and bad, though it could perhaps be made better—that's what the panel will talk about.

In discussing the use of the BSF, Mr. Geisenberger reminded the panel that the BSF and RDF were not merged, as was the earlier panel's recommendation. Having gone above 5%, we're still not quite to 7% in the "simple majority vote fund." It is a legitimate question as to whether we have enough set aside in that fund.

Mr. Roose discussed a chart showing the days of spending covered by reserves for Delaware and the 50-state median, with Delaware now ranking fourth-best in the country. He said that AAA-rated states looked very similar to the 50-state median, so Delaware ranks very well both absolutely and relative to other AAA-rated states.

Open Discussion: Mr. Cade asked how the BSF factors in when it comes to benchmark calculation, and should the status of the BSF have any impact on benchmark projections? Mr. Geisenberger responded that it doesn't have any impact on calculation of index or how we calculate the appropriate level of appropriation, but it does impact internal thinking of to what extent you go above the index. The Governor's budgets did not propose going above the index until we reached 5%, although the General Assembly has gone above the GRB. The positive aspect is that the GRB does help guide the debate, and when the BSF is fully funded it becomes more responsible to propose going above benchmark, and more responsible to propose sustainable tax cuts as was done this year—the first broad tax cut the Governor has proposed. It's responsible to do because the BSF is in excess of 5% of gross general fund revenues.

Mr. Houghton said he is particularly interested in the views of the legislators on the panel. His sense was that there is no perfect mechanism or calculation; what we've done was created a process five years ago, and it has worked very well for a process that is not fixed in statute but following the lead of the Governror and Administration. This is laudable, but how well is it working from a legislative standpoint? He asked Mr. Paradee how he thinks it has worked—an impairment, facilitator, or or something else?

Mr. Paradee said the focus so far has been on the revenue side; the biggest current challenge is wages on the expense side. In a rapid inflationary environment where state government is competing against private industry, attracting and retaining employees has been the largest challenge. Many in the meeting have had conversations about this problem. The three components of the benchmark don't account for a rapid inflationary environment. In his role as Joint Finance Committee (JFC) chair, he has not yet had to deal with a situation where revenues are declining. There needs to be discussion about changes to the formula to provide a mechanism so that if we find ourselves in an inflationary environment we can keep wages more competitive.

Representative Short asked what is the guarantee we'll continue with the budget benchmark? It would be tough to pass a constitutional amendment for the benchmark, but that's a conversation that should be had at some point. Unless we do something that locks this in it could change dramatically depending on where the General Assembly goes. Mr. Houghton agreed that the constitutional train has left the station, but there may be constructive legislative changes that could be made.

Mr. Ratledge said we've never had to touch the RDF because OMB would ensure expenditures were down to eliminate a deficit because the RDF had to be refilled the next year. He noted that personal income data is a mess, including all government social benefits (UI, Medicaid, medicare, social security), none of which leads to stability in that measure. Transfer payments from 2019 to 2022 include a bizarre pair of humps when federal checks were coming into the State and when they disappeared. At the same time, wage and salary income took a small hit and moved right back to that curve the next quarter. He believes wage and salary income is a better measure. There are countercyclical aspects to the benchmark, but they may not be that important. Capital gains is a huge part of spike in revenues in FY 2021 and 2022 that occurs periodically; we

also took a hit on the franchise tax from IPOs disappearing, and the realty transfer tax from the Federal Reserve's rate increases—another thing to think about is 4% to 4.5% interest rates over the horizon.

Mr. Gillan echoed the comments that the uncertainty pertaining to administrations is a concern, we need to codify the process to guarantee it for the long-term planning of the State.

Ms. Jones said overall the benchmark has been a very useful tool in budget conversations including sustainability, but clearly in many years expenditures are exceeding the initial benchmark. Some way to adjust that number would be helpful—salaries are an issue as Mr. Paradee pointed out. It would be helpful to have some adjustments made for future conversations.

Mr. Houghton asked if these measures are directing too much money to one-time spending—the cost of all those projects has gone up with federal and state money pumped into it. Mr. Geisenberger said we entered this cycle with huge backlog of maintenance, so this has served us extremely well. He asked Mr. Cade whether we're through that backlog or is there years more that could absorb additional funding.

Mr. Cade responded that a tremendous amount of deferred maintenance remains, especially in the school districts. We should be very cautious about establishing long-term policy based on where we are right now with respect to the construction industry because of ARPA—this is a unique scenario where there's so much capital for construction that it's very different than what we would typically be experiencing. He agreed that there should be some basis of factoring in expenditures, but we don't want to be adjusting the benchmark after we've implemented policy that increases spending. The question is how that could be implemented, factoring in expenditures, especially when discussing health care as well as wages. The conversation may come back to what we're measuring in inflation—how much are we factoring in wage inflation?

Mr. Geisenberger said we could come up with formulas that factor in inflation—using one year rather than three for inflation would bump up benchmark, but the following year the benchmark would come back down much quicker. It would also be interesting to look at wages and salaries rather than personal income. In the initial discussion of the benchmark some people said income should not be included—some states limit budget growth to inflation plus population growth, but that's a recipe that would bind the General Assembly moreso than the current formula. Staff can come up with examples with inflation a bigger component of formula. But we need to realize that if inflation goes back down to 2% then complaints will be that it's too limiting.

He said further that one of the lessons from experience is that constitutional changes may be taking a sledgehammer to a problem that doesn't require that. We've found between December and June things do change; flexibility has value. He again noted that if the starting point in the GRB is the benchmark appropriation, it imposes a level of discipline. We would have been on a path to fill the BSF in seven or eight years even without the

extraordinary revenues over past few years, and without following the constitutional construct perfectly. Following it near enough has gotten us to a satisfactory outcome—we may not need the constitutional structure.

Mr. Houghton said constitutional constraints do not give enough breathing room to follow the spirit and general direction of the 2017 recommendations, but the current benchmark process allows the political process to work.

Ms. Davis said more of the process needs to be formalized. Mr. Geisenberger responded that Executive Order 21 could essentially be codified, requiring the GRB to adhere to the methodology, and if there are exceptions to explain what they are and why. He said the discipline of going through the process is helpful for the Governor and members of JFC to hear what the numbers are but to have enough wiggle room to respond to what's going on from year to year or from December to June. It would also be good to establish the BSF in statute rather than epilogue, to which Mr. Houghton and Ms. Davis agreed.

Ms. Davis-Burnham said it may not be a good idea to make inflation greater piece of calculation.

Mr. Houghton said further discussion will occur in upcoming meetings. Mr. Geisenberger asked for ideas from members they would like staff to analyze over the next couple of weeks. Mr. Houghton asked Mr. Cade if he had any information on deferred capital needs it would be helpful—he would be interested to know how much progress has on those issues. Mr. Geisenberger said that when the benchmark was put together it created good countercyclical policy because capital projects can take several years, so we support industries that suffer most in downturns (construction) by building that in out-year spending, which helps support the economy.

The meeting was opened for public comment; there was none.

The meeting was adjourned at 12:35.