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STATE TREASURER

Bipartisan Budget Accord: Framing a Grand Bargain

I spent the formative years of my finance career in Chicago. If you have ever visited that city, you can't help but admire its site on Lake Michigan, the diverse but well demarcated retail, business and entertainment districts and the extensive park system that flows down more than 15 miles of Lake Shore Drive. The layout simply works.

Credit for the planning of Chicago goes largely to Daniel Burnham, a well-known architect of the late 19th and early 20th centuries. Burnham was the man to whom city leaders turned when Chicago had to rebuild after the Great Fire of 1871. That catastrophe – allegedly caused by Mrs. O'Leary's cow knocking over a lantern – burned almost the entire commercial area to the ground.

The devastation from the fire was so great that Burnham essentially had a blank canvas on which to paint and he took full advantage. So much so that the scope of his vision both astounded and intimidated the city elders who had engaged him. Burnham was urged to scale back or whittle down his scheme, but he held fast and ultimately rallied all in support of the larger and bolder plan.

I have always been inspired by the quote ascribed to Daniel Burnham in explaining the rationale for sticking to his guns. Stated plainly yet eloquently, he reasoned:

> Make no little plans; they have no magic to stir men's blood and probably themselves will not be realized. Make big plans; aim high in hope and work, remembering that a noble, logical diagram once recorded will never die, but long after we are gone be a living thing, asserting itself with ever-growing insistency.

That is not hubris, but logic. Burnham basically stands on its head the conventional wisdom that incrementalism is always a surer bet at effecting change than wholesale revision. Where the opportunity presents itself to paint with a broad brush in primary colors, Burnham urges boldness for the very fact that it incites passion and invites emotion. Properly channeled, these are assets to any movement that small-scale maneuvering simply cannot command.

Burnham's exhortation is apropos of our budget reform moment here in Delaware. During this next legislative session, we will have the know-how and the opportunity to effect changes to our fiscal framework of a scale that has not been witnessed since the Pete du Pont Administration of the late 1970s. We will have a chance to make a Grand Bargain, one that achieves long-term revenue stability with sustainable spending discipline.

Rather than being shy or quiet in peddling changes in a technical manner, we should embrace the magic. Let's dare at big things and stir some blood. To play our hand otherwise is to end up where we did this past session: a day (or three) late, and a few dollars short.

<u>A Little Back Story</u>
I walked out of the State Capitol building around 4:00 a.m. – yes, a.m. – on Saturday July 1, 2017. The quiet emptiness of the legislative mall stood in stark contrast to the atmosphere inside the General Assembly.

While almost all of Delaware was sleeping, our legislators, Governor, cabinet secretaries, support staff and a gaggle of lobbyists and members of the press were engaged in the annual ritual of closing out the public's business of fiscal 2017 and trying to come together on the State's budget for 2018. This bum rush during the waning hours of one year and wee hours of the next is accepted practice in Dover.

To an outsider – by which I mean 99.9% of our citizens, this process would appear nuts. After all, as the t-shirt says, "how many good decisions are made after midnight?" Take it from one who grew up on the border of Dewey and Rehoboth Beaches: not many.

As your State Treasurer, I can affirm that same logic holds for the conduct of state business. Stepping out the door of the General Assembly that pre-dawn summer morning, I will aver that sound fiscal management of our affairs had more or less given way to "get 'er done." My wife happens to be a big proponent of the expression "done is better than perfect," but nearing daybreak on what was supposed to be the first morning of the new legislative year, our budget was not done and it was far from perfect.

I had stayed through the night long enough to ascertain that while we would not be reaching a budget deal, a joint resolution had passed both chambers of the Legislature without a dissenting vote. Moreover, even at that hour, comments from lawmakers on both sides of the political aisle and both chambers of the General Assembly demonstrated familiarity with the bill and expressed hope that it might result in material progress in reframing our budget debates in future sessions. I heartily share those sentiments.

Honest to God reform of our revenue base – restructuring the taxes, fees and other income by which we fund our collective affairs, is absolutely necessary. Our current portfolio has grown too narrow, too volatile and too anemic to reliably fund our ongoing service levels.

I cannot conceive, however, that such reform is possible – or even argue that it is wise – without an equal commitment to the same level of revisions to our spending controls. The budget process we have today is focused myopically on short-term solvency – balancing the budget one year at a time – with no guarantees as to long-term sustainability, no meaningful measure of sufficiency and no confidence borne out of certainty.

It is time for a Grand Bargain that addresses our long-term revenue problems and institutes new spending discipline in one fell swoop. Only by doing that can we move on to the critical task of creating higher value for Delawareans and getting better at all that we do in state government.

What Makes a Grand Bargain?

The term "Grand Bargain" was used widely in the popular media circa 2011-2013 to describe a set of overarching budget negotiations between President Obama and Speaker of the House, John Boehner. The talks aimed to broker a package of long-term spending cuts and revenue increases involving our largest entitlement programs as well as key parts of our tax system.

While supported by many bipartisan think-tanks and study groups that had been tasked with designing, or took the initiative to outline the need for, a new federal budget framework, the negotiations ultimately cratered under the weight of the political process. The goal of achieving a "Grand Bargain" still floats out there, however, an elusive oasis on the fiscal horizon, the Holy Grail of budget reform.

Here in Delaware, we flirted with our own Grand Bargain during the last legislative session. The Governor and legislators from both sides of the political aisle demonstrated an appetite to consider a bundle of meaningful revenue reforms, including some tax increases, that combined with new spending controls would define and provide for a long-term sustainable rate of growth in state government. The measures included the idea of a savings account to smooth out budget growth over time, taking in surplus when times are good and paying out savings when times are not so good. (Contrast that with the up and down of last year's nearly 5% budget growth and this year's less than 1% increase.)

Our Grand Bargain was not realized this past year, but remains tantalizingly within our grasp. Similar to the debates in D.C., our reform negotiations collapsed due to a combination of factors: time pressures, outside attacks, arcane procedural impediments and partisan bickering. Unlike the Beltway negotiations, however, a key challenge in our instance was a lack of learning.

While much time has been devoted to exploring and outlining the pros and cons of state revenue reforms, very little has been allocated to studying and vetting the parameters of appropriate fiscal controls and the structure of a reserve savings account. That process is going on now thanks to a resolution passed in the last legislative session.

Though lawmakers were unable to reach a Grand Bargain, they laid the groundwork for exploring the key components of one in House Joint Resolution No. 8 (HJR8): "Creating an Advisory Panel to the Delaware Economic and Financial Advisory Council to Study Potential Fiscal Controls and Budget Smoothing Mechanisms." (Perhaps not the catchiest title, but, trust me, there's more steak here than sizzle, and perhaps just enough bipartisan grease to skid the wheels of our political machine.)

<u>What is House Joint Resolution No. 8?</u>
On its face, HJR8 creates a new Advisory Panel under DEFAC, the body that forecasts the State's revenues and expenditures. In practice, however, the resolution picks up on the broader discussion of our long-term financial stability where another DEFAC study body, Governor Markell's Advisory Council on Revenues, left off.

That earlier Revenue Council was asked to study the State's revenue portfolio and address three key issues: (i) *adequacy* (are our revenues growing enough to keep up with the pace of our economy and meeting our service level needs); (ii) *reliability* (is our revenue portfolio becoming more volatile and hence less predictable); and (iii) *favorability* (does the manner in which we collect our revenues stunt growth and could it be more conducive to economic development).

The Revenue Council concluded that meaningful reforms could address all of the foregoing criteria and offered specific suggestions for improving adequacy, increasing reliability and enhancing favorability of our revenue portfolio. Notably, the Council did <u>not</u> recommend raising or shrinking revenues; nor did it opine as to whether current revenues were too high or too low. For the sake of gaining unanimous consent as to the types of changes that should be made to our portfolio, the recommendations for reform were advocated on a revenue neutral basis.

In the same vein, without addressing the level of spending – whether too much or too little, the Revenue Council recommended that revenue reform should be accompanied by an analysis of new spending controls and consideration of a budget smoothing account. The consensus view was that focusing on optimizing our revenue portfolio was only half of a loaf. Examining the other half of that equation, however, was outside both the scope of the Council's mandate and the time allotted to complete its work.

The new Advisory Panel established by HJR8 takes up the unfinished work of the Revenue Council. Specifically, the Advisory Panel is to address:

- the State's current 98% appropriation limit and existing Budget Reserve Account;
- the need for restrictions on the use of budget surpluses; and
- the benefits of a budget stabilization fund.

The Advisory Panel is free to undertake such other inquiries as it deems appropriate in studying the foregoing issues and is specifically asked to indentify changes to the Delaware Constitution, Code and any other regulation or law required to implement its recommendations.

Like the Revenue Council before it, the Advisory Panel is composed of a bipartisan balance of members from academia, state government and the private sector. The 15 members include the chairmen of DEFAC and each of its Revenue and Expenditure subcommittees, four members of the General Assembly (one from each caucus), the Secretaries of both State and Finance, the Director of the Office of Management and Budget, the Controller General, three members of the public appointed by the Governor and me, the State Treasurer.[1]

<u>We Need Overarching Reform and All We Got Was A Lousy Advisory Panel</u>
Before you start sneering about the creation of one more study committee, take note: the kind of heavy lifting required to amend our Constitution and improve upon a 40-year old budget architecture does and should take time. This level of reform requires building an intellectual base and then distilling that information to policymakers. Short of an outright crisis, bipartisan committee recommendations formulated and supported by engaged representatives of both the Executive and Legislative branches are a key step to meaningful policy consideration.

By way of proof, not only has the work of the earlier Revenue Council been widely discussed and praised, some significant portions of its recommendations have been put into law. In the 2016 legislative session, revisions to the corporate income tax were codified in order to keep Chemours from decamping from Wilmington and otherwise improve on the competitiveness of our business tax structure. Similarly, the elimination of the estate tax and the measured increases to the corporate franchise tax just approved in the most recent legislative year were modeled on recommendations drawn from the Revenue Council's final report.

Also this past fiscal year, Governor Carney made liberal reference to the work of the Revenue Council in arguing for major reforms to our personal income tax. As part of his Budget Reset, the Governor proposed an elimination of itemized deductions coupled with increases in the standard deduction and increases to the age for

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[1] In addition to me, four other members of the new Advisory Panel also served on the earlier Advisory Council: DEFAC Revenue Subcommittee Chair, Ken Lewis, DEFAC Subcommittee Chair, Ed Ratledge, Secretary of State, Jeff Bullock and State Representative, Quinn Johnson.

receipt of certain tax credits. These changes proved to be a bridge too far in that session, but may reappear next year, particularly if they can be paired with complimentary reforms to our spending controls and reserve fund.

Getting to the Core of Our Budgeting Shortcomings

Providing policymakers some consensus ideas for what the additions to, or revisions of, our budget architecture might look like is the job of the Advisory Panel. While the baby should not be thrown out with the bath water, the Panel needs to determine if our financial framework is effectively handling challenges that are dissimilar to those for which it was designed and if it is meeting our needs in an economic environment very different from the one in which it was conceived. There is ample reason to believe that improvements to that foundation are warranted.

In the first instance, the State's core fiscal control – that we limit our spending to 98% of forecasted revenue (plus available cash) – was put into place in 1978 and has not been amended in the ensuing 39 years. Instead, a variety of patches and one-time workarounds have been adopted to try to correct for the systemic bias of such a rule to an ever-expanding budget.

The paradox is obvious: our current 98% Test is fiscally solvent in any one year, but potentially unsustainable over many years. The main reason is the underlying business cycle. Our test allows the State's budget to expand dollar-for-dollar with rising revenues during economic booms. Ensuing state spending increases become either fixed (e.g., pension obligations, long-term contracts, debt service, etc.) or politically challenging to eliminate or reduce (e.g., employee headcount, wages and benefits, social programs, etc.).

There is never, therefore, a true reckoning: a corresponding and equivalent decrease in the budget when economic booms turn into economic busts and state revenues collapse. Instead, a partial fix is typically engineered using a little decremental financing (every agency takes a 1-2% cut), foregoing long-term investments in infrastructure and capital spending and/or general ledger maneuvering that eliminates unfunded appropriations and vacant positions.

The foregoing "cuts" are always bundled with new revenues in a spirit of "shared sacrifice" – higher taxes, increased fees and other income boosts, often times in the form of reaches into someone else's pocket. I refer to this latter source of munificence as "OPM," or "other people's money," and it has been the means to remedy budget gaps that would otherwise create an additional and undesirable burden on Delawareans. (Think here of "silver bullets" such as bank franchise fees, casino revenues and, most recently, escheat or abandoned property).

The sustainability of this budget paradigm that rests in equal measure on (i) the foresight of policymakers to recognize and make one-time use of "budget surplus" and (ii) a never-ending supply of OPM is questionable and deserving of rigorous examination. The Advisory Panel is charged with exploring whether a different set of fiscal controls could achieve not just year-to-year budget solvency, but ensure long-term spending sustainability, meeting our needs while living within our means.

Similarly, the Budget Reserve Account (more commonly known as the "Rainy Day Fund") was implemented at the same time as our 98% Test and has been a fixture of our fiscal architecture ever since. In those four decades, the fund has never been used, not once. Was it raining during the Great Recession when state revenues swooned following the housing crisis by almost 25% or $800 million? What about when the tech bubble burst in 2000? The recession in 1991-92? Apparently no – not raining.

Rather than use the Budget Reserve Account to smooth over periods of economic hardship, policymakers have been forced to triage shortfalls with a mix of ill-timed and often untargeted cuts together with an assortment of unpredictable revenue enhancements. While these types of actions are required by our current fiscal controls to balance the budget, they are the antithesis of the actions that the State should be taking in a recessionary environment.

When the private sector is tanking, the public sector should be providing balance and stabilization, not contracting and piling on. Conversely, when the economy is expanding rapidly, government should be proceeding at a deliberate pace and harvesting part of that revenue growth for the next cyclical decline. This is the essence and function of a budget smoothing account.

Unlike our current Reserve Account, the rationale for which is unknown and the capacity of which has never been tapped, a Stabilization Fund would have the clear purpose of leveling out the peaks and valleys in our income streams and would be drawn on and funded with regularity as our economy expands and contracts.

Together with reforms to our revenue portfolio – greater adequacy, lower volatility and higher favorability – and long-term spending controls – that assure sustainability as measured by our means and our needs, a new budget stabilization fund would complete a set of budget reforms that collectively constitute, dare I say, a Grand Bargain.

Let's Think Big and Act Now

Daniel Burnham's defiance of conventional wisdom – to eschew small plans in favor of large visions – should be embraced by both our citizenry and our policymakers. I sense that all of us actually crave the idea of doing something big and bold, especially if it signals that we are collectively on a path that is certain, sufficient and sustainable.

We should also reject the conventional wisdom that holds that nothing big can happen now because it is an upcoming election year. Such reasoning rests on the premise that politicians are risk-averse and do not want to gamble with public wrath. Voters should make it clear to their elected officials that the far greater political danger lies in doing nothing, that kicking the can down the road is a terminable offense.

So, let's not play small ball and let's not kick the can. Instead, as a people let's signal we demand, and as policymakers let's focus on delivering, a Grand Bargain now – not in spite of an election year, but because of an election year. It's time for some magic to stir the blood.