


## ENERGY IN THE EXECUTIVE

# Pragmatic Prescriptions for Public Administrators

**KEN SIMPLER**

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KEN SIMPLER

## ABOUT THE AUTHOR

Ken Simpler served as Delaware's State Treasurer from 2015 to 2018, following his first run for public office. His tenure was defined by initiatives to restructure core components of Delaware's finances, including the State's banking and investment architecture, state employees' voluntary savings plan, and the statutory controls that govern the State's annual budgeting process.

Prior to entering public service, Ken Simpler served as the Chief Financial Officer of Seaboard Hotels, a manager and developer of hotel and resort properties on the Atlantic coast.

Previously, he held the position of Managing Director at Citadel, LLC, a leading global investment fund.

Ken began his career as a corporate attorney at Kirkland & Ellis, a national law firm.

He holds a graduate degree in public administration from the University of Delaware's Biden School as well as both an M.B.A. and J.D. from the University of Chicago's Booth School of Business and the Law School.

Ken earned his undergraduate degree from Princeton University as a political economy major. He is an alumnus of both the Aspen Institute's Rodel Fellowship and Leadership Delaware programs.

Ken and his wife Liz have three children—Blakeley, Gillian and Emmett—and reside on a small family farm in Newark, Delaware.

## ACKNOWLEDGEMENT

I wish to acknowledge the perseverance of my faculty advisor, Prof. Jonathan Justice. He doggedly encouraged me to complete a degree program begun before and interrupted by the public service it was intended to facilitate. In both undertakings, he demonstrated greater confidence in my endeavors than did I. For this, I am grateful.

## DEDICATION

The foreward to this compilation was written to satisfy the final requirement towards a degree in public administration. It and the essays that I drafted during my tenure as Delaware State Treasurer are dedicated to my fellow students and practitioners in this little-heralded field who I hope will find some pragmatic advice in these pages, not just to serve, but to lead.

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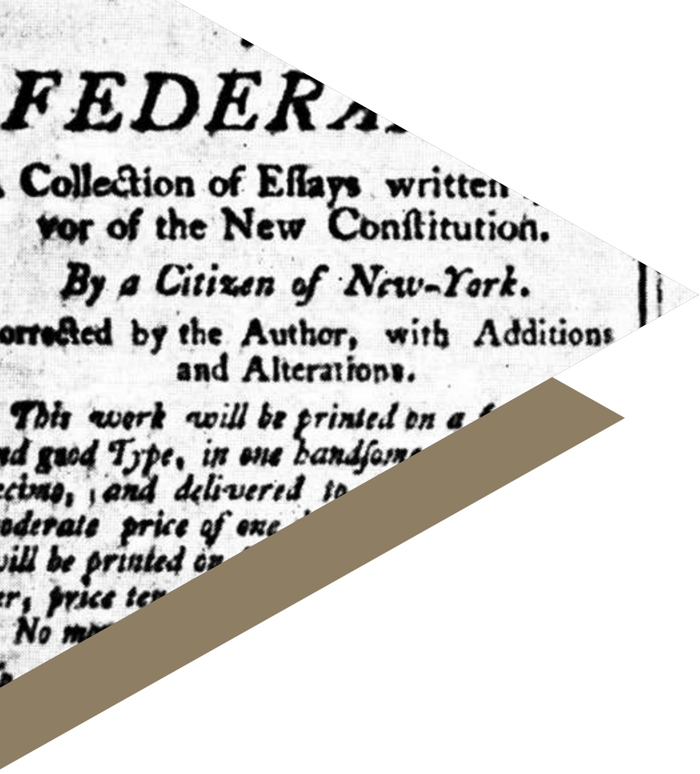
THEMES: MISSION SYSTEMS VALUE OVERSIGHT

# Energy in the Executive

## FOREWARD

"Energy in the executive is a leading character in the definition of good government...[A] feeble executive implies a feeble execution of the government. A feeble execution of the government is but another phrase for a bad execution; and a government ill-executed, whatever it may be in theory, must be, in practice, a bad government."

— Publius, Federalist No. 70 (Alexander Hamilton)



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## FEEL THE ENERGY

Of all the words he might have conjured from his vast vocabulary, Alexander Hamilton chose the term "energy" as the quintessential attribute to be admired in the executive branch of government. His choice was surprising then and ironic now.

Surprising then because formal control over the colonies had been wrested from the despised King George only five short years prior. Hamilton's call for an energetic executive provided powerful fodder for those opposed to the objective of his writings, the ratification of the Constitution.

In opposing Hamilton's defense of the new form of government, anti-federalists likened the "Imperial Presidency" to the British monarchy. They warned that a strong executive branch would inevitably lead to an outcome they had just fought a war to avoid—absolute and tyrannical control of the American people.

Today, Hamilton's choice of the word "energetic" appears ironic. Would anyone use that term to describe the modern state? I can assure you that in four years of governing, rarely was that charge laid in an accusatory manner at any public agency.

Looking back from our current perspective, the fears of those early opponents to a strong central government appear at once far-sighted and yet wholly wide of the mark. On the one hand, the anti-federalists were prescient to expect an active executive branch forever to be in search of means to expand its agency. The administration of our state since 1787 has in fact grown to be massive in both size and scope, dwarfing anything our founders might have imagined as "limited government."

On the other hand, those who opposed Hamilton's call for a strong central government were errant in imagining how such a state might manifest itself as a risk to its citizenry. Far from a form of monarchy that is ruthlessly efficient in exploiting its subjects, our modern executive branch is less to be feared for what it aims to do than what it fails to accomplish.

This is a dangerous place at which we have arrived.

While the political class can duke it out as to whether the government should do more or less, the absolute prerogative of those of us in public administration must be to manage that mandate with excellence, whatever its scale. Faith in our government resides in such execution.

Having made the political decisions over time to have government purvey or preside over the most critical components of our socio-economic systems—safety and security, education and healthcare, transportation and infrastructure, to name just a leading few—our task is to do so efficaciously and efficiently, and ideally in a manner that is transparent and accountable.

In too many ways, we are failing at that task, and in so failing, we are jeopardizing the trust that underlies the very institution of our government. To be clear, this is not a shortcoming of policy, but of practice.

If we are to rise to the challenge of our mandate—excellence in all that we administer—we need to heed Hamilton. We have to channel more energy.

It is energy in our executive branch that is the current that powers this giant apparatus we call government. When it falters, administration of the state can be likened to the experience of rolling brownouts—intermittent and untrustworthy; when it fails, things just stop working, and we are left in the dark.

When, however, the energy marshaled in the executive branch is focused, the analogy is akin to the lightening that illuminates an otherwise drab sky. Its phosphorescence bears witness to its surge far from its point of origin, and where it courses it leaves the air and all within its atmosphere charged by its brilliance.

As administrators of government, we have the power to unlock more of the energy that is latent in our agencies. The task of recharging and rebooting Leviathan requires both a precise identification of the faults in our circuitry as well as a robust set of tools to release our kinetic resources.

# FOMENT THE ENERGY

In the following essays, you will find an accounting of several of the major challenges of both managing and leading change that I encountered in the public sector.

The "newsletters" issued during my term as State Treasurer are presented in the chronological order in which they were written and published without editorial comment or revision.

Each paper typically addresses a then-current undertaking of my office to illustrate problems that if not endemic to, are particularly pernicious in, the conduct of government business.

> The newsletters were written for ordinary citizens so that they could glimpse the challenges of operating in the public sector and also understand the solutions that my administration was proposing or implementing.

The chief aims were to bring transparency and accountability to the conduct of my office, and offer some general edification to the body public.

It was not my intent at the time to speak to fellow practitioners, much less to put forward a cogent set of ideas to promote a more energetic administration of the public sector.

Only in hindsight, in treating these papers published over four years as a whole, do I see a body of writings from which some pragmatic guidance may be gleaned to aid the labors of the public agent and enhance the public good.

The core challenges that recur throughout the essays are identified or at least hinted at in the first and shortest of the collection. I group them under four headings:

- A nearsighted, managerial approach to governance;
- A proclivity for implementing piecemeal solutions;
- An obsession with revenues and costs but not return; and
- An overall lack of accountability for results.

In subsequent writings, as my administration wrestled with these institutional headwinds, a consistent set of strategies to deal with them became evident. Over and over, we found solutions emerged when we pursued some combination of the following steps:

**MISSION**

Revisiting and resetting the mission statement;

**SYSTEMS**

Taking a holistic or systems approach;

**VALUE**

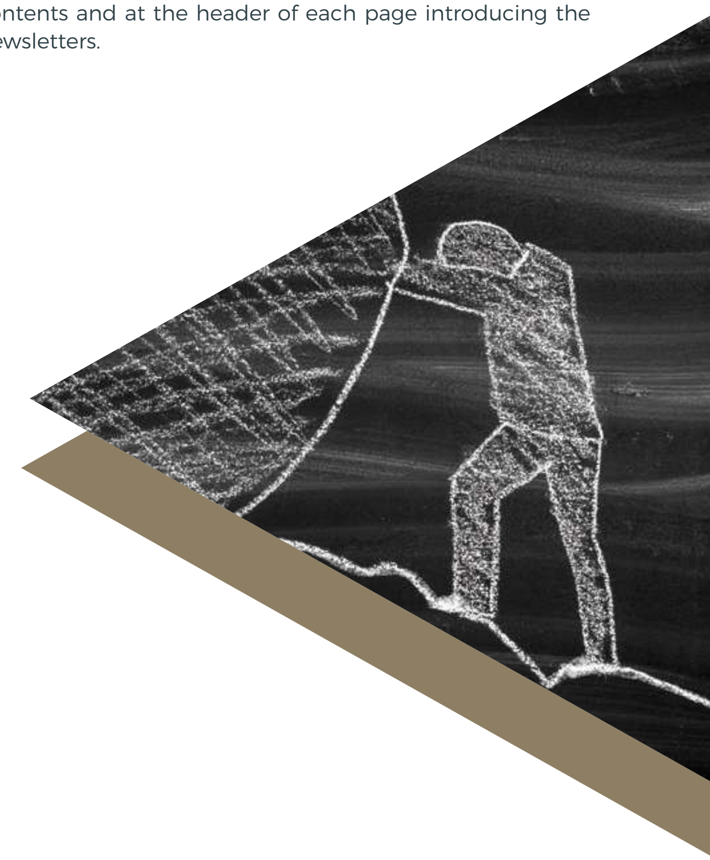
Focusing on the value equation; and

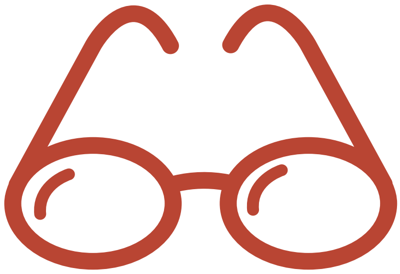
**OVERSIGHT**

Building engaged oversight boards.

Each of these thematic challenges and solutions is summarized in the sections of this foreward that follow.

In addition, to better aid the reader in identifying these themes in the essays, a key is included in the table of contents and at the header of each page introducing the newsletters.





MISSION

## NEARSIGHTEDNESS CAN BE ADDRESSED WITH MISSION CORRECTION

Every organization can fall prey to the tyranny of the now. It is human nature to deal with the stick that is poking you the sharpest. That approach, however, does not guarantee a focus on the spear that is the largest and/or the most lethal.

In the totality of my working experience—in the private sector, with big and small companies, as well as service for and on non-profit boards—government organizations stand out as especially myopic. Problems du jour and issues of fairly minor import receive an inordinate amount of attention from elected officials and unelected heads of agencies alike.

> It is easy to blame this "short-termism" on the popular notion that public officials are disinterested in events beyond the horizon of their next election. My own observations do not wholly discredit this theory, but point to a different causal factor.

The reason is less about a lack of interest in long-term vision and more about a deficit of bandwidth. Stated simply, elections are time-consuming, requiring public officials to exert substantial energy politicking that could otherwise be spent governing.

The capacity for members of our Legislature to think large-scale and long-term is further diminished by their need to focus time on issues of local import and constituent service. These efforts are not driven solely by the desire to be re-elected, but are genuine attempts to represent the interests of their districts.

Nevertheless, in the aggregate, they add up to playing small ball and greatly distract and detract from the ability to look at the big picture.

Unelected public administrators need to act as a counter-balance to the short-term cyclical dynamics and service demands that steer elected officials toward the shallow end of the pool of issues. In practice, however, members of the administrative state are beholden to comparable forces that focus attention on the annual budget cycle and allocate resources to maintaining the organization as opposed to improving it.

When recurring challenges are exposed as the result of large-scale, long-term problems, the earnest attempt to manage through is seen to fall far short of a serious commitment to resolve.

One common lesson from these experiences for the public administrator is that a clear articulation of mission matters. In many cases, calling a "timeout" from the administeria that often overwhelms public organizations, and having all relevant parties engage in a rigorous analysis to review and re-frame the strategic priorities of the agency, committee or organization can energize the stakeholders and catalyze necessary change.

As a famous U.S. venture capitalist, Eugene Kleiner, was fond of saying about many of the start-ups with whom he regularly dealt, "the problem with most companies is they don't know what business they're in." Silicon Valley aspirants who don't figure this out go bankrupt, shutter operations and cease to exist.

Unlike their peers in the private sector, state agencies that have lost their way never truly fail; they simply become zombie-like, monotonously going through the motions of discharging their daily functions with no awareness that their activities produce ever-decreasing discernible value.

When, however, these somnambulant public organizations are roused to a compelling vision of their true calling and potential for transformation, the increases in output, productivity and quality of results can be both meaningful and measurable. An energetic state requires a clear and compelling mission.

SYSTEMS

## A PROCLIVITY TO PIECEMEAL REQUIRES A SYSTEMS APPROACH

Separate and apart from government's myopia is a related but different problem. While the articulation of a clear mission can both propel motion and act as a rudder for an organization, it cannot redress the flaws of a fundamentally unseaworthy vessel or crew.

Imagine a ship that even if captained by a firm hand with a clear call to steerage, has no one aboard with a complete understanding of its workings. Instead, running about the boat's lower decks are a mass of ensigns, some with no engineering degrees, here and there independently adjusting its machinery in eager attempts to follow the skipper's directives. The collective process is uncoordinated, disjointed and sometimes counter-productive, leaving our modern ship of state wallowing and listless.

> Today's governments, some of the largest and most important organizations on the planet, are operated as adhocracies. Decisions of consequence are routinely made in silos or isolation, with little appreciation as to how they affect the larger whole or fit into a broader context.

Some of this balkanization can be attributed to the doctrine of separation of powers, some to the compartmentalization of responsibilities fostered by administrative policy.

On the one hand, decision makers in the executive branch are inclined to look for clear legislative permission to stray outside their lanes as opposed to moving boldly and asking for forgiveness. On the other hand, strict roles for personnel have been spelled out in administrative code, and human resource systems do not reward or incent public employees to venture outside these boundaries.

The overall result is a piecemealing of the administrative state.

This outcome is doubly damaging when you consider that its first negative consequence—suboptimal performance—is often exacerbated by a knock-on "remedy"—ad hoc policy action.

Essentially, haphazard executive function begets unacceptable outcomes that require seat-of-pant legislative correction. Once this course has run a few cycles, the very foundations and systems on which government operates can become riddled with dysfunction and disincentive.

Samuel Rayburn, the longest serving Speaker of the U.S. House of Representatives, once quipped that "any jackass can kick down a barn; it takes a carpenter to build one."

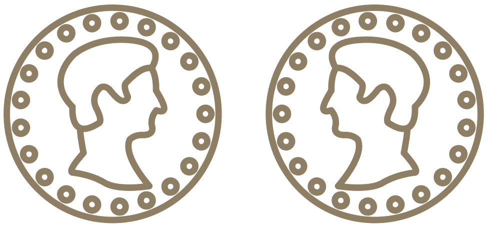
Public administration requires an understanding as to when and how to effectively employ both the jackass and the carpenter. Sometimes the barn must be razed before being rebuilt, and that assessment cannot be made without looking at the totality of the structure, including its foundation.

A second theme that emerges from the essays that follow is the need for the public administrator to take a holistic approach.

This may mean looking at an agency's operations across its various divisions and issuing a comprehensive RFP as opposed to replacing a narrow service. It might also mean studying the entire chain of a government function processed by several agencies and forming an inter-agency task force to address problems upstream at their source as opposed to dealing with them downstream where they dump out.

At its most ambitious extreme, this approach suggests taking on comprehensive reform of those over-arching components of our government architecture that affect all departments and agencies: the way we manage people, procure services, generate revenues, budget expenditures, and manage risk.

A holistic approach that rationalizes any of these functions can unlock tremendous amounts of latent potential and energize the foundational systems of the administrative state.



VALUE

## TURN AN OBSESSION WITH REVENUES AND EXPENSES INTO AN AFFAIR WITH VALUE

Public administrators need to embrace one word and focus on one concept above all others: value. "Value" is alternately defined by online dictionaries as "a fair return for something exchanged," "the importance or usefulness of something," and "the worth of something compared to the price paid for it."

In the administration of our state, there should be a relentless focus on maximizing value.

While it is not ours as administrators to determine how much is taxed or appropriated—that is a legislative prerogative—it is ours to do the most with what we have and to do so with excellence. This requires a rigorous commitment to monitor and measure what we get for what we spend.

> As we all know, however, the two major political parties have aligned themselves on opposite sides of the value coin. One is obsessed with the shortage of revenues, the other with the excess of spending. This schism has resulted in an administrative state that caters to both in framing its performance in terms of inputs and outputs.

So universal is this practice and so entrenched are these concepts that few even question their relevance. The failure to do so, however, leads to a host of problems: meaningless measures of achievement, faulty assessments of progress, irrelevant benchmarks and, more generally, a dereliction of the attempt to identify and communicate essential information.

Contrary to intuition, the advent of Big Data and the transparency movement across the public sector has not made the operations of government any less opaque to the average citizen, or even the administrators of state agencies!

The accessibility of information can actually confound as opposed to inform, unless there has first been applied some level of rigor to refine what is actionable intelligence versus what is white noise.

In many instances, the failure of the public organization to achieve superior results is rooted in confusion as to the means to identify its value proposition.

Even an agency that has committed itself with vigor to a mission and examined its challenges from a holistic perspective, must still discern how to measure success.

By focusing on value, administrators gain insights as to where resources are over-committed and where they are under-committed. (Note that my experience in state government suggests that there are significant occasions of both.)

With this information, public organizations often have the power to reallocate portions of their budgets without having to go as supplicants before the Legislature seeking remedy. This process alone is cathartic for an organization.

It is also a critical means of unlocking untapped potential. Divisions within agencies that are over-resourced will find the need to act with greater efficiency when forced to part with some of their largesse. Whereas divisions receiving additional resources will likewise be incented to demonstrate their ability to achieve more with more.

On the whole, organizations that reorganize themselves around defining and delivering value will emerge from the action both more empowered and more energetic.

OVERSIGHT

## ADMIT YOU HAVE AN ACCOUNTABILITY PROBLEM AND GET OUTSIDE HELP

Taking all the steps above will energize an organization, but that does not mean that an administration cannot still benefit from a watchful eye, some tough love and the occasional kick in the seat of the pants. Execution is almost always improved with informed advice and engaged oversight.

This kind of beneficial review is not generally forthcoming from the Legislature. While it is that body's constitutional duty to provide oversight of the executive, the exercise is often perfunctory if not disinterested—and the administrative branch likes it that way! When subject to such scrutiny, public administrators often perceive the review as either a threat or a nuisance.

In spite of or perhaps because of this state of affairs, lawmakers are relentless in creating oversight boards. Cynically, you might interpret this as an outsourcing of a task for which few of them have real appetite. Hopefully, you could acknowledge that such committees leverage the capacities of the Legislature to meet its oversight responsibilities. (Fairly, I can attest that these are not mutually exclusive rationale.)

As you will note from the readings, the State Treasurer is appointed to serve on a vast number and wide variety of committees, task forces, boards and commissions, numbering more than a dozen and covering the gamut of government operations. Some of the best work that was done during my tenure was with the active advice and support of boards and councils.

That said, the capacities of these groups to exercise their functions can vary substantially. Public administrators will encounter boards that are ill-conceived, weakly staffed, and poorly appointed or constructed. Rather than abide or overlook these failings, an administration should seek to rectify shortcomings to make the councils stronger.

An agency is frequently in a position to improve board composition. On occasion the power to steer or influence appointments is de jure or de facto.

Even without this authority over the appointment process, the public administrator can still actively recruit members with passion for the subject matter and encourage them to apply. Likewise, members serving on autopilot can be given a gentle nudge to step away.

As a general matter, the public administrator should adhere to the maxim that strong boards require members who want to pull the cart, not just walk along beside it.

In some instances, an administration can go further in building up its boards. Where regulations permit, committees can be expanded in size to allow more experts, and sub-committees can be created to examine issues in greater depth.

Where laws must be modified to achieve the needs of an oversight board, the agency can take the lead in drafting the new code and finding a sponsor to shepherd the bill through the Legislature.

Beyond improving composition and structure, public administrators can also aid boards by enhancing their operation and governance. They can assist councils with the engagement of best-in-class third-party consultants to improve decision-making and level the playing field with the administrative agency's superior knowledge of day-to-day operations. In the same spirit, administrations can decline the CEO/Chairperson model where the agency head also leads the board in favor of placing outside, independent members in charge of councils and committees.

The dividend to the agency that builds strong boards is three-fold. First, active boards can supply additional bandwidth to support operations and provide experiential learning to solve challenging problems. Second, committee approval of key initiatives serves as a "seal of approval" in seeking necessary funding, desired regulation, or general assistance from the Legislature or other executive branches. Finally, boards can provide cover for, urgency to or just reinforcement of agency initiatives that staff might otherwise resist or slow-walk.

Administrators who welcome effective oversight and look to the boards that provide it as partners in achieving good governance will find that the energy of their offices is amplified and conducted further than it might otherwise extend.

## FIND THE ENERGY

Do not take this introduction or the writings that follow as public sector bashing. I am a proponent and defender of good governance.

I ran for office and served because I want to believe and prove that a government of, by and for the people, is not only possible, but that it can be great, achieving excellence in all that it properly and faithfully does.

Those of us who would study and practice public administration should allow, however, that this right to self-governance remains a novel experiment when viewed through the long lens of human history.

Just over 100 years ago, there were barely more than a dozen democratic nations in the world. Today, that figure has increased almost ten-fold, to a majority of the recognized sovereign countries on the planet.

Among all such nations, however, America bears both a unique privilege and burden to defend the merits and viability of this fledgling form of governance.

We are the modern progenitors of this movement, and we remain, if not its most consistent, at least its most potent, defender.

That defense rests ultimately on the success with which we administer this model.

After all, "a government ill-executed, whatever it may be in theory, must be, in practice, a bad government."

Let's find and marshal the energy to be a good government.

Ken

Ken Simpler
Former Delaware State Treasurer
November 2019

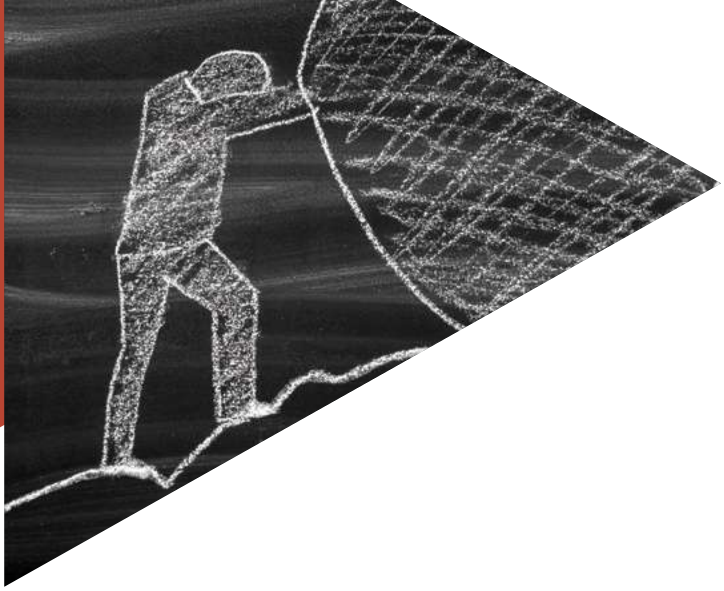
> Operating year-to-year and "getting by" is distinctly different than being disciplined and taking the long view. The latter approach creates value, the former approach creates problems.

NEWSLETTER | Q1 2015

# FIRST (AND LASTING) IMPRESSIONS:

# My First 100 Days


KENNETH A. SIMPLER
STATE TREASURER



Last week I had the invitation to sit down in studio with a media outfit to interview me on my first 100 days in office. The segment was less than 20 minutes but the interviewer was sharp and we did cover quite a few topics. I don't know that we broke any new ground, but one exchange stuck out.

The interviewer clearly came to the table poised to elicit some strong reaction from me on the most recent downward revision of Delaware's revenue projections by $45 million. How would the state handle this "collapse?"

Not really rising to the bait, I suggested three things: one, the act of forecasting is just that and there are still more forecasts to come; two, the budget director has means of "finding" revenues as the legislative session comes to an end that tend to mitigate shortfalls of manageable amounts; and third, the magnitude of the problem should be borne in mind — $45 million in the context of total spending north of $8 billion is not insignificant, but it is only about ½ of 1%. Not exactly a calamity.

I tried to pivot from this exchange to talk about the important work going on at the Advisory Council on Revenues, a committee designed to study our entire revenue portfolio and ask important questions about the adequacy and predictability of our tax base, as well as the economic competitiveness of the way we choose to raise our money, in all cases over the long term.

The interviewer wanted none of it. He took this opportunity to pounce: "Well, $45 million is sure a lot of money to the people who might have programs cut. You politicians like to talk about the long term, but what do you tell the people who are losing their funding."

What I wanted to say is that any government that can't figure out how to address a .5% budget shortfall has bigger problems. And, I would have liked to have added that there is far too little talk of the long term and far too much focus on the short term.

But, I bit my tongue, and patiently repeated the answer I had given previously. To be honest, I wasn't that engaged and I had a whole afternoon to come of meetings and what I thought were more pressing concerns.

Writing now, however, I realize I made a mistake. No matter the venue or the moment, I have to use every opportunity I get to bring this dialogue back to the big picture and the long term.

The obsession with (yes, I'll say it) the "small stuff" and the short term is really what is killing us. Politics, and sadly governing, is to a large degree a tyranny of the "now."

Lacking a fiscal framework that is holistic and long term leads to a lot of time being spent managing problems as opposed to solving them.

These efforts are made in good faith and often with sincere intent, but over any span of time they end up looking like band-aids, patches or, worse, punts.

This is why I think the work of the Advisory Council on Revenues is important. And, don't be too cynical. Notwithstanding its name, this is not the Advisory Council on Raising Taxes. The mission instead is to consider the historic performance of our revenue base (40 years worth) and ask some basic questions:

- Is the natural growth in our tax base slowing?
- Has our tax base become too reliant on unpredictable sources of revenue?
- Can the manner in which we raise money be made more "pro-growth"?

Now, I am not going to pre-empt the work of the Council by providing you with my view on these issues at this time. That will be the job of a future newsletter. Instead, I simply want to point out that these are the types of long-term, large-scale issues that we need to address, discuss and resolve.

The output of this Council should ideally inform both the members of our General Assembly and our state as to the way to think about our revenue system so that a framework can be devised and agreed upon that eliminates some of the "adhocracy" of our budgeting process and allows us to solve today's problems in a manner that will not create tomorrow's crises. That's what a good finance system does.

In addition, I expect the Council or some body formed to continue the work started by the Council to dive into the other part of the "value equation" and offer structural recommendations as to how we avoid common budget traps.

In the first instance, note that there is too much fussing over how much spending or taxing and not enough discussion about the value we get out of the spending of our tax dollars. I've said many times that even the conservatives I know will accept a good value out of government.

> What should worry us all is when we spend a relatively high amount and get a relatively mediocre outcome. That's trouble and that's where we are now.

In the second instance, I hope that we undertake a rigorous overhaul of our "structural fiscal governors." In theory, these are the procedures, practices and protocols that are statutorily or constitutionally built into our finance system that recognize our proclivity toward poor fiscal practices and preclude behaviors such as spending more when we have more (instead of saving for a rainy day) and putting off capital investments and foregoing funding long-term liabilities (in favor of current programs and transfers).

We have many such "fiscal governors" but over time they have ceased to be as effective as they once were and some have been deliberately "worked around." It's time to take up consideration of a new financial framework that addresses these shortcomings and provides greater long-term discipline.

By this time, I am sure I have you worried that I am spending too much time on esoteric financial designs that while well-intentioned will never see the light of day in our political grinder in Dover.

Perhaps, but ideas have a way of purposing themselves when they are needed most. To have a chance at putting them to work we first at least need to conceive and design the systems that will lead to greater transparency, accountability and certainty in how we do finance. That may be a push, but I'm eager to put a shoulder into it.

Also, take comfort that I am allocating the lion's share of my days to the actual functionings of the Office of the State Treasurer. I have embraced the idea that I must act and learn on two paths, idiosyncratically and systemically.

While I am immersed in banking service RFPs, revisions to the guidelines of our state investment portfolio, redesign of our state employees deferred compensation plans and a myriad of daily operational matters, I have an outside consultant rigorously reviewing and mapping our office's workflows and work product.

If all goes as planned, she will complete her analysis in tandem with the conclusion of the fiscal year, leaving me a few summer months after the General Assembly goes home to study her recommendations and make decisions for next fall's budget proposal that takes this analysis into account.

Whether inside the office or outside, I am committed to the idea that reforming our government to be more productive and create more value requires studying our systems and taking a long-term view. If I can't lead on those ideas through my committee work, I sure intend to lead in the Treasurer's Office by example!

So, let me conclude with two final examples from my first 100 days to convince you that planning and fiscal discipline over the long-term matter. These come from two very different sources: state employee benefits and charter schools. In both cases, however, the lesson is clear: operating year-to-year and "getting by" is distinctly different than being disciplined and taking the long view. The latter approach creates value; the former approach creates problems. I think you'll agree.

**CASE 1: CHARTER SCHOOL LOSSES COMPOUND**

A private company engaged to run one of our state charter schools was not paid for management services over a period of years and was granted an award of nearly $1,000,000 in 2008. This verdict was affirmed by our Chancery Court in 2010 with interest on the bulk of the judgment granted at a rate of 18% until paid in full. Seven years later, no amounts have been paid on the award, and I sit now with an order of a Dover superior court to identify all monies of the school under the control of my office and conserve them for the potential benefit of the creditor. Interest alone now exceeds the amount of the original claim. Subject to the results of an objection that we have filed, I may be left to either disobey a court order or suspend the activities of an operating school for lack of funds. To date, I have received no credible explanation as to how such a situation could have been left to fester for the better part of a decade into such an awful mess.

**CASE 2: HEALTH FUND FOUNDERS**

The health fund that pays all self-insured claims of state employees is scheduled to begin the next fiscal year with no reserves and insufficient assets to meet its forecasted liabilities. Fewer than three years ago, the plan boasted a reserve of more than $70 million and surpluses of nearly that amount again on annual expenditures of roughly $600 million. This rapid reversal reflects a conscious decision during the intervening period to stop raising health care premiums during a stretch of below average claims experience. The monies that would have been transferred to the health fund were left to support other general fund expenses of our state government. Employees now face a raft of plan cuts and/or the General Assembly must find at least $60 million this year just so we can muddle through. There's more to this tale, but suffice to say there's not likely to be any happy ending.

These examples beg the question of our capacity to consistently show long-term fiscal discipline and to address situations unlikely to end well in the "out years" proactively, when they are most manageable during the "in years."

Good finance is good government. And my mission.

Ken

Ken Simpler, Delaware State Treasurer

> Our structural problems do not lack structural solutions. We just need the financial imagination to conceive them and the political will to implement them.

NEWSLETTER | Q2 2015

# THE BUDGET TRIFECTA: Revenue Stability, Spending Discipline and Value Creation


KENNETH A. SIMPLER
STATE TREASURER

## FRAMING THE BUDGET DEBATE

This past quarter for me was dominated by the conclusion of two processes: a macro-level examination of our State's revenue system and a micro-level review of my office's workflow and resource utilization. If that is not a topic sentence that grabs you, I suspect the rest of this read might require a little exertion on your part.

So, let's jump right in using two related questions that I get asked all the time:

**—How bad are our budget issues?**
**—Do we have a spending problem or a revenue problem?**

In the latter case, I always give the same answer: "Yes." In the former instance, I usually remind people that you can drown in 6 inches of water; it's not the depth but the duration that matters. I am not trying to be cute with these responses, although they do seem to get people's attention. I simply believe that they are the truest answers that I can give.

In my view, both our revenue system and our spending constraints are flawed in design, and that leads to poor decisions and outcomes from a budgeting perspective. More importantly, the focus on too much or too little expenditure or income tends to overlook the obvious nexus of the two: value. What are we getting for our money?

Finally, the obsession with micro-managing the annual budget leaves little oxygen in the room to deal with the long-term aspects of our fiscal picture. This is where the real trouble lies.

If you watched our latest budget debate, the concept of return on investment did not make it to center stage. Rather, the political sides seemed to have arrived at the statehouse seeing our fiscal quandary as either too much spending or too little revenue.

Democratic legislators generally argued for more money, whether a greater share of the realty transfer tax, more fees at the DMV or a new income tax bracket. Republicans countered with a unanimous call for a 5% across the board cut in expenditures. Ultimately, to avoid stalemate, they had to do a little of both. Emphasis on "little."

I say this not to undercut the efforts of our General Assembly.

I respect and honor our legislators for their significant and sincere annual exertions. I believe, however, that the system in which they operate is defective and that the flaws of that system cost them great time and effort accomplishing what amounts to trivial adjustments in our budget from year to year.

The upside of these observations is that our structural problems do not lack for structural solutions. We just need the financial imagination to conceive them and the political will to implement them.

Cue the Advisory Council on Revenues.

## THE REVENUE SIDE

When I last wrote to you I alluded to the then unconcluded work of this body, a bi-partisan panel of current and former officeholders, academics and budget officers convened by our Governor to study our state revenue system's adequacy, predictability and economic impact. Strict partisans will not find the Council's report as a whole much to cheer.

Those interested in serious, large scale thinking on how to improve our budgeting and long-term finances should take notice, and heart.

In the revenue case, the report makes clear that we have come to rely on a portfolio of income streams that is "doubly narrow." Personal income and our corporate franchise (in which I include our unhealthy reliance on abandoned property), account for more than 70 cents of every $1.00 of our operating funds.

The rest of our revenue sources, a baker's dozen or so that we regularly report, contribute a few pennies each, maybe a nickel here and there, by way of comparison. A well-balanced and diversified portfolio this is not. And that raises concerns about adequacy when the economy weaves and bobs.

Moreover, in virtually all cases, the bases of our revenue streams have become narrower over time, not broader. Whether corporations or individuals, we have come to collect a greater share of taxes from a fewer number of higher payers. Revenues at the margin therefore have become subject to greater swings based on the actions of a relatively small number of taxpayers who can choose to (legally) defer or otherwise not recognize income in a given year.

More revenue volatility means more annual scrabbling for minor make-wholes and patches to our budget — a disruptive and unpredictable process.

The structural fix for these shortcomings is to take an active approach to re-constructing our revenue portfolio on a revenue neutral basis (i.e., same amount of money, but different pockets). The specific suggestions here are too numerous to cover in this letter, but the key ideas are to:

- broaden the base of the personal income tax via elimination of major deductions coupled with an offsetting across the board cut in rates and the elimination of the estate tax;
- manage the corporate franchise fees targeting a certain growth rate with predictable fee increases that the market will bear;
- reduce or even eliminate our corporate income tax while raising our gross receipts tax by an equal amount; and
- cut back our reliance on escheat/abandoned property over time in favor of greater dependence on own source revenue from a property tax, ideally administered at the county level in exchange for more local control of education spending and/or transportation expenditures.

Politically speaking, these recommendations provide something for everyone to hate. Practically speaking, they constitute a revenue portfolio that is more robust, more predictable and more conducive to economic growth.

Moreover, in the aggregate, the portfolio is designed to grow over the long-term at a rate that approximates inflation plus population growth.

In an uncertain world, a sound revenue system that keeps up with predictable demands on spending can command a premium from individuals and businesses alike who will take more risk, make more investments and, dare I say, create more jobs.

It also makes it easier to isolate and focus attention on our spending issues and critically the value we are getting for our money.

## THE EXPENDITURE SIDE

The foregoing is only half a loaf. The Advisory Council also concluded that our current constitutional limit on spending is inadequate and that we need enhanced fiscal controls embedded in our legal framework.

While it sounds fiscally responsible to have an annual balanced budget requirement, that limitation embodies short-term restraint at the risk of long-term profligacy. And we have the data to prove it.

It boils down to this: when the economic cycle is hitting on 12 cylinders our revenues go up, often by a lot. Rather than put some of this newfound wealth away to anticipate the cooling of the economy, our "balanced budget" rule allows us to spend it all in the year received. And therein lies the rub.

New heights of spending established in good times are very difficult to descend from in bad times. If anything, demands on public services tend to run higher when the economy is sick.

In the past, it has been our good fortune to get through these troughs in the business cycle by finding "silver bullets": first, bank franchise taxes (now at a third of the share they once contributed to the general fund); then racino money (now at half its peak percentage contribution); and most recently, escheat or abandoned property (still in excess of 10% of operating revenues, but down from as much as 16%).

Having your cake and eating it too is great until there's no more cake. Recently, our core revenue growth (think personal income, corporate franchise and a combination of business taxes) has not fully recovered coming out of the Great Recession and our existing "silver bullets" are fading with no new cartridge found to load in the chamber. This has created the current budget "crisis."

The inescapable background fact, however, is that our state and local governments already spend an amount per person that is among the highest in the nation — greater than 43 other states and 20% above the U.S. average.

Twenty percent is a lot. We also do the lion's share of that spending at the state level — 80% as opposed to the state average of 55%.

In other words, there is a significant amount of spending done by our state government that merits scrutiny. And that scrutiny is minimal.

Spending as we all know is an intoxicating experience. Who does not relish a great vacation, a night on the town or, in the case of my daughters, an afternoon at the mall? The joy of later getting the credit card statement and analyzing that spending, well, not so much.

Realistically, we are not going to have great success making performance auditing of our collective spending "fun" for our General Assembly, but we do need to create an incentive to make oversight both a perfunctory and rewarding process.

The genius of adding to our budget framework a "fiscal governor" that limits spending to the long-term growth rate in inflation and population is that it only provides our government with the means to carry on with the programs we have today. It insures that we meet current service levels in the future by tracking increases in price levels and headcount, but nothing more.

If policymakers want to fund new initiatives, then they must find the dollars to support their projects through more efficient use of the monies we already have.

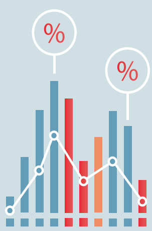
"Extraordinary" revenues in this new system, whether from a surging economy or spikes in silver bullets, will be constitutionally set aside in a "budget smoothing" account and applied when the business cycle turns down.

This automatic balancing of revenues and spending over the ebbs and flows of our economy will free up the time that our legislators ordinarily are required to expend on short term budget fixes to be applied to the far more productive exercise of auditing spending performance and identifying efficiencies. In a word, creating "value."

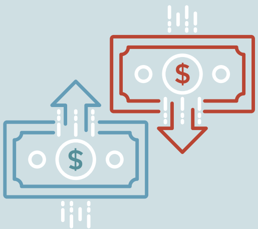
# DELAWARE'S BUDGETING PROBLEM

START

Personal income and our corporate franchise (incl. escheat) account for more than 70¢ of every $1.00 of our operating funds.



Whether from corporations or individuals, we have come to collect a greater share of taxes from a fewer number of higher payers.



Lack of diversity and balance leads to unpredictability and volatility in the revenue stream.

Instead of addressing the structural shortcomings of our budget process, lawmakers scrabble through ways to patch the budget or spend the excess – without setting aside for leaner times.

New heights of spending established in good times are very difficult to descend from in bad times. Demands on public services tend to run higher when the economy is sick.

Our state and local governments' per capita spending is already among the highest in the nation – greater than 43 other states and 20% above the U.S. average.

Our outcomes in our major spending buckets – healthcare, education, safety and infrastructure – are not commensurate with our investment.

This is not a sustainable formula, much less a boon to prosperity and economic growth. We need to make a rapid transition to focusing on value and devising a means to generate it.

# THE VALUE PROPOSITION

If you've followed me this far, the questions I hope you have at the forefront of your mind now are two-fold: Are there really efficiencies to be gained? And, if yes, how do we unlock that value?

The first question goes to the heart of the value equation — are we getting our money's worth? I've noted above that we do an awful lot of spending at the state level with a combined amount of state and local spending well above the norm. Do we get superior results for our superior spending?

For the bulk of our expenditures in the four categories that comprise the lion's share of our spending — education, healthcare, safety and infrastructure, the answer is consistently "no." At best, we get an average return.

- Our students' test scores, matriculation rates and college preparedness measures are decidedly mediocre using a comprehensive set of national measurements.
- Our population enjoys neither longer nor healthier lives than the average U.S. citizen.
- Our per capita rate of violent crime is higher than all but three other states and our largest city is ranked one of the most violent in the country.
- The quality of our roads, bridges and water is, as the Governor has made clear, poor and certainly not markedly above average.

On the whole, there is no getting around the fact that when it comes to state spending our output is not commensurate with our input.

This is not a sustainable formula over the long-term, much less a boon to prosperity and economic growth. We need to make a rapid transition to focusing on value and devising a means to generate it.

That is where my direct experience in government ties in. I want to discover for myself if and how we realize more potential and productivity in operating our public sector.

In the last four months, that is the exercise that we have commenced in the Treasurer's office.

Admittedly, mine is an agency of no more than two dozen souls with a direct budget in the millions, not the tens of millions much less the hundreds of millions. However, the same civil service rules apply to my personnel as apply to the workforce of the rest of our state government.

The same procurement rules govern my office's engagement of goods and services. And, the State Treasurer goes through the same budget process as the rest of our state divisions and branches. The scale may be smaller, but the same challenges are present.

When I write you next, I will look forward to spelling out the processes that we are going through to identify efficiencies, increase productivity and ultimately generate more value from the resources that we have.

It's one thing to talk about creating value; it's another to actually do it. That topic deserves a newsletter in its own right, and, to be fair to my staff, the changes we will be working through should be embraced internally before they are broadcast externally.

That said, I will preview one conclusion. I do not think value creation is an act of "ideation" — some brilliant thought or revolutionary concept that instantly makes government more productive; Rather, I contend that value creation is a function of perspiration.

Productivity gains will be realized one employee, one contract, one resource at a time through rigorous review and alignment of incentives.

Let's have at it.

Ken

Ken Simpler, Delaware State Treasurer

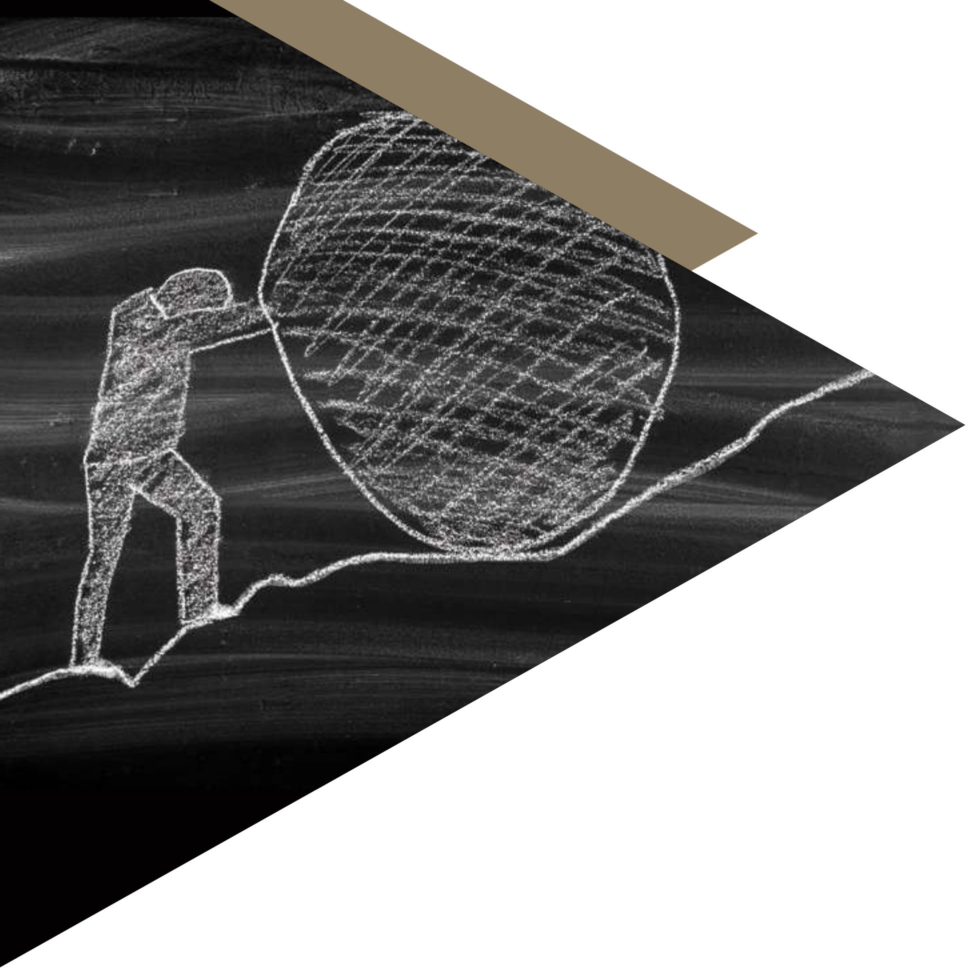
I do not think value creation is an act of "ideation" — some brilliant thought or revolutionary concept that instantly makes government more productive; Rather, I contend that value creation is a function of perspiration.

> If we are going to try to wring more efficiency out of government in the short run, there's good reason to take a hard look at how we make our people more productive and our contracts more valuable.

NEWSLETTER | Q3 2015

# Who Doesn't Want a Good Value?


KENNETH A. SIMPLER
STATE TREASURER



## WHO DOESN'T WANT A GOOD VALUE?

I find that question brings us together. It's easy to fall into our political divide of too much spending (Republican) vs. too little revenue (Democrat) when we argue over just one side of the equation.

There's far more concurrence, and curiosity, when we look at the nexus: what are we getting for our money?

Sadly, the answer in Delaware is "not enough."I pointed out in my last letter to you that our largest areas of general fund programmatic spending: education, healthcare and safety are all getting mediocre to poor outcomes when measured against the achievements of our 49 sister states.

If we were miserly with what we spent in these areas, we might conclude that was an acceptable political bargain: spend a little, get a little. However, I also pointed out that when you combine state and local spending, Delaware ranks as the 6th highest state in per capita expenditures, a level that is 20% greater than the national average.

Why are we spending so much more but getting relatively little in our core service areas?

That's a question that I hope is being examined closely by the Governor's newly-formed committee on expenditures.

I am not part of that panel, but if it's anything like the companion council on revenues on which I served this past spring, the members will proceed by delving deeply into each of our major programmatic spending areas. I look forward to their findings.

In the meantime, however, I want to offer what I suspect are a different set of insights into how we might get more bang for our buck out of state government. These ideas arise from the direct experience that I have had managing a state agency and specifically from the iterations I have gone through in contracting for outside services and hiring and managing personnel.

My concern is with the rules that govern our operations. Just as I have suggested previously that we have to rethink our revenue portfolio and the fiscal controls that we have in place to manage our budget, we also need to examine and adjust the architecture of our personnel and procurement systems.

This might sound dry and esoteric, but let me explain the magnitude of what is at stake.

## ANOTHER WAY OF LOOKING AT OUR SPENDING

Earlier, I noted that when we talk about spending we generally do so by program area: 40% of our roughly $4 billion general fund budget on education, 30% in healthcare, 13% for safety (i.e., courts, cops and corrections). That's an accurate way of looking at our major spending programmatically.

If you think about getting more value out of government in programmatic terms, then the obvious conclusion is that we've got to get better in those areas.

We need to raise our student achievement levels, improve our population's health outcomes and lower our rates of violent crime using the resources we currently allocate to those services more effectively and more efficiently.

The challenge in all these cases is that there is much disagreement over how to "do" education, healthcare and safety better.

Delaware is right now in a crisis in each of these areas, with many different and mutually exclusive views held by our policy leaders. That we must rise to the challenge of solving each is not in question. That the path to reform of any will be straight or short is less certain.

However, there's another equally accurate way of looking at our general fund spending that might yield results with less contention and greater speed: categorically.

If the "big three" in the general fund spending by program are education, healthcare and safety, then the corresponding "dynamic duo" by category are personnel and contractors.

Personnel expenses comprise a little more than half of all state spending, and contracting costs are in the neighborhood of 15%.

Overall, that's roughly two-thirds of our total spending on employees and contractors. In other words, this is where the money is.

And, note two other advantages of thinking categorically as opposed to programmatically:

First, the solutions found by examining expenses categorically apply universally across all of government and are not department, agency or program specific. In other words, there's tremendous scale to any ideas that can be leveraged across the whole enterprise when talking about people and procurement.

Second, the rules of how we better manage personnel and engage third parties are easier to implement than the corresponding "fixes" for education, healthcare and safety.

Changes in the areas of personnel and contracting need not be radical; the intent of these rules is generally sound, their application simply needs to be modified to have a positive and meaningful impact on our productivity.

If we are going to try to wring more efficiency out of government in the short run, there's good reason to take a hard look at how we make our people more productive and our contracts more valuable.

I'll offer a few thoughts on each based on what I've seen and tried in managing my own office these past three calendar quarters.

Delaware ranks as the 6th highest state in per capita expenditures, a level that is

>20%

above the national average.

## OUR PEOPLE

Let's take the case of our personnel rules first. The civil service or "merit system" as it is generally referred to is founded on several ideas: that the "spoils system" is not a good way to run a government; that the bureaucracy should be managed by an expert and largely non-partisan body; and that advancement and opportunity should be determined by experience and competency as opposed to any form of favoritism. I agree with all of these concepts, in concept.

However, the rules also have a pernicious side. They do not lend themselves to rewarding people for exceptional work, challenging them with new opportunities that will help them build their skills or incenting them to consider how different ways of doing things might improve operational efficiencies.

The system also makes it very difficult to challenge those who underperform or eliminate positions or work that are outdated or no longer critical to the operations of the organization. Finally, the current framework for hiring new people is a laborious and time-consuming task that encourages a mindset of filling empty seats as opposed to examining the workflow needs of the office as a whole.

In short, the civil service system tends to reinforce the status quo and frustrate material change, even if that change would benefit all stakeholders.

However, if we have a government that needs to get a lot more efficient to justify the extra 20% that we expend over the average state and fully half of that spend is on our people, then the rules that govern how we make our people more valuable need to be reformed, and a better balance among our objectives must be struck.

Here are some modest ideas:

1. Agency heads need the power to bring in a few more people from outside their office who will share their tenure and can bring different experience to bear. I have a diverse agency with a number of very discrete and complex functions, but my appointments are limited to just two positions: my personal assistant and my deputy.

   Otherwise, I am bound by the personnel decisions of my elected predecessors. If I am intended to make meaningful organizational change and deliver higher value during a four-year term, I need a few more opportunities to build the team of my choosing.

2. Managers need modest powers to promote and demote and otherwise provide pecuniary carrots and sticks. Job security cannot be synonymous with job stagnation. If someone outperforms for me, I want to be able to offer him or her more than a pat on the back and an "attaboy".

   Conversely, if someone is not meeting expectations, I need to show them "tough love" — tolerating underperformance is damaging not just to the institution but also to the individual.

3. We need to modify the rules hampering labor mobility to allow people to move more freely where they can deliver the most value. Our system of job descriptions, position reclassifications, employment postings, candidate screenings and personnel interviews has become too cumbersome. It disqualifies and discourages many talented people from the private sector from considering public service.

   Its rigidity also limits people within the public system from making lateral moves that would benefit both them and the organization. Moreover, the system leads managers to settle on serial hiring for the same duties as opposed to actively evaluating the needs of the organization — an outcome that benefits no one.

# CONTRACTING

Like the system that governs our personnel recruitment, management, development and payment, the rules that have grown up around our third party procurement are well intentioned.

> Our contracting regime is designed to ensure both transparency and fairness. In my experience it achieves those outcomes but at unintended cost.

In general, any contract with a value in excess of $50,000 must go out to public bid, or RFP (request for proposal). To do this, the basic form of the RFP must be adapted to the current engagement, the scope of services and evaluation criteria designed, a lengthy questionnaire composed and a variety of attachments and appendices prepared.

Prior to issue, the RFP must be reviewed and approved by the State's procurement, IT, legal and budget personnel, and, in many cases, an oversight board must also sign off.

The RFP must then be put out to bid for a prescribed period of time, during which potential bidders are allowed to submit questions and formal responses must be catalogued and supplied to all bidders by the issuing office.

Once the RFP responses are received, a specially formed selection committee must review all responses and rank the bidders. Finalists are interviewed and scored by the same committee and often times an oversight board must ultimately approve the committee's selection before a contract can be awarded.

You should conclude from the foregoing summary that the RFP procedure is both time-consuming (easily requiring hundreds of man hours) and lengthy (generally taking 3-6 months). That said, there is nothing inherently illogical or wrong-headed with this process. That is not to say there are not unintended and unfortunate "side effects."

The time and energy required to undertake RFPs means that most agency staff are not inspired to effect them any more frequently than responsibly required (if then).

Second, and akin to our personnel hiring process, the RFP system leads to a serial as opposed to holistic approach to contracting.

Third, contracting in the open for existing engagements effectively shows bidders "our hand" and reduces the value we might otherwise get from competition for our business.

Finally, the very open and lengthy process of conducting an RFP invites significant and generally not disinterested political involvement.

Again, here are a few thoughts:

1. Require agencies to develop and publish on their website an RFP schedule for all third party engagements that ensures regular rebidding and periodic evaluation of groups of contracts.

   Contracting infrequently and piecemeal is not a likely path to substantially higher value. We need systems that ensure regular review of the entire body of related contracted work and that ideally incent inter-agency collaboration where engagements affect more than one department.

2. Pricing information in current contracts should be subject to strict confidentiality during the contract term (not to exceed a period of five years), but only where an independent board has provided review and approval.

   This would limit but not unduly infringe on the Freedom of Information Act, and would not affect the reporting of expenditures in the State's online checkbook.

   It would, however, provide contracting parties with less insight into the terms to which the State is likely to acquiesce and produce a more competitive environment for bidding ongoing business.

3. We must shorten the time period and streamline the RFP process. At this time, I don't have enough experience to say how, but I suspect others do.

   I am not advocating a Blue Ribbon Panel of experts, but some inter-agency task force of actual users could be convened to discuss best practices and common complaints and consider alternatives, exemptions and modifications to this rational but cumbersome process.

## WRAPPING UP

As I hope I've made clear above, there is nothing nefarious or ill-intentioned in our personnel and procurement systems.

The former aim at creating a competent meritocracy that is politically agnostic, and the latter seek to insure third party arrangements are arms-length and fairly-awarded. And, for the most part, they do a good job of achieving those goals.

As any economist will tell you, however, decisions are made at the margin, and that is where we need to examine and challenge the strictures of our current regimes.

We need not rewrite these rules wholesale, but the sheer magnitude of their import — two-thirds of our collective spending, as well as their scope — governing every agency of our state government, compels a hard and holistic look at the impediments such systems impose on the efficacy and efficiency of our operations.

Unlocking more of the potential of our people and our contracts will not relieve us from the task of getting better results in our key programmatic service areas: education, healthcare and safety.

These efforts, however, are complimentary, and reinforcing. The theme both programmatically and categorically is the same: we simply need to get better.

After all, everyone wants a good value.

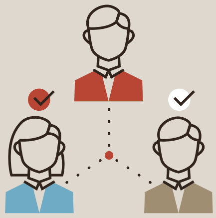
Ken

Ken Simpler, Delaware State Treasurer

State employees must be incented to deliver more value with employee performance systems that reward quantifiable improvement over the status quo and empower managers to hire and fire.

Contractors must be incented to deliver more value. Our contracting processes need to be revisited to take less time, foster competition, and provide less insight into the terms to which the State is likely to acquiesce.

# ADDRESSING DELAWARE'S VALUE PROBLEM



Across education, healthcare and safety, roughly two-thirds of our total state spending is on employees and contractors. Focusing our efforts categorically on these labor costs can foster improvements more quickly across the board.


The challenge in all these cases is that there is much disagreement over how to "do" education, healthcare and safety better.

Our outcomes in our major spending buckets — healthcare, education, safety and infrastructure — are not commensurate with our investment.

Our state and local governments' per capita spending is already among the highest in the nation — greater than 43 other states and 20% above the U.S. average.

START

> As important as it is to operate in a sustainable fashion, I would submit that this is a necessary but insufficient component of our budget system. The discipline to live within our means says nothing about the value we get in return.

NEWSLETTER | Q4 2015

## A WHOLE LOT OF ALLITERATION:

# Spending Sustainability, Sufficiency and Soundness


KENNETH A. SIMPLER

STATE TREASURER


## 'TIS THE SEASON...

... for budgeting. And often, for gnashing of teeth and rending of garments. Not so this year.

If you have followed developments since just before this past Christmas, you know that the Delaware Economic and Financial Advisory Council (DEFAC), the body that forecasts the amount of revenues that the General Assembly is limited to spend, sent our legislators a holiday surprise. While not trimmed with ribbons and bows, DEFAC's forecasts for each of the current fiscal year that ends June 30 and the next fiscal year that begins July 1 were revised upwards, substantially.

In a little understood quirk of our budgeting system, this $170 million basket of good news, while realized about equally over the two budget years, essentially creates a double-windfall in the next fiscal year. That is because this year's spending is already fixed by the bill that passed during the last legislative session.

Unless the General Assembly were to pass a "supplemental spending bill" for the current year, unanticipated monies that come into our coffers cannot be expended this year, but are effectively rolled into the funds available for next year's budget.

That is why the Governor, in his Budget Proposal in January, was able to propose a more than 5% increase to our operating budget for next year. Some quickly denounced this increase as "eye-popping" or "jaw-dropping" – implying lack of fiscal restraint, while others immediately set to talking about the many ways to appropriate this newfound wealth.

For those running for re-election this year on either side of the aisle, the amped up budget proposal provides a platform from which to ether criticize largesse or trumpet the allocation of the "winnings".

The question I get posed, and likely one that any normal person would entertain given these opposing views on our spending, is: "What's reality? What is responsible?"

Here we need to take a deep breath and draw on a little perspective.

Rather than getting caught up in a knee-jerk reaction to one year's spending growth, we should have a means of putting our annual spending in context and answering some basic questions:

- What is our long term trend in spending growth – is it **sustainable?**
- Is our level of spending relatively high or low – is it **sufficient?**
- Does our budgeting system lead to sustainable and sufficient spending over time – is it **sound?**

As this is far too much to cover in one sitting, I am going to confine the following to a discussion of the first question, addressing spending growth and sustainability here and deferring the equally, if not more, important topics of sufficiency and soundness to future updates.

You'll thank me for that by the time you are done reading.

# FRAMING THE QUESTIONS

In analyzing our budget growth, two considerations are key: the base and the trend.

Recognize that the propriety of a 5% increase is an issue of trend; however, one year does not make a trend. Also, note that the budget base referred to in this instance is our State's General Fund. But that fund represents less than half of total state spending. The better test of sustainability should focus on our total spend.

The questions we should be asking therefore are: "What is our trend rate of total spending?" and "What do we measure this trend against to know if we can sustain it?" Or, in layperson's terms: "Is our spending keeping up with our needs? And, can we afford our needs?"

Before we entertain these questions, recall that our General Assembly is required by law to balance the General Fund annually by limiting spending to projected revenues. Revenues, however, are based on the tax system voted on by the General Assembly and approved by the Governor.

In theory and practice, a supermajority of our elected officials can simply mandate higher taxes to pay for the spending they want to do.

One cannot determine a trend in sustainable spending growth by comparing it to a set of revenue goal posts that the political class can maneuver.

A true study requires looking past our politically determined spending and revenues to an objective set of benchmarks and trends.

So, let's begin with trend. Trend is best examined not over a set number of years (i.e., 4 quarters, 10 years or a generation), but over an economic cycle – those periods of expansion and contraction that occur regularly if not predictably.

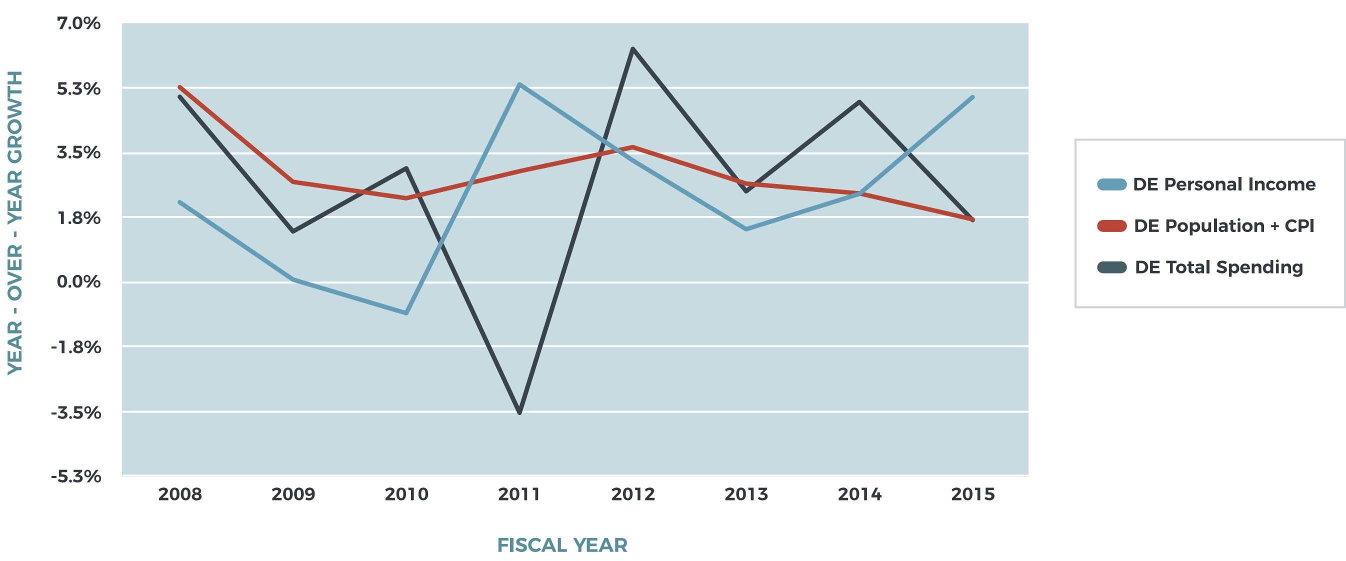
Our last expansion peaked in 2007, the ensuing contraction troughed in 2009 and the current expansion is still in process (if ever so weakly).

If we look at the eight years of the current cycle through 2015, the average growth rate of total state spending is 2.3%. Of particular interest, total state spending grew through the recessionary period, even as General Fund spending contracted.

This divergence highlights the need to look at the totality of the money we spend and not focus exclusively on the General Fund.

But establishing the right base and calculating the trend is only half of the exercise. To know if that level of trend is sustainable over the long term, we need to have a base of comparison. Our 2.3% growth in total spending may not sound like a lot, but what is the right point of reference?

**Growth Rate of State Spending in Current Economic Cycle**



## INFLATION AND POPULATION GROWTH
## ARE WE KEEPING UP?

One position cited by DEFAC's Advisory Council on Revenues advocates targeting spending growth against a two-part test that combines inflation with population growth.

> The theory is that government spending should not grow more quickly than the general increase in the prices of goods and services plus the number of people for whom the government is responsible.

Delaware's population growth has averaged roughly 1% over the period under measurement. That metric is straightforward; the choice of inflation gauges is not.

Depending upon the measure of inflation that you use, combined price and population growth averaged somewhere between 2.2 – 2.7% over the period from 2008 – 2015 (a reasonably wide range)[1].

The recently completed report by the Expenditure Task Force Committee applies a rate near the mid-point of this range to growth in the General Fund to justify its statement that "the state budget has shrunk by an average of 0.58 percent per year during the Markell Administration."

Using the more comprehensive measure of total state spending, the report might more fairly claim that real spending growth has been flat over the period – and it has generally kept pace with population growth and inflation.

## STATE & NATIONAL ECONOMIC GROWTH
## CAN WE AFFORD WHAT WE WANT?

A second check on spending growth involves comparing that rate of increase to the expansion of our economy.

After all, any system of spending that is growing faster than the revenue base that supports it simply cannot last over the long haul. Here again, we have different measures against which to compare.

At the state level, most studies typically look at either the growth in aggregate personal income or gross state product (GSP).

While 2015 data is not available, the figures for the remaining period of comparison reflect a growth rate of 2.3 – 2.5%, a virtual dead heat with the 2.3% trend of increase in total state spending.

At the national level, the most commonly used and broadest reference for economic growth is gross domestic product, or GDP.

Over the period ending in 2015, nominal GDP grew at an annualized rate of 3.2%, well ahead of both our State's economic growth and our total State spending.

Since Delaware derives revenue from sources both inside our State and outside of our borders, an ideal comparison to state spending growth might use a blended revenue growth rate. Regardless of how you construct it, such a blended rate would more than cover our 2.3% spending growth.

[1]The most commonly cited and broadest reference point for inflation is the Consumer Price Index (usually the CPI-U). It is also worth noting, however, that inflation varies by region and that there is a Philadelphia Regional measure of CPI that includes the State of Delaware. Moreover, government spending might be more appropriately measured by looking at a narrower basket of publicly-provided goods and services discounted by an index known as the State and Local Price Deflator.

## SUMMARY ON SUSTAINABILITY AND CAVEATS

Based on the foregoing, we can say two things with some confidence as concerns our spending growth over the most recent economic cycle: (i) we have spent an amount sufficient to maintain our level of services and (ii) our spending has been within our means. Of course, there are caveats to these conclusions, at least two of which merit mention here.

First, the future is uncertain, and this an historical analysis over a single economic cycle.

> Current economic conditions raise valid concerns regarding a downturn in Delaware's growth without a commensurate fall in the price levels of and demand for government goods and services.

There is simply no way of guaranteeing that economic growth will equal or exceed inflation and population growth.

Second, this is a study of broad-based spending growth that can hide alarming trends.

Even if totals are controlled, there is reason to be concerned if large and fast growing areas of the budget "crowd out" other public goods and services.

Formal reports from both the Expenditure Review Committee and the Health Fund Task Force make it clear that there are significant components of our spending with unsustainable growth trajectories.

In short, continued caution and more detailed analysis are critical, as there is no guarantee that the practices that have led to sustainable spending over the most recent period will continue to safeguard our solvency.

> It is time to move past just considerations of sustainability and focus our collective attention on the areas of our budget's sufficiency and soundness.

## LOOKING AHEAD – SUFFICIENCY AND SOUNDNESS

As important as it is to operate in a sustainable fashion, I would submit that this is a necessary but insufficient component of our budget system. The discipline to live within our means says nothing about the value we get in return.

There is also something fundamentally unsound about a budgeting architecture that permits the level of volatility and degree of uncertainty imposed by our current system. These features are every bit as important if not more so than a singular focus on managing spending growth.

In the first instance, the amount of resources we consume and produce as a state government and the return on investment we generate has enormous implications for the health of our economy.

Across all funds, our state government spends or transfers close to $10 billion – more than $10,000 for every man, woman and child in the state, and roughly 1/6th of our state economy as measured by gross state product.

If we are getting a good return on that money, then we can reasonably assume that those efficiencies will filter their way back into our Delaware economy, boosting productivity and gearing growth.

If we fail to get an adequate return, then we jeopardize those efficiencies and run the risk of a lower standard of living in the future.

This requires a hard look at the amount we spend and the value we get in return. I refer to this as sufficiency.

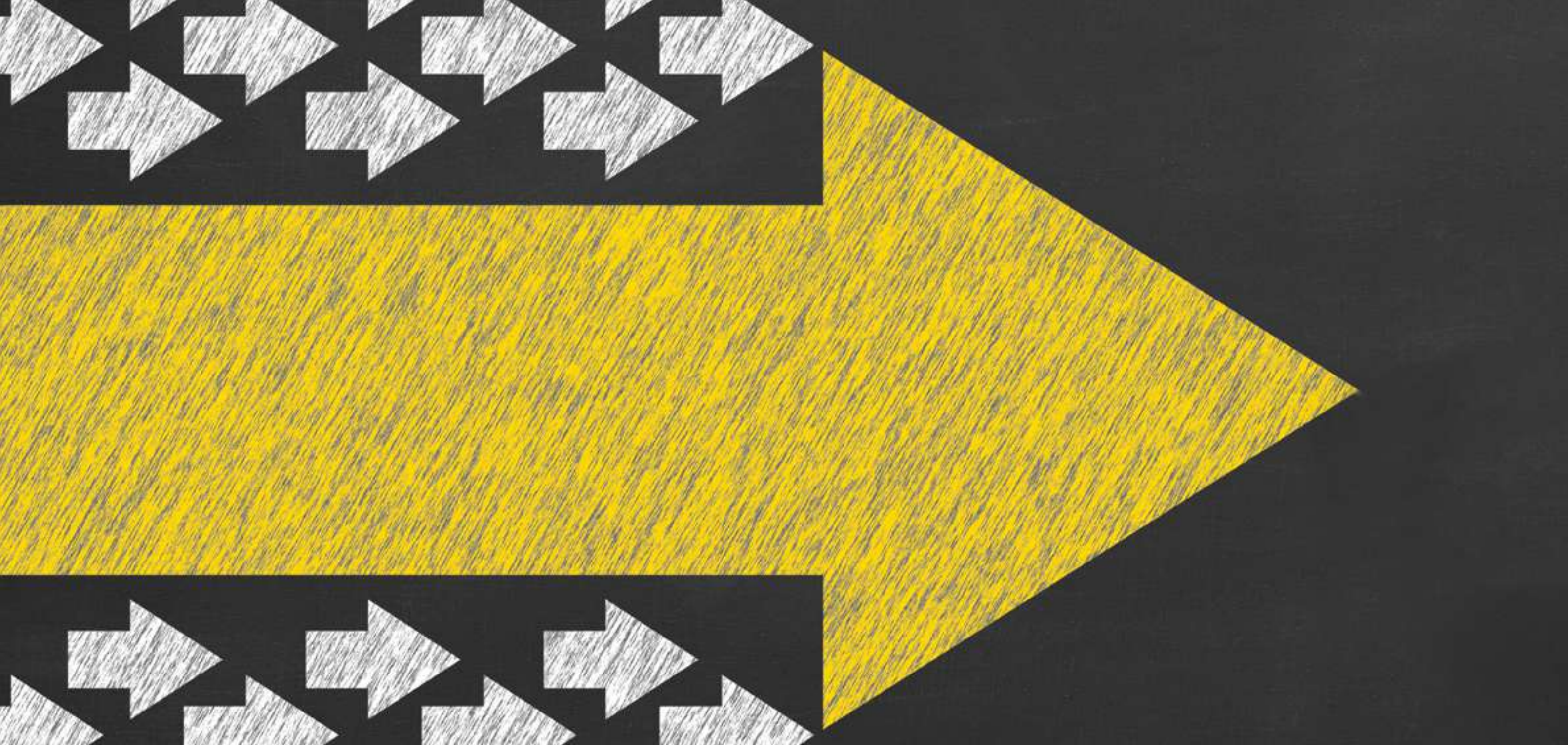
Second, while our budgeting system has proven to produce sustainable outcomes during the most recent economic cycle, there is no accounting for the collateral damage inspired by our process.

This variability is highest and most apparent in the swings in our General Fund, from a contraction of as much as 6.6% in one year to growth of 9.8% in another. Year-to-year changes in total spending exhibit less variance, but still more than the fluctuations in our economy as a whole.

The manner in which we manage our public fisc directly affects the risk appetite of our private sector.

If our government's budgeting processes create uncertainty as to our means of achieving sustainability, confidence is eroded and investment levels fall.

We need to examine not just the ends, but the means to sustainability and seek out methods and rules that foster a sounder, more certain approach to budgeting.



## LEVERAGING DEFAC

That said, the making of the annual budget takes place in a partisan crucible that does not always permit, much less reward, the examination of large-scale, long-term trends.

Good policy, however, should rest on a sound set of assumptions. As I have previously observed, it is one level of knottiness to have our 62 General Assembly members conceive of competing policy responses to a commonly understood set of facts. It is an entirely different kettle of fish to begin with 62 different sets of facts.

The former may prove intractable, the latter impossible.

Fortunately, for Delaware, there is a body whose veneration, capacity and mandate make it the optimal venue in which to explore and expound on these matters – DEFAC.

As one of roughly 30 members, I hope to use my service on the Council to encourage this institution to continue to offer guidance to our Governor and our General Assembly on the sufficiency of our spending and the soundness of our budgeting systems. And doing so should not always require an Executive Order.

That assistance can begin with a greater contextualization of DEFAC's periodic revenue and expenditure forecasts and the development of a more media-friendly means of communicating the Council's findings.

It can also take the form of an analysis of any systematic bias in the forecasts themselves, with an aim of reducing the volatility of such estimates and avoiding "surprises", happy or otherwise.

DEFAC can also build on the work of the Advisory Council on Revenues and the Expenditure Review Committee to develop a general framework for addressing the sufficiency of our state spending and establishing a means to evaluate our return on that spending.

Ideally, as was the case with both of these task forces, this work could be handled in a bi-partisan manner and expressed in non-partisan terms.

Finally, DEFAC can and should examine the efficacy of our current budget framework. Most of this architecture was put in place during the late 1970s and early 1980s to address and remedy a set of fiscal problems that may be different than the challenges we face today.

Moreover, no one gets everything right the first time, and I am not certain that the foundational pieces of our fiscal systems have received robust review in the subsequent 35 years. That they have stood the test of time so well is testament to their ingenuity, but even genius succumbs to diminution from the political process over four decades.

Sort of puts a 5% spending increase in perspective.

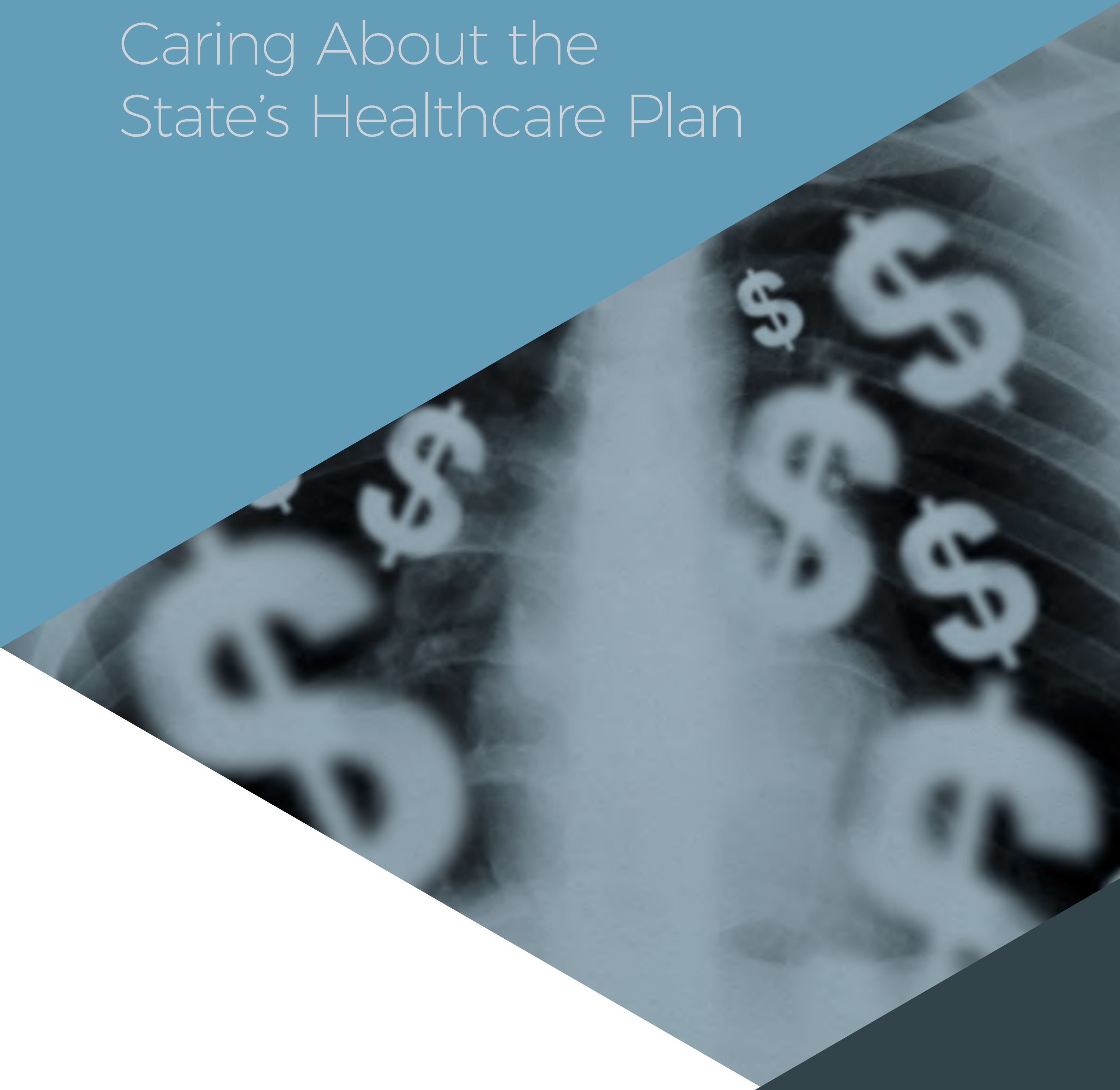
Ken

Ken Simpler, Delaware State Treasurer

> As we consider how to structure healthcare for state employees and retirees, we are indirectly shaping healthcare markets for all Delawareans, directly affecting the delivery system for the half of our population in the commercial insurance markets and very pointedly impacting the 70,000 or so Delaware workers in the healthcare field.

NEWSLETTER | Q2 2016

# Caring About the State's Healthcare Plan



KENNETH A. SIMPLER
STATE TREASURER

Chances are that you have had some meaningful encounter with our healthcare system. I don't mean an annual physical or a one-off trip to an urgent care center.

I am talking about a lengthy interaction, over a few months at least, involving multiple doctors and/or specialists. And, if not you personally, you have almost certainly been part of such a process with a loved one.

In my case, I have experienced such episodes of care through each of my parents' bouts with cancer, my wife's episodic migraines and my daughter's diagnosis with Celiac Disease.

In all cases, the ultimate outcome has been successful — permanent cure or manageable condition, in each case with a high quality of life. These happy results belie a sometimes bewildering and frustrating process, where waste of both time and resources is all too apparent.

My own, direct experience with healthcare is more benign. I am generally healthy and but for a few mishaps with some power tools, allergic reactions and periodic testing, I have not had occasion to interact meaningfully with our healthcare system as a patient.

I have, however, over the past twenty years "touched" healthcare from other perspectives. I have invested in the managed care industry as an asset manager, studied the economics of health policy as a student of public administration, and served on the finance committee of one of our local healthcare providers.

All these experiences taken together add up to me being an informed layperson when it comes to understanding this industry that constitutes almost 1/5th of our U.S. economy.

As your State Treasurer, you would not think that it would be incumbent upon me to be a healthcare expert. You would be wrong on at least three bases.

## WHY HEALTHCARE IS AN AREA OF CONCERN FOR ME — AND YOU

First, and most broadly, I am a statewide fiscal officer. In that capacity, it would be negligent of me not to have an understanding of expenditures that total in excess of 30% of our general fund spending (i.e., our $4 billion operating budget).

It's simply too big a use of resources to ignore, even if I do not administer the departments responsible for our healthcare programs.

Second, I am the head of a state agency that hires and employs people; I worry about both their care and their compensation. I want healthy, productive workers who earn a fair and competitive living for the work that they do.

Healthcare benefits comprise an ever larger share of the remuneration of my workforce, both as current benefits and as promises of care in retirement — nearly 20% of total compensation.

As such a critical component of the employment relationship, care needs to be affordable, accessible and high quality.

Finally, and most directly, I am one of nine members of our State Employee Benefits Committee (SEBC), the body that determines how we design, administer and pay for healthcare for more than 120,000 Delawareans.

Yes, you read that figure correctly.

Our Group Health Insurance Plan (GHIP) for active state employees, retirees and their dependents covers in excess of 12.5% of our State's population.

Consider that more than half of our 945,000 citizens are either uninsured (70,000) or covered for healthcare by Medicaid (230,000), Medicare (180,000) or other government programs (30,000). Of the remainder in the private and/or commercial market, the GHIP's share is almost 25%!

That's the third major part of my concern with how we "do" state healthcare and the reason I apply a considerable amount of my time to my appointment on the SEBC.

When you have at least one quarter of the market share as a buyer, there's a reasonable chance that you are the market.

As we consider how to structure healthcare for state employees and retirees, we are indirectly shaping healthcare markets for all Delawareans, directly affecting the delivery system for the half of our population in the commercial insurance markets and very pointedly impacting the 70,000 or so Delaware workers in the healthcare field.

So, whether you are a state employee, healthcare worker, taxpayer or average citizen, what the SEBC does affects you.

As a consequence, after 18 months on the job, I wanted to share with you a little bit about this Committee, its composition, recent history and my hope for its direction. Decisions of import are afoot.

Our Group Health Insurance Plan (GHIP) for active state employees, retirees and their dependents covers in excess of

12.5%

of our State's population.

## SEBC AND GHIP — A PRIMER

The SEBC was legislated in 1999 to serve as the policy board for the State's group health plan, a self-insured vehicle that pays for health benefits for employees and retirees of the State and other participating groups like the University of Delaware, City of Dover and the Delaware Solid Waste Authority.

Of the 122,000 lives covered under the GHIP, a little more than 100,000 are active employees or retirees not yet eligible for Medicare (i.e., under 65 years of age) and their dependents. The remaining 20,000 members are covered by Medicare, in addition to which the GHIP provides supplemental insurance.

The composition of the SEBC includes three statewide elected officials (the State Treasurer, the State Insurance Commissioner and the Lieutenant Governor), three of the Governor's Cabinet Secretaries (from the departments of Finance, Health and Social Services and the Office of Management and Budget), the Controller General (who reports to the General Assembly), the Chief Justice of the Courts and a rotating representative from one of the four principal state employee unions (currently Corrections).

The Director of the Office of Management and Budget is the chairperson of the committee, and it is his office that is responsible for the administration of the GHIP.

The group plan budget for the current year is $800 million. Roughly 95% of that amount is used to pay claims and 5% to administer the program (a good expense ratio).

As with plans all over the country, the GHIP has been struggling to control plan costs. Both utilization and price levels have been increasing over time, resulting in plan expenses rising by 6% per annum on average over the last decade.

That rate of increase is twice the pace at which state revenues rose over the same period, posing a significant fiscal problem, to put it mildly.

Prior to and during my tenure on the SEBC, efforts to rein in costs have consisted of plan design changes aimed at ensuring that healthcare is purchased by participants at the lowest cost provider(s), eliminating coverages that are not commercially standard and pushing for the provision of care in bundles and not à la carte.

These methods have been employed by virtually all plan sponsors and nothing the GHIP has done to control costs would be considered outside the ordinary.

Beginning a few months before I took office, however, the GHIP went from an ongoing management problem to a crisis.

After a period of unusually low claims experience, resulting in significantly lesser than expected costs, claims soared and plan expenses wiped out nearly $100 million of the fund's reserve and contingent liability.

The length of this newsletter does not allow me to go into the historic management of the fund, but suffice to say that the "emergency" could have been less severe had plan funding increases been steady and the reserve not drawn down to fund predictable price increases.

The rapidity with which the fund's costs exploded required the General Assembly to scramble budget priorities to accommodate the need to finance the plan for Fiscal 2016 (which began on July 1 of last year).

The scale of the "surprise" provoked a predictable response. A Task Force was formed to study the issue and make recommendations to the General Assembly. Some forensics were to be engaged and a series of solutions solicited.

## THE HEALTH FUND TASK FORCE – PRECURSOR TO PLANNING

The Health Fund Task Force (HFTF) began its meetings in September of 2015 and concluded in December of that year.

The 12-member panel consisted of four legislators representing both caucuses of each chamber of the General Assembly (i.e., 2 Ds and 2 Rs), four members of the main unions representing plan participants (teachers, troopers, corrections and AFSCME/other) and four members of the SEBC (me, the Insurance Commissioner, the Chief Justice and the Director of OMB).

As with the SEBC, the HFTF was chaired by the Budget Director and administered by the staff of the Budget Office.

Notably, the legislation establishing the HFTF required the Office of Management and Budget to hire a consultant not currently retained by the State to assist the Task Force.

As a practical matter, this instruction meant that the advisor then engaged to assist the Budget Office with the management of the GHIP could not also serve as the advisor to the HFTF. More about that below.

What ensued over three months were a series of seven meetings – generally 2-3 hours in length – during which HFTF members were "educated" by various outside stakeholders (e.g., consultants, providers, doctors and insurers) as to the state of healthcare markets in Delaware, the economics of the GHIP and the health status of plan participants and Delawareans in general.

Debate during these sessions was sometimes vigorous, but on the whole, the exercise produced little detailed understanding of our problems much less appropriate solutions.

The members of the HFTF were effectively healthcare lay people with limited pre-existing knowledge of the intricacies of health plan design and healthcare reform.

The amount of information directed at the members was overwhelming and the timetable to assimilate all such information and reach any consensus was too aggressive.

Owing to the lack of any clear set of agreed upon conclusions among the members, the HFTF was unable to make any unified recommendations.

At best, the exercise of the HFTF served as a primer on healthcare in Delaware for the twelve members of the Task Force.

Owing to the lack of any clear set of agreed upon conclusions among the members, the HFTF was unable to make any unified recommendations to the SEBC, the Governor or the General Assembly.

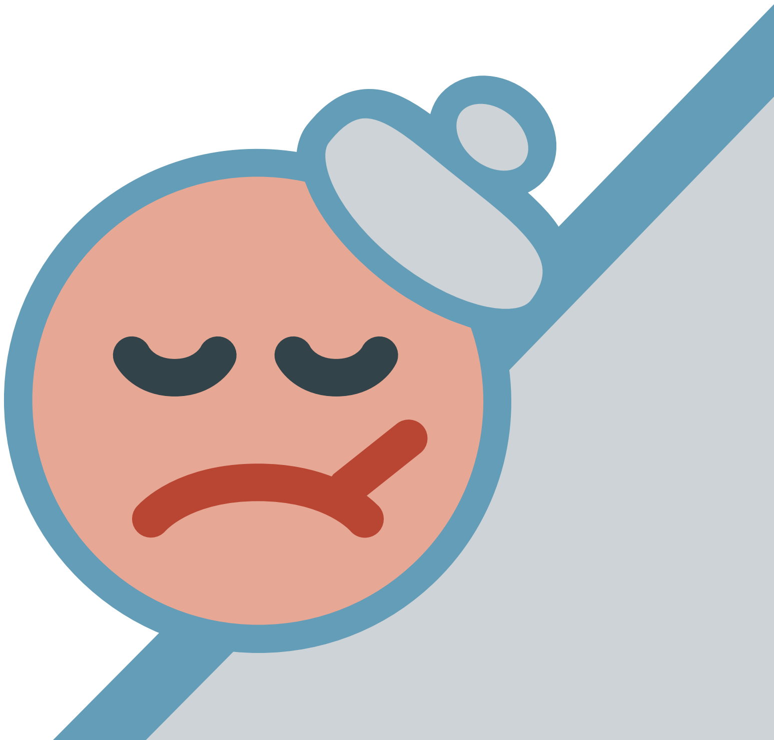
Rather, the final report of the HFTF serves as a summary of the information presented to the Task Force and articulates a number of "findings."

To say that the exercise was a waste of time would be too harsh – though you will find members of the HFTF with that opinion.

In my view, however, the HFTF was a necessary step in the evolution of a strategic plan for the GHIP. I liken it to the seven stages of grieving.

Whereas the SEBC and the General Assembly had to first grapple with disbelief (how could the GHIP be broke?), express denial (not my fault!) and do some bargaining (we can tinker with this and get through the budget year), the HFTF and its composition provided the vehicle that allowed for expressions of guilt (we made some mistakes), anger (yes, you did make some mistakes!) and depression (how are we ever going to fix this?).

Upon conclusion of the HFTF, I would like to think that the members (and other stakeholders who participated in the process) are ready to move to the seventh and final stage – acceptance and hope. And there is evidence of both.



## THE WAY AHEAD — MISSION, GOALS, STRATEGIES & TACTICS

In the first instance, the variety of stakeholders on the HFTF have come to recognize that there is not likely a silver bullet solution to our healthcare problems, and that the costs of resolving them is not going to be hung around the neck of any one, single group — participants, providers or taxpayers.

Moreover, as raucous as some meetings became between representatives of members and industry, the wake of the Task Force process has shown some reconciliation and resolve to work together to see if there is a long-term means of sharing the pains and gains of this exercise.

> There is, in short, begrudging acceptance that we are all in this together.

In addition, there is hope. Just over the course of the last few meetings, I perceive that there is a greater resolve among members of the SEBC to pick up the Task Force's findings and convert them into an actionable set of recommendations to be implemented by the GHIP.

The most cynical observers of how things get done in Dover may disagree, but I see green shoots.

One source of hope lies in the selection of a new, strategic consultant for the GHIP. The SEBC's current consultant has served in support of the Budget Office in a principally administrative role.

Conversely, the HFTF consultant was engaged primarily to lead a holistic review of the GHIP and offer forward-looking recommendations, but not aid with plan administration.

The most recent hire will serve in both capacities, resulting in what I hope will be greater "ownership" by the consultant of plan performance.

That dual mandate is being put to the test immediately. Begun in June and to be finished by November, the new consultant will have assisted the Budget Office in completing a competitive RFP process to retain third party administrators for the GHIP (i.e., potential replacements for Aetna and/or Highmark).

Over the same 6-month period, the consultant will have led the SEBC through the development of an over-arching 3-5 year plan for reform of the GHIP.

Given the scale and complexity of these twin undertakings, it won't take us long to know if we've chosen the right horse to ride or if we need to switch out ponies again.

The second basis for hope is that — for the first time in my experience on the SEBC — we are engaging in the development of a comprehensive strategic plan.

Concurrence around such a plan will allow Committee members to evaluate if and how each action of the SEBC, beginning with the selection of vendors under the above-mentioned RFP, fits into the overall framework for GHIP reform.

Befittingly, the initial presentation for development of the strategic plan was, in fact, strategic. The new consultant outlined a process model to develop (i) an overarching mission for the GHIP, (ii) goals that support the mission, (iii) strategies to effect the goals and (iv) tactics to implement the strategies.

In each case, the responsibility for the development of these was clearly assigned: the SEBC was to frame the mission and articulate the goals and OMB was to present the SEBC with strategies for approval and then implement the tactics to achieve them.

Significantly, the consultant has encouraged the SEBC to frame its goals in terms that are S.M.A.R.T., an acronym that stands for Specific, Measurable, Attainable, Relevant and Time-bound.

This level of discipline has been lacking on the Committee to date and the shift to adopt such rigor augurs for a higher level of performance and measurement of the GHIP.

Finally, there is hope in so far as the SEBC has begun to engage in some introspection. Conversations have occurred among a variety of Committee members as to whether the body is properly constituted, led and organized.

Should the public, or at least experts from industry, be represented on the Committee? Can OMB successfully serve as the chair of a body that it also administers? Is the single committee, one meeting per month structure adequate to do all the business of and strategizing for the GHIP?

Production before year-end of a thoughtful, holistic framework for reforming the GHIP would validate the capacity of the SEBC to execute its fundamental purpose.

Failure should invite the next Governor and the General Assembly to address the questions posed above and then some.

The "patient" in this case is sick, but not terminal. A proper remedy requires skillful intervention under a thoughtful plan of care, not more palliative treatment.

Let's hope.

Ken Simpler, Delaware State Treasurer

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At the overarching level, we determined that the mission statement for the plans was deficient. Whereas the State had been focused on simply "offering a benefit" to employees, a new mandate was laid down: "help employees achieve independent retirement readiness."

NEWSLETTER | Q3 2016

# RETIREMENT REFORMS: A Bipartisan Success Story

KENNETH A. SIMPLER
STATE TREASURER

## INTRODUCTION

In what should come as a surprise to no one, everything in Dover is political. Politics, is, after all, the means for deciding who gets what, when and how.

This is not a cynical assessment, but rather a reminder that politics is the best system we have yet invented for the free people of a Democratic Republic to make collective decisions about their common governance and allocation of public resources.

What I aim to share in this newsletter is my first experience as an elected official with the political process and what I would say were the Four C's that made this particular episode successful: Candor, a Cause, Credibility and Congeniality.

Perhaps like the C's of our Delaware economy (Cars, Credit Cards, Chickens, Chemicals and [health]Care), some of these elements may fade in and out of importance, but collectively prove robust over time. We'll see.

Even if the lessons I took away from this episode prove unique to the circumstances, those circumstances are worth understanding in their own right.

The context is the major overhaul of the State's defined contribution plans. This is an area of great import, as the retiring Baby Boomer population will strain our fragmented system for managing retirement readiness. As a State, we can and should do more to prepare.

## DELAWARE'S DEFINED CONTRIBUTION PLAN ARCHITECTURE

Delaware's 35,000 state employees and teachers enjoy significant pension and healthcare benefits in retirement that are guaranteed by the State. In addition, all employees are eligible to receive Social Security from the federal government.

Collectively, these benefits are estimated to provide the average employee with as much as 70% of annual working age income in retirement.

That average belies several assumptions. First and foremost, that the employee remains with the state and that his/her pension is fully vested. Second, that federal entitlement reform does not diminish projected Social Security benefits.

Finally, more recent research into retirement readiness suggests that the old benchmark of having 70% replacement income is not proving satisfactory or even sufficient for many retirees who do not want to "downsize" their standard of living in retirement.

Recognizing that voluntary, supplemental savings are an important means of augmenting employee retirement readiness, the State of Delaware launched a program for state employees akin to a 401(k)-style plan almost twenty years ago.

Soon thereafter, the myriad of retirement plans for state teachers (which varied by school district and numbered over 100 providers) was consolidated to a retinue of 13 vendors under a single state-run "teachers plan."

The two plans — employees and teachers — are legally separate but essentially identical. Employees and teachers direct money from their paychecks into federally tax-advantaged savings accounts sponsored by the State but over which the participant has investment discretion.

The State's plans are overseen by a Board comprised of elected officials, cabinet secretaries, state employees and members of the public appointed by the Governor. The Office of the State Treasurer supports the Board and manages the administration of the plans via a network of record-keepers, investment vendors, compilation firms, accountants and attorneys.

## A POOR STATE OF AFFAIRS

When I arrived at the Treasurer's office in January of 2015, the Board had initiated a process to review the overall architecture and administration of both the employees and teachers plans using a third party consultant.

As fiduciaries for the plans, the Board members were rightly concerned that the plans had not undergone meaningful reforms since inception, while over the same period the regulatory environment and the retirement industry had changed in substantial ways.

Notably, the sole vendor for the employees plan had not been bid out competitively since the plan's inception in 1999.

Similarly, the investment managers for the teachers plan had not been through such a process since the plan's consolidation in 2009.

In all other areas for which my office manages financial services for the State of Delaware, the norm is to bid out contracts every 3-5 years. The plans were an anomaly.

Moreover, from inside the office, the inefficiencies of the plans' administration were obvious. Staff skilled in financial planning spent most of their days trying to ensure that administrative matters such as file transfers, participant contributions, changes to accounts and permitted withdrawals were handled properly by the network of third party providers.

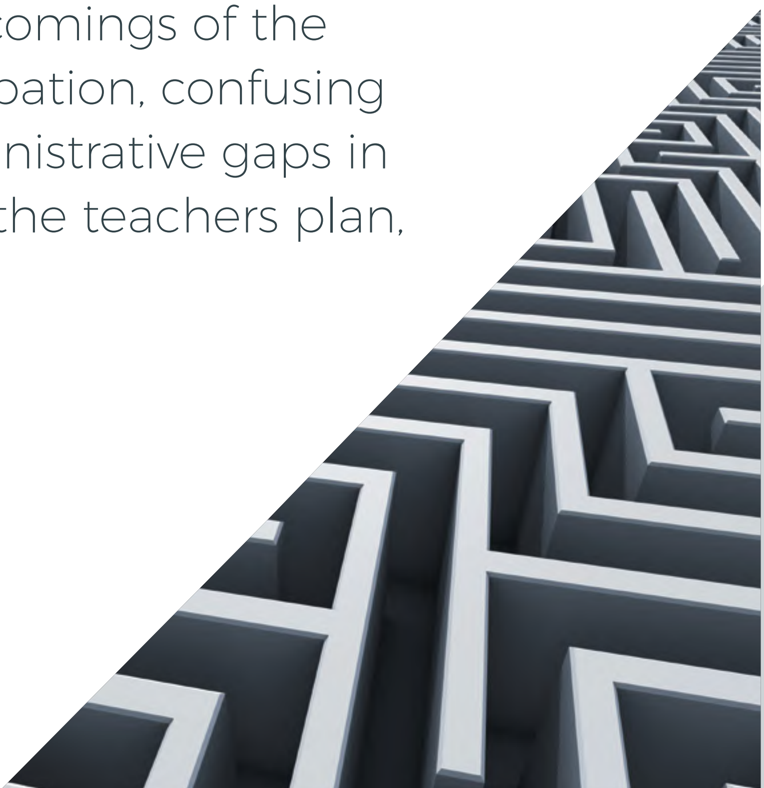
Little to no time was available for strategic outreach or participant education. As a consequence, plan participation rates hovered around 30% with average account balances less than one year's earnings.

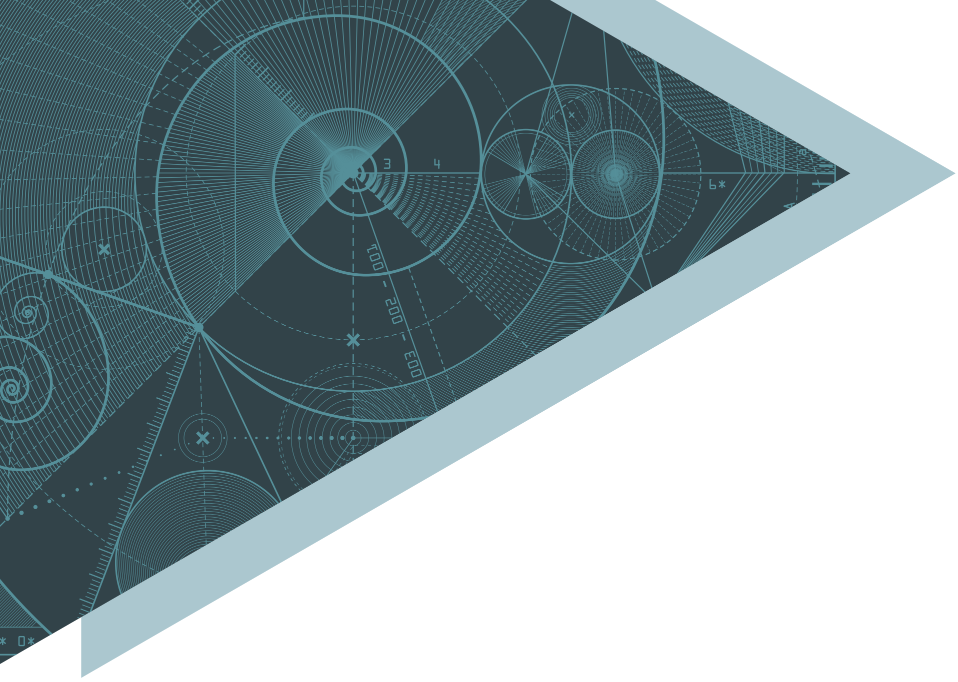
With the engagement of the consultant in the early spring of 2015, there emerged a consensus among Board members that material changes to the plans were in order and that the new architecture had to address the shortcomings of the existing plans: low participation, confusing investment choices, administrative gaps in service and, especially in the teachers plan, unreasonably high costs.

At the overarching level, we determined that the mission statement for the plans was deficient. Whereas the State had been focused on simply "offering a benefit" to employees, a new mandate was laid down: "help employees achieve independent retirement readiness."

This strategic shift was not to be fulfilled by investing greater resources, but by a more efficient and thoughtful allocation of existing monies and manpower.

There emerged a consensus among Board members that the new architecture had to address the shortcomings of the existing plans: low participation, confusing investment choices, administrative gaps in service and, especially in the teachers plan, unreasonably high costs.





## THE EMPIRICAL PROCESS

After a comprehensive, independent review of the State's plans, the consultant submitted a report to the Board recommending that the employees and teachers plans be consolidated under one vendor and that the core investment choices available to participants be narrowed and differentiated.

In the consultant's opinion, this would lead to several benefits for participants: lower costs, higher participation rates and more robust services.

The report also emphasized the difficulty of this undertaking.

Participants would require education and outreach to understand the benefits of the changes. State IT systems would need to be tested and modified to accommodate the conversion of the plans.

And, most ominously, political opposition from existing plan vendors who would not be part of the future plan structure would be fierce.

Each of these challenges alone would prove substantial. Collectively, they would test the resolve of the Board and my office over the ensuing year.

The consultant's initial conclusions were not adopted outright, but instead were put to close scrutiny by two independent committees, each comprised of members of the Board and my office.

One body led an omnibus request for proposal (RFP) process both to due diligence the plan architecture and to solicit potential vendors for the plans. The other committee reviewed a variety of fund offerings, means of selecting among investment choices, and tiering of investment options.

From design to completion, the two committees conducted a process that took nearly 10 months, involved multiple rounds of vendor interviews and hundreds of man hours of outside study.

The consultant informed the Board that in all its engagements with other states and public entities it had never been part of a more thorough process.

The core recommendations from the two committees were unanimously approved by the Board in May of 2016 and, in general, followed the advice of the consultant:

I. All plans were to be consolidated under a single vendor, that in addition to administrative recordkeeping, would provide four full-time salaried personnel to support participant retirement planning;

II. The funds to be offered under the plans would not be products proprietary to the single vendor, but would instead consist of a fund array independently recommended by the consultant and approved by the Board; and

III. Participants would be offered a tiered menu of fund choices, prominently emphasizing low-cost, age-indexed portfolios with meaningful growth potential and no charges or fees for changing investments or moving their portfolio to another sponsor if separated from the State of Delaware.

Though the Board and my staff were confident that we had done a responsible job and acted throughout the process in the best interests of plan participants, we were regularly reminded that our work was not taking place in a vacuum, but under a microscope.

## THE POLITICAL PROCESS

From the time of the consultant's initial recommendations, the Board and my staff held meetings with both the Governor's Office and the General Assembly in order to apprise them of the potential for significant reform of the employees and teachers plans.

Independent of but related to the RFP process, we sought changes to both the Board structure and the organization of my personnel as well as the return of the management of the College Investment Plan to the Treasurer's office from the Department of Education.

Specifically, we proposed consolidating the three boards overseeing plans for retirement investing, college savings and disability planning into a single Plans Management Board.

We also requested a reclassification of positions in my office to allow for the creation of an operating division dedicated exclusively to servicing the plans and supporting the new Board.

In both cases, the changes were designed to focus and harness greater expertise and improve the management of the plans.

Conversations with a great number of legislators ensued on those two parallel tracks. On the one hand, we worked with lead sponsors from both sides of the political aisle in each of the House and the Senate to draft the legislation that would be required to effect the merger of the boards, conform the governance provisions of the plans and place administration of the college plan at the Treasury.

On the other hand, we held meetings with groups of legislators to provide both background on and a roadmap of the RFP process and solicit concerns and advice.

These included members of the education and finance committees, but also Democratic and Republican leaders in each chamber of the General Assembly. While these actions were technically on independent tracks, the issues became politically commingled given outside opposition to the RFP process.

Soon after the announcement of the RFP, letters from organizations representing vendors opposed to the process flooded the Legislature. Concerns were also sent to lawmakers from the union representing state teachers, including a few waves of automated emails directed to specific members by constituents in their districts.

Blogs were developed urging employees to write their legislators and call on my office. The vendors' national organization even hired a prominent local firm to lobby for its members, going so far as to craft legislation to have the General Assembly halt the RFP.

While many of the concerns expressed were valid, a good number were designed simply to slow us down and otherwise cast doubt on the process.

Throughout the RFP we were at a significant disadvantage in terms of communication. The State's procurement rules and the attorneys that advised the Board and my office limited what we could say regarding the plan review lest we compromise the process.

Within these limits, we held meetings with interested legislators and penned general responses to several of the mass mailings sent by our political opponents to the General Assembly.

Ultimately, the year-long odyssey culminated in a 30-minute meeting three days before the end of the legislative session. I was called by the Controller General to speak with the heads of the Joint Finance Committee, the legislative body that drafts the annual operating budget.

In that meeting, the co-chairs showed me language that had been prepared as an addendum to the budget's epilogue that would have undone the work of the Board, my office, the consultant and the various state agencies involved in the RFP process — literally months of exertions defeated by a few sentences.

In that small enclave, I was the recently elected Republican State Treasurer and they were two veteran Democratic lawmakers.

While none of us were oblivious to the politics of the situation, the focus of the conversation was on whether the results of the RFP process and the accompanying legislation were in the best interests of plan participants, our state employees and teachers. We all concluded that that they were.

The proposed addendum was not added to the budget bill. Our reforms passed.

## SUMMING UP

For a Treasurer in only his second year in office, this was a protracted "teachable moment." As noted at the top, I cannot claim that the lessons of this episode can be applied universally with success, but I would wager that they are worth following.

First, politics involving major reform is a lengthy process, requiring a high level of engagement with multiple stakeholders.

Frequent and candid communication of a straightforward message is therefore critical. In this case, the simple truth was that our plan architecture was dated, costly and failing — our employees and teachers were not achieving retirement readiness. The devil was, of course, in the details, but this was the honest headline with which we stuck throughout the process.

Second, politics favors being on the "right" side of the issue. As any political decision produces winners and losers, this may simply boil down to being on the side where the winners outnumber the losers, but it is still best to have your side believe in the justness of their cause.

Our Board and our office were not zealots or partisan warriors in this instance. Rather, we were fiduciaries for state employees and teachers and we took that obligation to heart.

The changes we made were effected solely in the best interests of our participants. These facts created cohesion and a commitment to seeing our cause to the end, win or lose.

Third, the political process does not ignore evidence and empiricism. Though every side to a political contest will marshal its own facts, the more credible group has an advantage.

The hundreds of man-hours poured into researching plans across the country, studying behavioral finance theory, interviewing our network of vendors and working with one of the top consultants in the industry paid off.

Conversely, the "facts" and attacks asserted by our political opponents were not rigorously evidence-based. Many were hollow and shrill assertions that did not hold up to close scrutiny. We had done our homework with an open mind to our opponents' positions. They had not; advantage us.

Last, and this one may be the most important of all, politics should not be confused with partisanship. While all issues of governance are political, not all political issues are divided along party lines.

In this case, I had to confront some fairly angry legislators from both sides of the aisle. But I also received support from key Democrats and Republicans. In both cases, being congenial within and across party boundaries was a positive.

Politics is ultimately about resolving Conflict and Confrontation; but, it can and should be done Constructively and Civilly. Candor, a just Cause, Credibility and Congeniality matter.

I know that's a lot of C's, but if they work for our Delaware economy why not our state politics?

Ken

Ken Simpler, Delaware State Treasurer

# EPILOGUE

For those of you who will allow me a few more lines, I want to make a couple of points about the context of this epistle.

Retirement readiness is a topic with which we are all going to becoming more familiar with as the number of retiring Baby Boomers continues to peak.

Will they be prepared? Will Social Security and Medicare remain solvent and provide a floor to other individual savings and benefits? What will be the impact here in an aging Delaware?

As State Treasurer, I have no role in reforming Social Security, Medicare or any of our other federal programs that provide a safety net and dignified retirement for our seniors. I need to hope that federal lawmakers get it right on those issues as the long foreseen “gray wave” is here.

I also have no formal role in helping Delawareans outside the public sector prepare for retirement.

Many state treasurers across the country have launched financial literacy campaigns with the goal of making the general population more fiscally responsible.

Personally, I am dubious about the impact of these models as my experience tells me that most adults planning for retirement really want to understand their own particular financial situation, not be educated on general finance theory.

In my opinion, the latter is best done in K-12 education, but that is not going to address the current flood of retirees.

At the state level I do not even have a seat at the Pension Board, the body that manages the State’s defined benefits plans. At roughly $9 billion in assets, these plans are substantially larger than the $1 billion that employees and teachers have amassed in the defined contribution plans that I do oversee.

The logic on having these plans managed by separate state agencies, the Office of Management and Budget and the State Treasurer’s Office, respectively, is not obvious to me — particularly when the Treasurer’s Office used to manage both.

In my present role, I do have the authority to implement the meaningful reforms that we have achieved in the narrower but significant area of employee voluntary retirement.

The complete overhaul of these plans to world class platforms for supplemental savings is something that I can now confidently promote to the 35,000 state employees and teachers whose immediate families make up as much as 10% of our State’s population. That’s a start.

The reforms to these plans and their administration are also a place from which to learn about ideas that may be scalable within and outside state government.

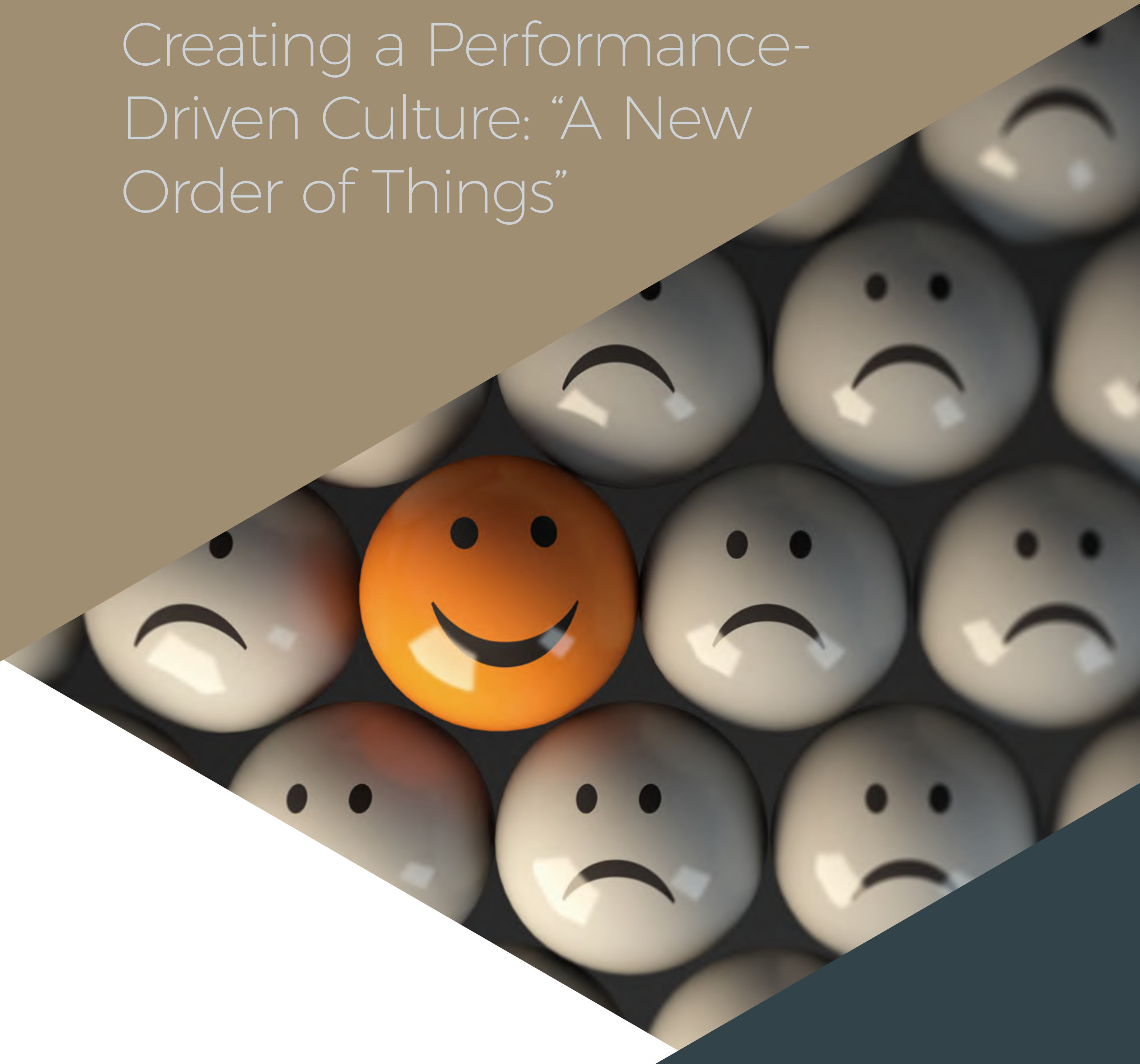
Looking at returns earned in the pension fund and by individual investors could be instructive. Offering employees the option to allocate more funds from a collective pension plan to their own savings plan may be worth exploring.

At a minimum, funding levels, the character of long term assets in plans and the pros and cons to both participants and taxpayers of all possible means to achieve retirement readiness should be examined objectively and thoroughly. It’s time to make certain were on top of this wave before it crests.

If we cannot count on the marketplace to supply the public sector with the incentives to become a more performance-driven organization, those of us in management positions in state government have to be more proactive, thoughtful and rigorous in designing them for our agencies.

NEWSLETTER | Q2 2017

# Creating a Performance-Driven Culture: "A New Order of Things"



KENNETH A. SIMPLER
STATE TREASURER

## In my first two years as State Treasurer, I have struggled to bring the core tenets of performance-driven organizations to bear on our office's operations. Within weeks of taking on the job, I could see that we lacked the most basic components of such a system.

We had no benchmarks or metrics for success and our most valuable assets — our people — received no performance plans or reviews. We were a static organization, where most of our staff showed up every day to do a good job, not a dynamic one, where everyone showed up every day to do a better job.

Fast forward 24 months and I will claim that we are well on our way to becoming a results-oriented operation, with meaningful performance measures and a personnel system focused on aligning individual and organizational interests.

The journey has been steady if not always smooth and there is much still to be done, but I am proud to say that this spring we completed our inaugural employee performance reviews.

In addition, had I been given the opportunity to present to the legislature's Joint Finance Committee (JFC), I would have given them our office's first Report Card.

In both cases, I had to make the case to my staff that there was a need for these processes and reports! Culturally, I determined that I was coming from a different place than some of my peers and co-workers.

In both politics and government, I have come to see too much credit given for good intentions and too little scrutiny applied to outcomes. My formative experiences outside of the public sector have taught me a different lesson: the world may recognize effort, but it rewards results.

## FIRST, A LITTLE BACKGROUND

My first full-time job was as a corporate attorney for a firm based in Chicago. Fresh out of law school, I was staffed on a transaction with a senior partner to assist our client with the purchase of a division of a larger company. On less than 24 hours' notice, I was sent to Detroit where a roomful of attorneys, business people and consultants spent a lot of time negotiating the transaction and, in particular, talking about "escrowing monies" (the nuances of which escaped me).

Leaving the daylong meeting in the cab on our ride to the Detroit airport, the partner spent about 15 minutes telling me what I had to do that night when we got back to Chicago. He wanted a draft of an escrow arrangement on his desk first thing in the morning. When we landed around 8:00 p.m. I returned immediately to the office, worked through the night and, as the sun was rising, gave the draft agreement a final proof. Given my limited understanding of the transaction, lack of sleep and the bare guidance that I had received, I simply did my best.

Not knowing the partner's work habits, I left the agreement on top of some mail and other papers on his chair at 6:00 a.m. I could not leave it on his desk or even find his inbox as binders, contracts and other documents covered the surface and were piled all over one another in what appeared complete chaos. I went home, showered, grabbed breakfast, drank the better part of a pot of coffee and came back to the office at 8:30 a.m. to await further instruction.

By mid-morning, I was worried as I had not heard from the partner. I went up to his office, knocked on the door and peered in to see him furiously marking all over some agreement. He was almost hidden from view by the mounds of paper on his desk. He looked up at me and, at first, I did not think he even recognized who I was.

Nervously, I asked if I could provide any more help. He looked at me quizzically. I clarified that I had left the escrow document on his chair and wanted to know if I needed to make any edits or changes. He stopped writing and looked around at all the papers strewn about his desk and shook his head — as if to say he was unaware of what I was talking about. Then he looked over the side of his desk at the overflowing trashcan and, without looking back up at me, said, "I threw it away", and he went back to scribbling.

Feeling stupid that I should have left the agreement piled on his chair and not in a more prominent place to avoid it being tossed casually in the garbage, I quickly volunteered to print another copy and bring it to him. With a studied patience, he stopped writing, put down his pen and looked directly at me. "Your agreement was a piece of trash. I threw it away." He paused another second to ensure that I got the message and then went back to his work.

I retreated to my own office to seethe and contemplate my future at the firm and in the legal field more generally. Though sleep-deprived and ashamed, I recall sitting at my desk as a realization struck me. This firm, its clients, and perhaps the world at large did not really care if working hard and doing my best produced unacceptable work. Results, not effort, were what mattered.

I stayed at the firm another two years before moving on to a career in finance and then hotel operations and commercial real estate. Over that time, I have never forgotten that formative lesson. Indeed, I have applied it to the businesses in which I have worked and those that I have helped create.

> While some may perceive the goal of being a results-driven organization as a choice, I view it as a necessity.

In the first instance, the world is a demanding place and the standard for what is acceptable is always being driven higher. The businesses in which I have been involved have had to constantly reinvent themselves to succeed. Staying the same does not equate to staying in the same place, but rather to falling behind. To get ahead, you have to know if you are progressing, and, if you're not measuring progress, chances are you aren't making any.

Second, in all these businesses, personnel are key. Like the law firm where I began my career, the service industries in which I have worked are "people businesses" — their most valuable assets are their employees.

Failing to attract, train and retain great people is a recipe for mediocrity or even failure. In such organizations, personnel systems must be engineered to incent and reward out-performance and to point out and correct under-performance. Neither the organization nor its people will thrive if the development of human capital is not embraced as vital to success.

The attributes of a performance-driven organization — a commitment to results and people — while universal, can and should be tailored to fit the contours of its milieu. In addition, the systems that drive outcomes and incent personnel should not be made rigid or static, but must be constantly surveilled and re-engineered.

The manifestation of this form of organization is less about the end state and more about the journey — the mandate arises from an ethos that is cultured, not a diktat that is coerced.


## CHANGE IS HARD, ESPECIALLY SO IN STATE GOVERNMENT

Leading the kind of cultural change that embraces a performance-driven culture is never easy. In general, there is often no clear demand for and no immediate reward to be gained in pioneering such a transformation. After hearing me address this topic in a recent small group setting, a friend sent me this quote from Niccolo Machiavelli's "The Prince":

*It ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new.*

Since joining state government, I have come to appreciate that change is even more difficult in the public sector. In contrast to the private sector, incentives are weak, ineffective or simply don't exist.

On the one hand, there are few price signals from "buyers" (i.e., citizens) for public goods and services. An election every 2-4 years doesn't tell us much about the quality of what we are producing.

On the other hand, "sellers" (i.e., government officials and employees) have no profit motive. If you earn the same amount of remuneration regardless of the quality of the product (or lack thereof), what reason have you to make it better?

The feedback loop that typically drives the risk-taking and innovation that I have encountered in every other field in which I have worked is missing in government. An insidious knock-on effect is that creativity and imagination in our state workforce goes unrewarded, or worse, is stymied. The result is a culture that is not performance-driven, but one beholden to the status quo.

This order of things can be re-engineered to create a newfound dynamism. The inertia in our organization arises from systems problems, not immutable laws of nature. That changing them is challenging should be recognized, but not met with surrender.

Moreover, if we cannot count on the marketplace to supply the public sector with the incentives to become a more performance-driven organization, then those of us in management positions in state government have to be more proactive, thoughtful and rigorous in designing them for our agencies.

## LAYING A FOUNDATION FOR CHANGE IN THE TREASURER'S OFFICE

At the Treasurer's Office, the sojourn to becoming a performance-driven organization has taken more than two years. In fact, we are not there yet — the initial processes will culminate this October with the submission of our fiscal 2019 budget and Report Card and the completion of our first full year of employee plans and reviews. Before describing the "semi-finished" products, let me first provide a recap of the four critical steps in our process:

**Step 1: Review and Document Current Operations (March – May, 2015)**
Working with an outside consultant, we performed a thorough review of all operations of the Treasurer's office. We set out the governance and personnel structure of each unit, documented controlling laws, rules and regulations, identified and itemized material contracts and mapped all major processes and workflow. In the case of each operating unit, we described current challenges, bottlenecks and areas for improvement.

**Step 2: Identify Key Functions and Assess Competencies (June – August, 2015)**
Building from the operational review, we identified "critical value functions" — the key deliverables of each business unit. We then assessed the core competencies (i.e., the required skills, knowledge and abilities) required to execute each of the critical value functions.

These functions and competencies were discussed and debated at length with the divisional leaders of the office and then submitted for further assessment and revision by the full staff of each division. Our goal was to create and foster office-wide understanding of and buy-in for these overarching themes.

**Step 3: Set Priorities and Prepare Budget (September – October, 2015)**
We used the findings and conclusions from our review and reassessment to draft a final report with detailed recommendations for each division and an overall plan for restructuring the office. In effect, the report became the foundation for our strategic planning, setting out operational priorities for the ensuing calendar year, outlining the parameters of our fiscal 2017 budget request and providing the roadmap for what would become a more than 100-page request for personnel changes impacting more than 75% of our workforce.

**Step 4: Restructure Organization (November, 2015 – August, 2016)**
The longest step in this process involved the reclassification of the office's personnel into three new operating divisions and one support division. Reclassification is a formal process that requires approval of both the Governor's Office of Management and Budget and the Legislature's Office of the Controller General.

We took two months to write the "omnibus request" for reclassification. The implementation then took another nine months for approval and revision of the request, integration of exiting personnel and filling of open positions. Unnecessary and vacant posts were eliminated and critical but missing posts were created.

Overall, there were several staff promotions and even one voluntary demotion. While the net effect on the budget was neutral, the realignment provided the office with significantly greater horsepower to achieve critical value functions.

The completion of the foregoing steps consumed nearly two years — half of my elected term! — and hundreds of hours of senior staff time. The investment has, however, paid off. On the basis of the solid strategic and organizational foundation that we had formed, we were able to design and develop individual performance plans for everyone in the office and meaningful performance metrics for each of our operating divisions.

# EMPLOYEE PERFORMANCE PLANS

In October of 2016, every employee in the Office of the State Treasurer received a performance plan for the period commencing that month and ending in September of 2017.

In each case, the plan was provided to the employee to review at least 72 hours before scheduling a face-to-face meeting with the employee's supervisor and our HR representative.

The meeting was framed as collaborative, an opportunity for the employee to ask questions and provide feedback on his/her plan.

After such meeting, plans were revised or clarified, and then signed by the employee and supervisor in duplicate, with both parties receiving an original copy.

Critically, each plan followed the same structural outline:

- The first section of each plan set out the critical value functions and core competencies of the employee's division per the comprehensive report. This section was designed to be identical for every employee in the division and was not expected to change significantly over time.

- The second section of each employee's plan laid out the priorities of his/her operating unit for the plan year. The employee was not necessarily responsible for all such priorities, but was expected to be apprised of the unit's full set of undertakings. Priorities were anticipated to change from year to year as completed, amended or abandoned. A place-saver was included in this section for the articulation of performance metrics for each operating unit "to be developed." (More on that below.)

- The final section of each plan contained the employee's personal goals and areas of development. Goals represent those parts of the operating unit's priorities for which the employee is responsible. They were organized into four categories based on when they were to be started and completed: first half of plan year, second half of plan year, full plan year, and longer term (i.e., to be started but not completed in the plan year). Areas of development were not tied to the priorities of the employee's unit, but rather reflected individual opportunities for focus and/or improvement.

To be clear, these meetings were not performance reviews. Rather, discussions were based on the new plans and were strictly forward-looking. This helped focus attention on what had to be done going ahead, and eliminated anxieties about backward-looking assessments when there was no established set of expectations.

Dates for the first mid-year reviews were scheduled for April of 2017 with final reviews in October of 2017.

Over the first six months of the plan year, division heads reported progress on priorities at monthly team meetings. Employees were encouraged to read over their plans on a regular basis to ensure attention to their goals and areas of development.

In April, both supervisors and employees were tasked with assessing progress on individual plans using a form that focused on the completion of first half priorities and assessed progress toward full year goals.

For each of the employee's goals and areas of development, both supervisor and employee were asked to respond to two sets of variables: timeliness and quality. The former required either a "yes" or "no" as to whether the goal had been achieved within the designated timeframe (or an explanation as to an agreed upon change to the delivery date).

The latter assessment of quality was rated on a five-point scale designed by the Office of Management and Budget: distinguished, exceeds expectations, meets expectations, needs improvement or unsatisfactory. Supervisors and employees were told that marks other than "meets expectations" had to be supported with clear explanations.

Meetings were subsequently scheduled between each employee and his or her supervisor, and attended by one or more of the office HR manager, Deputy Treasurer and/or me. At the meetings, employee and supervisor discussed and compared the independent assessments of the employee's work on each goal and area of development.

The meetings focused on any variances in assessments and particularly on areas requiring improvement or rated unsatisfactory. This was not meant to overlook or ignore areas of strong performance, but rather to achieve consensus on how underperformance at the mid-year point could be raised to satisfactory performance by year-end.

In my experience sitting in on and conducting reviews with senior personnel, the meetings were straightforward and positive, focusing on constructive guidance and problem resolution. I was impressed that employees provided rigorous self-assessment and were highly engaged in wanting to understand how to improve in areas where they and/or the supervisor felt performance was not meeting expectations.

While a large part of the staff — many of whom had never been part of a review process, came to the meetings with trepidation, most left more secure about their role and expectations for performance.

## The message emphasized over and over was that leadership was deeply committed to both them and the success of the organization.

That said, I would be sugarcoating reality if I did not admit that there was some blunt talk and tough love. In a few cases, emotions became raw but not confrontational. Honest assessments simply cannot be watered down, but can and should be delivered with sensitivity and always concluded with a focus on improvement.

While identifying and being plain spoken about failure can be hard, re-orienting the discussion after such admission on how to overcome shortcomings can be cathartic and gratifying.

Overall, I was highly satisfied with the design and execution of the review process and only slightly disappointed with the results.

On the positive side, quality of work across the office met or exceeded expectations at a rate slightly in excess of 75%; unsatisfactory outcomes were experienced in less than 10% of cases, with a balance of about 15% requiring some improvement.

Plans proved surprisingly realistic with fewer than 10% of goals and areas of development being revised at the mid-year point. Notwithstanding that conclusion, there was a general consensus that we struggled with timeliness – a little less than 40% of our near term goals were substantially completed and more than half were less than 50% completed.

A table with results from our mid-year reviews is shown below to shed a little more light on how our office performed at the aggregate level. The clear import of our mid-year reviews is that we need to do better at meeting milestones while maintaining and even improving on our quality of work.

Given the substantial amount of positive discussion that took place as to how to prioritize initiatives and rectify areas requiring improvement, I would be surprised if full year reviews in October do not reflect greater levels of timely, satisfactory performance.

During those fall meetings, we will also be asking employees and supervisors to rate and critique the review system itself.

As noted above, nothing is static and the opportunities for improvement are never-ending.

## MIDYEAR PERFORMANCE REVIEW

**Office of the State Treasurer**

2016-2017 Performance Plans Progress Report

| Evaluation Type: | Mid-Year Review As of: 3/30/2017 |
|---|---|

| OST | # | Percentage of Completion | | | | Performance Ratings | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | <25% | 26%-50% | 51%-75% | >76% | D | EE | ME | NI | U | Total |
| **Goals** | | | | | | | | | | | |
| Near-Term | 121 | 34 | 28 | 14 | 45 | 0 | 1 | 96 | 16 | 8 | 121 |
| % of Total | 100% | 28% | 23% | 12% | 37% | 0% | 1% | 79% | 13% | 7% | 100% |
| Full Year | 82 | 42 | 23 | 4 | 13 | 0 | 0 | 66 | 5 | 11 | 82 |
| % of Total | 100% | 51% | 28% | 5% | 16% | 0% | 0% | 80% | 6% | 13% | 100% |
| **Areas of Development** | | | | | | | | | | | |
| Near-Term | 54 | 8 | 36 | 10 | 0 | 0 | 1 | 39 | 9 | 5 | 54 |
| % of Total | 100% | 15% | 67% | 19% | 0% | 0% | 2% | 72% | 17% | 9% | 100% |
| **Total** | | | | | | | | | | | |
| Goals & Areas of Development | 175 | 42 | 64 | 24 | 45 | 0 | 2 | 135 | 25 | 13 | 175 |
| % of Total | 100% | 24% | 37% | 14% | 26% | 0% | 1% | 77% | 14% | 7% | 100% |
| Employee Avg. | 10 | 2 | 4 | 1 | 3 | 0 | 0 | 8 | 1 | 1 | 10 |

| Evaluation Criteria |
|---|
| Period: Mid-Year Review |
| Include Near Term Initiatives: Yes■ No☐ |
| Include Full Year Initiatives: Yes■ No☐ |
| Include Second Half Initiatives: Yes☐ No■ |
| Include Long Term Initiatives: Yes☐ No■ |

| Evaluation Periods | |
|---|---|
| Periods | Mid-Year Review: Progress between Oct-Apr<br>Periodic Review: Progress between Apr-Oct<br>Full-Year Review: Progress between Oct-Sep |
| Near Term | Initiative should be completed by the mid-year review (in April). |
| Full Year | Initiative should be started or in process in the first half of the year and completed by the end of the year (between October and September). |
| Second Half | Initiative should be initiated and completed in the second half of the year (between April and September). |
| Long Term | Initiative should be started and in process during the year but not expected to be completed within the year. |

| Performance Ratings | |
|---|---|
| **D**<br>Distinguished | Employee produces exceptional or commendable work in multiple responsibility areas on a consistent basis, and at least meets expectations in all other areas. Usually recognized by peers, internal and external leadership as a major contributor or expert in the field. |
| **EE**<br>Exceeds Expectations | Employee exceeds standards set for one or more major responsibility areas and at least meets expectations in all other areas. May sometimes produce exceptional work in one or more areas. |
| **ME**<br>Meets Expectations | Employee meets standards set for all major responsibility areas without notable exception; but may infrequently exceed or fail to meet standards in one or more major areas. |
| **NI**<br>Needs Improvement | Employee fails to meet standards consistently in one or more areas of responsibility despite sometimes achieving or even exceeding standards in other areas. Opportunities for improvement have not been sufficiently met. |
| **U**<br>Unsatisfactory | Performance in one or more major responsibility areas is chronically deficient. Employee has been unable or unwilling to meet minimally acceptable performance expectations in one or more areas despite being given opportunities to improve. |

## DIVISION PERFORMANCE METRICS

While the office had no employee plans or review processes in place when I arrived, I became aware of the existence of our performance metrics almost immediately.

Surprisingly, the measures were not brought to my attention by the leaders of our operating divisions, but by our senior fiscal officer in charge of the annual budget submission.

As it turns out, division leaders were not regularly apprised of or asked to monitor the metrics requested by the Office of Management and Budget and the General Assembly.

This disconnect proved fortuitous as the requested metrics were incomplete in scope and largely meaningless in content. To be fair, they sought to ensure compliance and document output, but core components of operations were excluded from measurement, metrics could not be interpreted to indicate whether performance was improving or declining and there were no benchmarks against which absolute performance could be judged.

If an organization is going to be performance-driven, metrics need to be meaningful. At a minimum, performance metrics should be (i) holistic (i.e., cover all core parts of the organization's operations), (ii) evaluative (i.e., measure efficiencies or efficacies) and (iii) bench-marked (either against external comparables or internal targets).

That does not mean that performance measures need to be numerous or complex. In fact, quite the opposite is true. Fewer is better (perhaps 1-2 for each core area of operations); and ease of calculation and understanding should be favored over rigorously complicated computations that are not readily intelligible.

In contrast to those parameters for effective metrics, let me give you some specifics as to what I found when I arrived at the Treasurer's Office.

In the first instance, the office had six operating units, but metrics covered only four of them. Core operations in banking services and collections were not measured.

Second, metrics were not derived from ratios of outputs to inputs but were simple outcomes. In the case of the management of the State's $1.6 billion of investments, the sole metric asked only whether the portfolio was being managed in accordance with established guidelines — "yes" or "no," nothing about returns, gains, losses, volatility, etc.

Other metrics asked for outcomes with no indication of desired direction — is it more or less desirable that the number of ACH transactions (i.e., electronic payments) increases or decreases? Even where the desired direction of a metric could be divined — say in the instance of the number of employees with defined contribution accounts (where we clearly want to see more accounts), the measurement was problematic as it was not expressed as a percentage of employees much less the amount of actual savings in the accounts.

Finally, there was nowhere a set of expectations or targets against which to judge performance. Even taking the measures alluded to above as flawed, what were the expectations? Should compliance be 100%? Are ACH transactions expected to reach a certain threshold? Is there an optimal number of defined contribution accounts?

While the failings of the existing performance metrics were obvious, the specifics of the future system of measurement were not. Throughout the steps involved in laying our strategic foundation—the two-year process described above—we kept asking ourselves, "how do we measure success?"

We knew we wanted a system that was holistic, evaluative and bench-marked, but designing the measures to meet those attributes involved a long, hard slog.

Fortunately, we had a deadline. At our JFC hearing in February of 2016, we asked legislative members for permission to junk the old metrics and return the following year with a new set of measures. In anticipation of our 2017 hearing, we condensed all the deliberations and calculations we had tried, tossed out and retried during the intervening year into a single two-sided piece of paper titled simply "Report Card".

The report set out eight performance metrics for our office, indicating in each case whether performance improved, declined or remained stable during the year. The key initiatives and events affecting each metric were described in a single, concise paragraph.

In all candor, I was not totally satisfied with the Report Card that we planned to present to the JFC. While we were able to come up with a holistic set of evaluative measures, we were not resolved on all benchmarks. In the case of some measures, we were in the midst of redesigning the architecture for an operating unit and it was hard to nail down a target in such a state of flux.

In other instances, we were unconvinced that we had the right data and/or calculation for proper comparison. In still other cases, external benchmarks did not exist and we just did not know what targets represented achievable and optimal performance. In short, there remained much to resolve, but the overall set of measures that we had developed was far more robust than its predecessor.

I also took some comfort in realizing that the development of our first Report Card was as much the "product" as the report itself. The journey to create meaningful metrics, to push ourselves to ask what was important and deserving of measurement — what would constitute success, was the first critical step to the transformation we were seeking.

Yes, our goal was to end up with an optimal set of metrics, but the search to articulate them had already made us attuned to the need to be a performance-driven organization and to prioritize and account for those activities that are critical to our existence.

Finally, it turned out that we had a bit more time than planned to get the first draft of the Report Card right. In wrestling with another challenging budget year, the JFC notified me in February that my hearing would be moved back by a month, then two months, then May and as of May, well, not at all.

While unusual, the cancellation of my hearing had much to do with the fact that I had not made any extraordinary budget requests and the budget for my office (excluding debt service) is quite small. As a courtesy, I was extended the chance to make brief remarks to the JFC, but I demurred, knowing that I would be able to submit something more complete in the fall.

While the JFC has not seen our first Report Card, I attach the proposed draft for you here to consider. Note that it is still undergoing revision as we speak and that I have not included the appendix that provides for each metric a detailed explanation and rationale, shows the calculations and identifies the sources of data. If you want to get into the weeds, I will be posting the full report on the State Treasurer's website when we make our budget submission this fall.

## WRAPPING UP

Our path to becoming a performance-driven organization has just begun, and, as noted throughout does not end but rather continues to evolve and improve. As I write, we are in the process of combining the exercises of devising more granular performance metrics with the development of next year's personnel plans.

Next year's individual employee plans will rely less on achieving a prescribed set of priorities and more on improving a specific set of performance measures. In effect, we want to supply employees with a target for the ends and let them figure out the means. This can only happen successfully when individual interests and organizational goals are aligned around performance. I think we are there. That said, when I decided to run for State Treasurer, I had no idea I would spend this much time focused on metrics and personnel. However, a major part of my message as a candidate was that I was more concerned with fixing existing processes than inventing new programs.

As a finance professional, my attention has always centered on the systems that inform us as to the prioritization of our collective resources, hold us accountable for the outcomes associated with their allocation and ensure that the whole operation is sustainable over the long term.

The shorthand that I have used then and since is that my mission is to bring transparency, accountability and certainty to all of our financial operations.

When I initially gave that pitch to friends and acquaintances, I generally got one of two reactions. The positive response took the form of a complimentary statement, such as "awesome — we need people with your background." The negative feedback was almost always posed as a question, some variant of "why the heck would you want to do that?" often with an expletive substituted for "heck."

The naysayers were not questioning my motives, but were instead expressing a pessimistic view that I would be wasting my time or subjecting myself to fruitless frustration. A little probing elicited an almost verbatim response from all of them: "the system is broken." To which I have always replied, "then why don't we fix the system?"

While I may be fairly accused of being the type to see the glass as half-full, fifty years on the planet has shown me that people and organizations respond to incentives. If you can get the incentives right, then good results often follow.

Machiavelli notwithstanding, "a new order of things" is possible. Results matter. Organizations, including our state government, that put their emphases on measuring performance and motivating people can achieve them.

Ken

Ken Simpler, Delaware State Treasurer

Office of the State Treasurer

CY 2016 Report Card

| Grading Key | Improved | Stable | Declined |
|---|---|---|---|

## Part I. Delaware's Money– Cash and Debt Management Report

The Office of the State Treasurer (OST) manages the disbursement and collection of state funds, arranges the banking services that enable such transactions, reconciles the balances in state accounts, and oversees the investment of the State's cash on hand. OST also shares responsibility with the Division of Revenue for the issuance and servicing of the State's debt, and the State Treasurer serves as one of four Bond Issuing Officers. The following metrics are designed to track and promote progress in these areas.

| Cash & Debt Management Metrics | CY2015 | CY2016 | CY2017 | CY2018 |
|---|---|---|---|---|
| Investment Return | .76 | 1.26 | | |
| Banking Efficiency | $0.11 | $0.10 | | |
| Transactional Productivity | $1.66 | $2.00 | | |
| Debt Feasibility | AAA (3) | AAA (3) | | |

### 1 ) Investment Return: Improved

Investment Return improved due to technical changes to the State's guidelines implemented in 2015 that allowed for greater diversification, investment in less over-bought areas of the credit market and implementation of strategies that assume a measured but certain path to rising short term rates. An ongoing review of the State's operational cash requirements is expected to result in changes to the portfolio architecture that will improve Investment Return by focusing on better liquidity management. The changes will not involve the lessening of current, stringent security requirements for the investment of state funds.

### 2) Banking Efficiency: Improved

Banking Efficiency improved slightly due to a variety of factors. For instance, small gains attributable to newer technologies that lower unit transaction costs and the time for reconciling deposits (e.g., Remote Check Deposit) were offset by a greater volume of inter-bank transactions. These off-setting gains and losses are representative of the balance that OST seeks between the need for flexible services that meet the various demands of agencies and the efficiencies that come from scale. A comprehensive review of the State's overall banking architecture using an outside consultant and an inter-agency task force is currently underway. This exercise is expected to improve Banking Efficiency while simultaneously achieving higher levels of both service and security.

### 3) Transactional Productivity: Improved

Transactional Productivity improved as a greater volume of transactions was handled by the same number of OST staff. This improvement occurred even as more senior personnel retired or resigned and were replaced by more junior hires or existing employees. An emphasis on engaging technology and enhancing personnel skills and training are anticipated to increase efficiency and allow for greater improvement in Transactional Productivity.

### 4) Debt Feasibility: Stable[1]

Delaware's Debt Feasibility remained stable with all three major rating agencies issuing the State the highest possible certification of creditworthiness. During 2017, OST has initiated plans with the Department of Finance to prepare a Debt Feasibility Study aimed at better informing policymakers as to the outlook for the State's maintenance of the highest rating for its debt. In addition, the study will examine the State's debt policy to ensure that use of the State's borrowing capacity is being optimized to meet capital requirements over the long term.

1 OST does not manage the State's budgeting or revenue collections; nor does it have control over the capital appropriation process by which debt-financed projects are selected. The Office does participate in the new issuance process led by the Department of Finance and manages all aspects of the servicing of the State debt. In addition, the State Treasurer serves as one of four Issuing Officers for the State of Delaware with consent over debt issuance.

## Part II. Your Money – Retirement and College Plans Report

OST administers the deferred compensation programs for state employees and education professionals and has oversight for the administration of Delaware's 529 College Savings Plan. In addition, OST has recently been asked to develop a program to implement Delaware's ABLE statute for persons with disabilities. All of these plans are tax-advantaged, voluntary savings vehicles that do not involve state monies. The following metrics are designed to track and promote progress in these areas.

| Retirement & College Plan Metrics | CY2015 | CY2016 | CY2017 | CY2018 |
|---|---|---|---|---|
| Retirement Readiness | n/a | n/a | | |
| Retirement Participation | n/a | 36.8% | | |
| Retirement Return | n/a | n/a | | |
| College Rating | Neutral | Bronze | | |

#### 1) Retirement Readiness: Unavailable

Retirement Readiness is a new metric that was not available for calculation under the prior plan structure. A complete overhaul of the State's retirement plans during calendar years 2015 – 2016 has resulted in a single plan structure for all state employees and teachers and a renewed focus on preparing participants for retirement (as opposed to simply offering a benefit). Promotion of Retirement Readiness will begin in 2017 with an emphasis on greater one-to-one counseling and use of state-of-the-art online planning tools.

#### 2) Retirement Participation: Stable

Retirement Participation remained stable at roughly 37% under the legacy plan architecture. As noted above, the State's deferred compensation plans underwent a substantial restructuring and strategic shift over the past 18 months. In 2017, a number of targeted campaigns will be launched to increase Retirement Participation. Outreach will be focused on increasing awareness of the plans and educating participants as to the need for supplemental savings to augment pension and social securityincome.

#### 3) Retirement Return: Unavailable

Retirement Return is a new metric that was not available for calculation under the prior plan structure. Beginning in 2017, the metric will reflect performance of the plan line-up approved by the Plans Management Board with the assistance of an independent, outside consultant.

#### 4) College Rating: Improved

College Rating improved as Delaware's 529 plan was upgraded by independent rating agency, Morningstar, Inc. The upgrade was based on several factors: implementation of lower plan fees, maturation of the plan's active asset allocation model, and recognition of improved plan oversight. During the second half of calendar 2017, OST will be conducting a comprehensive RFP that will emphasize improvements to Delaware's plan offering designed to increase College Rating.

> 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.

NEWSLETTER | Q3 2017

## BIPARTISAN BUDGET ACCORD:

# Framing a Grand Bargain


KENNETH A. SIMPLER
STATE TREASURER

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.

## A LITTLE BACK STORY

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.

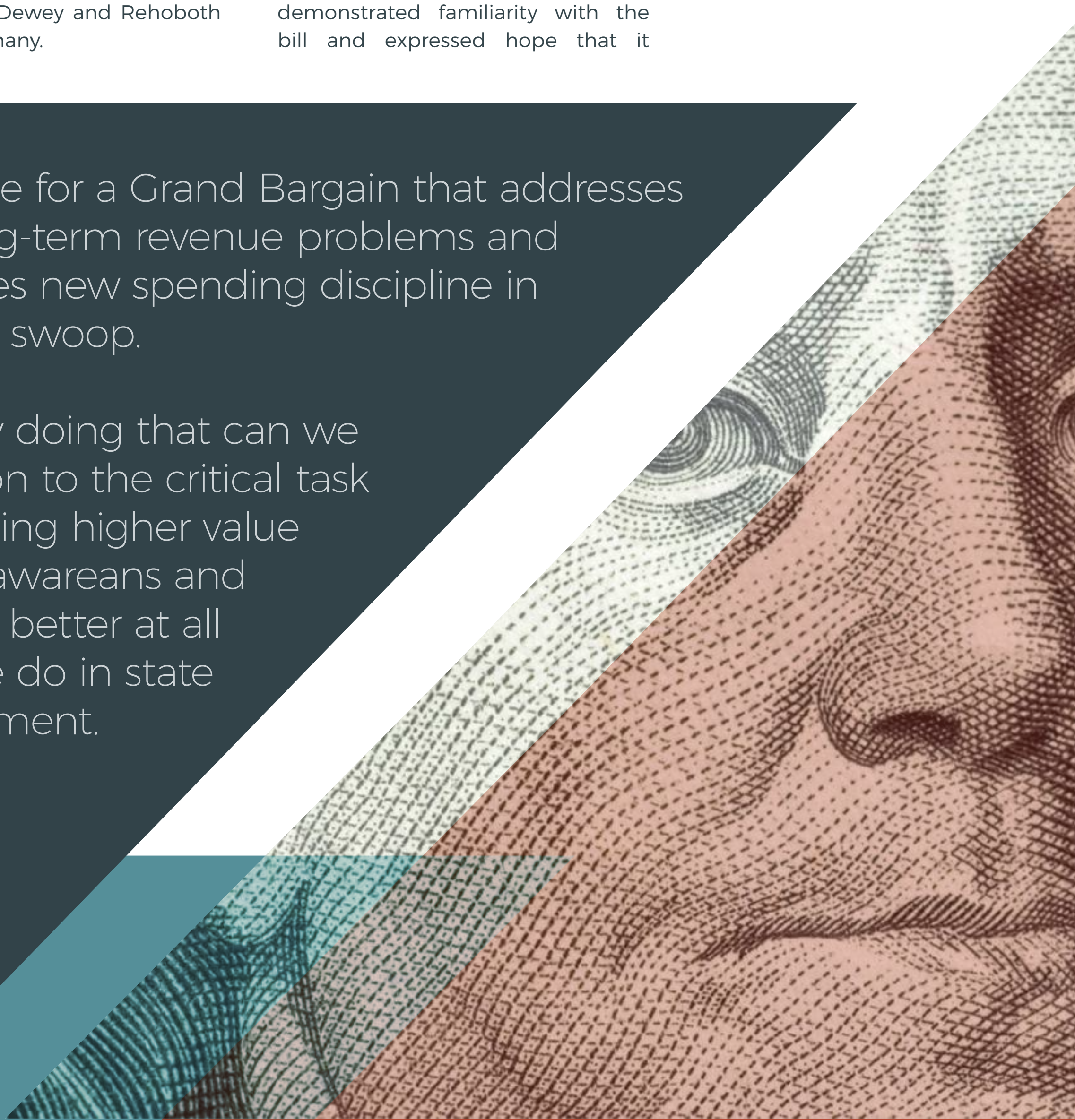
Honest to God reform of our revenue base — restructuring the taxes, fees and other income by which we fund our collective affairs — is absolutely necessary. Our current portfolio has grown too narrow, too volatile and too anemic to reliably fund our ongoing service levels.

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.

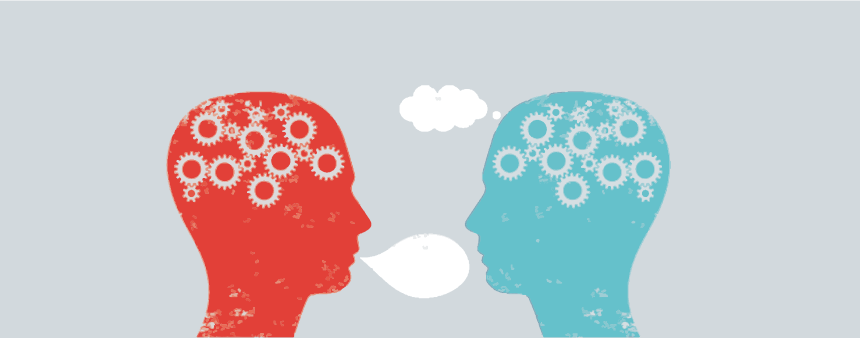
Unlike the Beltway negotiations, however, a key challenge in our instance was a lack of learning.

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.



## WHAT IS HOUSE JOINT RESOLUTION NO. 8?

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 not 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 identify 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]

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.

## We Need Overarching Reform and All We Got Was A Lousy Advisory Panel

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 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 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 complementary 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.

Ken

Ken Simpler, Delaware State Treasurer

Conservatives, Progressives, Democrats, Republicans, Independents and everyone in between want to see our government officials and agencies engaged in providing and procuring goods and services that are commensurate in quality and quantity with the taxpayer monies we spend and invest. Our current budgeting system does not rally us around that goal. It is time to institute reforms that do.

NEWSLETTER | Q1 2018

# BLUEPRINT FOR A BARGAIN:
# Let's Listen and Act

KENNETH A. SIMPLER
STATE TREASURER


## DELAWAREANS, WE ARE HAVING AN "E.F. HUTTON MOMENT." LET'S LISTEN.

For context, E.F. Hutton was a dominant financial advisory business for several decades during the last century. The firm was swallowed up in a wave of bank mergers in the 1980s, but only after running a series of attention-grabbing television commercials on par with today's GEICO ads.

Instead of comical send-ups ending with a reminder that "15 minutes could save you 15% or more on your car insurance," the Hutton spots had an ordinary Jane or Joe refer to "E.F. Hutton" in casual conversation. The mere mention of the Hutton name triggered a sea of otherwise preoccupied people to stop whatever they were doing to lean in and listen. The tagline was: "When E.F. Hutton talks, people listen."

The public may no longer be straining to take in Hutton's fiscal wisdom, but I urge Delawareans to lend an ear to absorb what those in our State's high offices are saying about our collective finances. They are talking, and we should listen.

During the last legislative session, the General Assembly passed a joint resolution (HJR 8) to create an advisory panel under the Delaware Economic and Financial Advisory Council (DEFAC) that would undertake a sweeping study of our budgeting processes and make recommendations as to if and how we can improve on a framework that dates back to the late 1970s. The General Assembly spoke in unison in adopting HJR 8, and we should listen.

Members of the newly formed DEFAC panel (the Panel) asked the State's top four financial officers — the Governor's Secretary of Finance and the Director of the Office of Management and Budget, the Legislature's Controller General, and the State Treasurer — to work together to present information and make proposals for the Panel's consideration. Those financial officers began with differing concerns and alternative solutions, but ultimately came together to offer consensus proposals to the Panel. Again, we should listen.

This month, the full Panel — a group consisting of legislators, chairs of DEFAC and its subcommittees, appointees of the Governor drawn from the public and private sectors and the aforementioned financial officers — released the report envisioned by HJR 8 (the Report), reflecting a bold set of recommendations to enact new spending controls, create a budget stabilization fund and revamp our revenue portfolio. The Panel voted unanimously on the need for and means to achieve historic budget reforms. Truly, we should listen.

And, when we are done listening, we should act.

## THE STAKES ARE HIGH AND AFFECT ALL OF US

For too long, we have allowed our State's finances to be run using budgeting systems that were put in place before half of us were even born. The then radical financial reforms undertaken in the late 1970s — when Delaware was in a sorry fiscal condition and declared "bankrupt" by then Governor Pete du Pont — put our State in the vanguard of good governance and ushered in a generation of prosperity.

The bloom, however, is off that rose. Forty-year old fiscal practices and policies are failing to meet the needs of our citizens in a manner that is certain, sustainable and sufficient. Take the current and next fiscal years as cases in point.

Less than one year ago, our State government was absorbed in finding solutions to dig our way out of a 10% budget deficit. The debates in the General Assembly as to how to cut and spend our way out of that hole were both paralyzing and polarizing.

Flash forward eleven months and we are looking at budget growth of more than 10%! The crisis this year is how to restrain the spending gusher in a free for all reminiscent of a typical Black Friday.

If real people, small businesses and critical service providers were not affected by this seeming absurdity, the scramble this year to undo parts of what was done last year might appear comical. The reality is no farce.

Last year's spending cuts were not mapped out in advance as part of a long-range strategic plan. They were contrivances to "balance the budget," determined over a matter of weeks by well-meaning legislators acting on a fraction of the information that they should have to make such decisions. Much of those cuts could now be reversed as the requisite revenues have reemerged.

Similarly, some of the tax increases that were professed to be so badly needed to "balance the budget" during the last legislative session likely will be revisited. In the fallout, revenue forecasters are suspected of sandbagging income figures to achieve politically motivated outcomes. In reality, the tax system that we have put in place over decades and failed to manicure in a rational fashion has led to a revenue portfolio that is both lagging in growth even as it is increasing in volatility, a combination that makes predicting our future tax income ever more challenging and less reliable.

Have we allowed process to triumph over progress? Some, especially veterans of our Legislature, claim in defense of the status quo that adhering to our well-worn practices has allowed us to balance the budget every year for the last four decades. But is this the height of good finance, or to borrow a term from our budget process, just a "door opener" — a necessary but far from sufficient duty?

We can and should do much more than just "balance the budget" from year-to-year. The recommendations of the Panel tell us both what and how. Taken together, the three-part package of reforms builds on our current, myopic focus on annual solvency by instituting mechanisms that will foster year-over-year certainty and ensure long-term sustainability.

Moreover, the reforms will orient us away from the task of simply allocating the fiscal purse and place greater scrutiny on how our investments are paying off.

Three years of serving as your State Treasurer has convinced me that we need to refocus our entire State financing system around the concept of value: not how much we tax or how much we spend, but what we get for what we pay.

## Value is not just the key to fiscal prosperity, it is the consensus issue that tamps down political discord and dysfunction.

Conservatives, Progressives, Democrats, Republicans, Independents and everyone in between wants to see our government officials and agencies engaged in providing and procuring goods and services that are commensurate in quality and quantity with the taxpayer monies we spend and invest.

Our current budgeting system does not rally us around that goal. It is time to institute reforms that do. And we need to act quickly.

"Neither party has a monopoly on applying common sense to these issues. Both parties must agree that a more permanent solution involves addressing both spending and broadening reliable revenue sources. And doing so requires some faith and trust in the other side, something the political process here and elsewhere struggles with these days."

— Mike Houghton, Advisory Panel Chair
The News Journal
May 16, 2018

"We do not face a budget deficit this year but, as a state, we cannot lose sight of our long-term financial challenges… This is a long-term challenge that will require a long-term commitment. We should finally commit to addressing our budget problems so we can get back to making investments that matter — in our schools, our communities and our economy."

— Governor John Carney
Official Statement
May 15, 2018

"The problem is structural, which means you see it less in good times than in bad. This proposal is not about managing year-to-year solvency. It's about eliminating these peaks and valleys in a way that maintains a level of growth we can sustain long term."

— State Treasurer Ken Simpler
The News Journal
May 16, 2018

"If we had this (Budget Stabilization Fund) in place, if it was fully funded, 90 percent of all economic situations that we've ever encountered we would be able to handle with this fund and not have to make significant, drastic decisions."

— State Rep. Quinn Johnson
Delaware Public Media
May 15, 2018


## TIME IS OF THE ESSENCE — YOU CAN MAKE A DIFFERENCE

The window to effect these reforms is closing rapidly as our fiscal year ends on June 30th. Critical components of the budget recommendations advocated by the Panel require the Legislature to vote on amendments to our Constitution. Under Delaware law, such legislation must be approved by super-majorities of two consecutive General Assemblies.

The current General Assembly is in its second year and will be dissolved after the end of this fiscal year, ushering in a new General Assembly for another two years. If the reforms are not voted on in this session, there is little likelihood they will be taken up in the first year of the next General Assembly, as they could not be voted on again for another two years. The time to act is now.

Even legislators with some misgivings as to portions of the recommendations should be willing to take up the initial leg of the required amendments as such a vote is required but not adequate to amend the Constitution.

As a matter of law, the first vote of this General Assembly has no force or effect by itself and does not bind the next General Assembly to take the second vote. In effect, the first vote to amend the Constitution simply makes the second leg possible, preserving a valuable option to study details of the recommendations further and/or provide legislators with more time to resolve competing ideas as to how to handle some aspects of the accompanying statutory proposals. (Note that only a portion of the Panel's recommendations requires constitutional changes; Other parts of the proposals can be implemented via statute).

The following pages of this newsletter set out the recommendations of the Panel as well as portions of the preamble to the Report. The Report and the entirety of the materials presented to the Panel, including the minutes reflecting the discussions that transpired during those meetings, can be found on the Department of Finance's website at: finance.delaware.gov/publications/BudgetSmooth/res8.shtml.

Critically, the legislation to enact the Panel's recommendations will be submitted to the General Assembly when the members reconvene the week of June 4th for the final push to fiscal year end. In just those four weeks, the fate of the reforms will be determined.

Our elected officials in the Legislature will either step up and provide for our ability to reinvent the way we do business in state government, or they will falter and consign us to the status quo. The former path holds the promise towards progress, the latter a commitment to a tired process that puts form over substance.

> If after considering these reforms, you concur with their intent and effect, I urge you to pick up the phone, pen a letter, send an email or otherwise contact your Representative and Senator and let them know that you want to see these changes made to our budgeting processes.

We are tired of seeing the can kicked; we want the system fixed.

Do not underestimate the power of your voice, individually, much less collectively. Reforms of this scale present themselves for consideration infrequently — judging by Delaware's history perhaps only once every half century or so.

If you've listened and heard the blueprint for this bargain, let's act now to see it implemented. The next generation is counting on you.

Ken

Ken Simpler, Delaware State Treasurer

## SELECTED SECTIONS OF THE PREAMBLE TO THE REPORT

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:

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. 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]

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.

**RECOMMENDATION NO. 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 its 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.

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.

RECOMMENDATION NO. 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 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.

RECOMMENDATION NO. 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.

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.

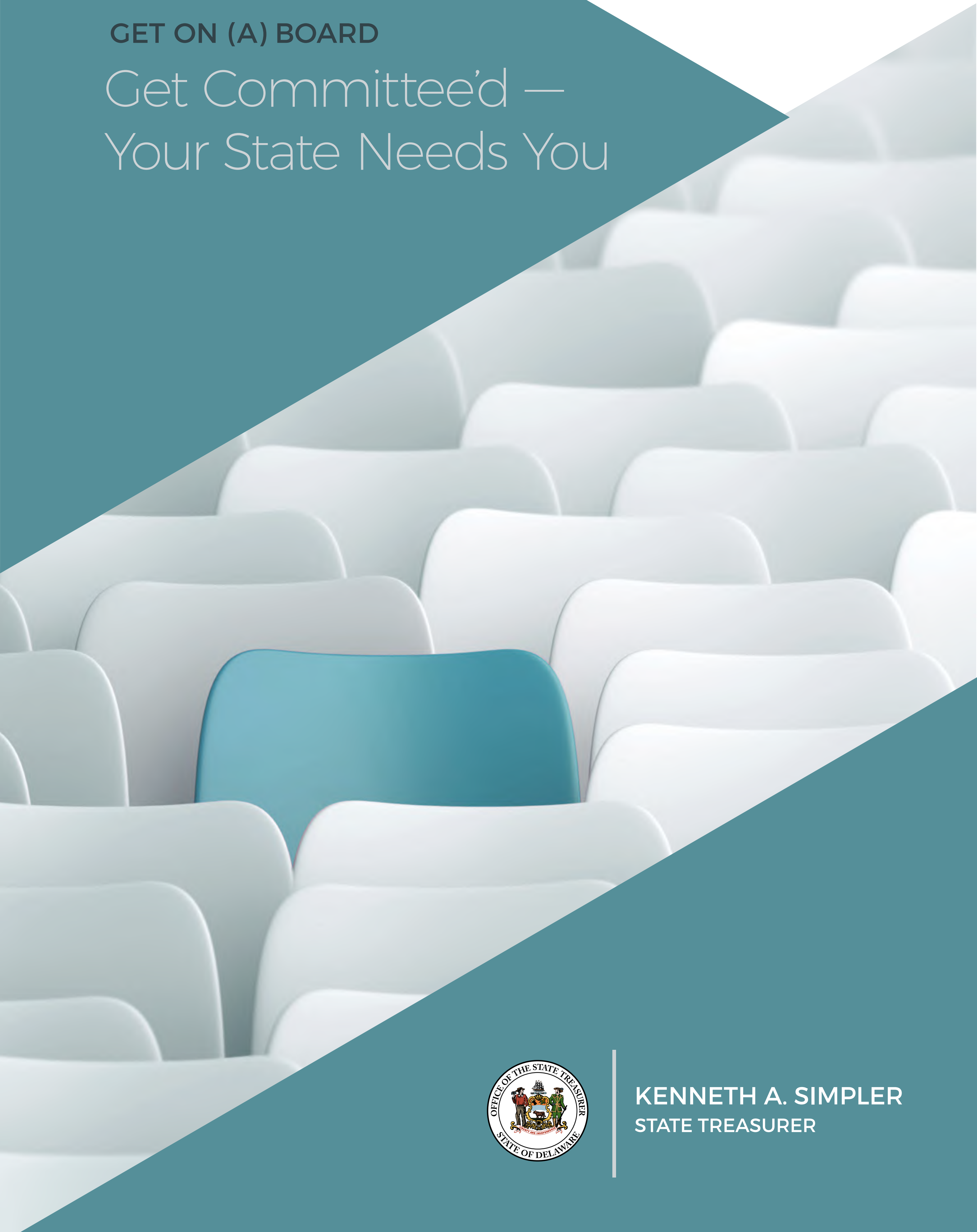
3 The Panel also recognizes that changes were made to escheat, the third largest source of revenues for Delaware, but these were outside of the mandate of the previous Council and therefore not a part of the report. Similarly, the Panel recognizes that the 2015 Report recommended a change to provide 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.

> A lot can happen in four years when the leadership and staff of a state agency and the members of the oversight board they administer are pulling together and engrossed in the good work of simply making our government's operations run more smoothly, securely and efficiently.

NEWSLETTER | Q4 2018

GET ON (A) BOARD

# Get Committee'd — Your State Needs You



KENNETH A. SIMPLER
STATE TREASURER

## INTRODUCTION

A lot can happen in four years.

On November 28, 2018, I attended my last meeting of the Cash Management Policy Board as State Treasurer. By no coincidence, but rather through careful planning and deliberate execution, the meeting brought to different stages of completion three distinct strategic initiatives on which my Office and the Board have collaborated.

At the top of the order was the first quarterly performance report on a new platform for the State's investment portfolio that was put in place as of the beginning of the current fiscal year.

That framework was nearly three and one-half years in planning, design, contracting and implementation, and marks a departure from a scheme in place for nearly four decades.

Second was a vote to award contracts to a consolidated set of financial service companies to take on the totality of banking business for the State of Delaware — a holistic approach without precedent.

The hard work of implementing this vision across all state agencies will take at least as much time as the two and one half years spent on the due diligence and deliberation of the revised banking platform.

Finally, a memorandum representing the better part of a year's worth of research was delivered to the Chairman and certain members of the Board who participate as officers in the State's debt issuance process.

The memo invites consideration of an expansion of the Board's mandate to provide for the oversight and review of Delaware's debt policies and practices. That process is projected to require another 18-24 months to study, legislate and implement.

At the end of the two-hour meeting, John Flynn reflected on his 38 years of serving as Chair of the Board: "[C]ompared to the previous 34…we have done more to help the State in the last four years than I can remember."

A lot can happen in four years when the leadership and staff of a state agency and the members of the oversight board they administer are pulling together and engrossed in the good work of simply making our government's operations run more smoothly, securely and efficiently.

Four years can also be a slog when the opposite is true.

# A BRIEF LOOK BACK

Those who have no inkling of what the Cash Management Policy Board does might still have had their memories jogged by the dry and obscure sounding committee's name.

The Board featured prominently in news headlines for a good portion of my predecessor's term in office. That notoriety stands in stark contrast to its unheralded role for much of its 40-year history.

The Board was put in place in 1981 as part of a series of reforms aimed at improving Delaware's financial condition and fiscal practices.

Specifically, the Board was chartered to set policy for the investment of state monies by third party managers. This was deemed prudent in so far as all of the State's funds had previously been deposited with Farmers Bank, an entity that while effectively controlled by the State had nonetheless mismanaged its way into insolvency and receivership.

Under the new advisory arrangement, the State Treasurer was appointed to serve as one member of a nine-person policy-making group that was otherwise split between those serving in ex officio capacities — the Secretary of Finance, the Controller General and the Secretary of State — and those public members appointed by the Governor and confirmed by the Legislature.

The State Treasurer remained the day-to-day administrator of state funds, and retained authority for managing collections and payments, movements of funds across state government and the engagement of banks and investment managers to facilitate those activities. In all cases, however, those actions were to be effected within the policy guidelines determined by the Board.

This division of authority between the State Treasurer and the Board is not clear-cut, but requires some give and take. That process broke down during my predecessor's term in office, leading him to contest what he perceived to be the infringement on his constitutional authority as an elected official by the determinations of the unelected members of the Cash Management Policy Board.

Midway through his term in office, those differences had gone well beyond the boardroom, bubbling over into disagreements with other key branches of state government, most notably the Governor's Office. [1]

Ultimately, their resolution required both a legal determination by the Attorney General as well as legislation passed by the General Assembly.

The Delaware Code was amended in 2013 to clarify some ambiguities over the specific matters that had been focal points of the clash between the Treasurer and the Board.

In general, however, the new provisions simply restated what had always been the intent of the original legislation: the Board sets policy; the Treasurer administers pursuant to such policy.

There was much ado made of this legislation and a significant amount of press was spent debating if and how the Treasurer's authority had been reduced relative to the Board.

Lots of ink was also spilled on stories of personal animosity between the Treasurer and members of the Board, as well as speculation on what influence the Governor's appointed Board members had over his administration's determination to "punish" the State Treasurer.

Obscured in all this was the fundamental observation that the Board is a creation of the Legislature, and represents a means for the 62 members of the General Assembly to exercise their critical role in overseeing the executive branch of government.

Conflict between these branches is not only unsurprising, it is by design.

1 As a minor historical footnote, this drama finally ran its course some four years after the events that precipitated it, when the former treasurer and the new governor reached a settlement involving the payment by the State of $22,500 to dismiss all Freedom of Information (FOIA) requests related to this matter.

## THE ROLE OF BOARDS IN STATE GOVERNMENT

The basic constitutional framework of our federal and state governments involves a separation of powers among the executive, legislative and judicial branches.

As between the legislative and executive branches there is a shared power over the purse: "the executive proposes, and the legislature disposes" (as the saying goes). Likewise, in the operation of governance, there is given to the executive branch the power to effect, and to the legislature the power to oversee.

In Delaware, that relationship may not be as clear when applied to independently elected offices such as the Treasurer, the Auditor of Accounts and the Insurance Commissioner.

But, in the scheme of checks and balances, these are simply other executive branches akin to the Governor's Office that share authority for governing with the Legislature.

The fact that the General Assembly frequently delegates to the Governor the obligation to appoint members to the boards, committees and councils it creates across state government may also sow confusion as to "who" is exerting authority.

This appointment power, however, is a matter of administrative convenience, as the Governor maintains a staff whose full time role is to accept, vet and approve applications for appointments to the roughly 400 state boards and committees currently in existence (or at least listed as extant on the Governor's website).

In some instances, as is the case with the Cash Management Policy Board, the Governor's appointees must be submitted to the General Assembly for approval. However, even where the legislative branch does not put the individual composition of a board under its ultimate discretion, it retains a power over the whole.

Boards and committees created by the General Assembly receive periodic (e.g., every 5-7 years) "sunset reviews," where their conduct is examined and purpose reassessed, not infrequently resulting in some legislative action or mandated follow-up.

Moreover, the Legislature need not wait on any periodic review to alter, amend or eliminate boards and committees; such legislation can be taken up by policymakers at any time. [2]

The General Assembly relies on the boards, committees and councils that it creates to extend its oversight capacity. With some 17,500 employees (which does not count local educators) and operations that extend into almost every field of industry, the scope of government is simply too vast for a part-time legislature with minimal staffing to monitor on an ongoing basis.

As I have seen first-hand in my service on more than a dozen committees, councils and task forces across state government, the efficacy of this model varies from board to board.

Effectiveness can even fluctuate on the same board over time given the composition of its members and the context of its challenges.

For instance, my predecessor and I both administered a Cash Management Policy Board comprised of a majority of the same individuals.

The background dynamic of legislative and executive tension were present in both cases. Operational demands were also comparable, and the financial environment was similar for a good amount of our respective tenures.

What therefore is to explain periods of decidedly different progress on the Board? The four years preceding my term — even as witnessed in the minutes under the drafting of my predecessor's administration — were fraught with what appear to be turf battles and a high level of unproductive confrontation.

Conversely, differing views during my term were channeled constructively, allowing for what the Board's Chairman deemed an unprecedented level of productivity.

As our State relies on boards, committees and councils to do yeoman's labor, it is worth examining what worked in my experience and how a balance was struck between the executive's operating autonomy and the Board's oversight responsibility. There is much to be gained in fostering such successful collaborations.

2 In fact, there were amendments to the Delaware Code affecting both the Board and the State Treasurer enacted through both processes during my predecessor's term in office. In both 2012 and 2014, modifications were made extemporaneously to address the ongoing dispute described above. In 2014, additional amendments were passed as a consequence of a scheduled sunset review.

# THE WORKINGS OF THE CASH MANAGEMENT POLICY BOARD

The Cash Management Policy Board is comprised of two subcommittees, banking and investments, each of which is made up of five members of the full board.

The Board Chairman serves on both subcommittees, as do the State Treasurer and the Secretary of Finance. Two pairs of the four other public members are assigned to each of the Banking Subcommittee and the Investment Subcommittee based on their respective backgrounds in financial services and asset management.

The Board and each subcommittee meet at least once per calendar quarter. Issues of complexity relevant to the subject matter of each subcommittee are first wrestled with at that level and then recommended for action to the full board.

The Office of the State Treasurer supplies the administrative support for all three panels, including staffing meetings, taking minutes, preparing materials and responding to follow up.

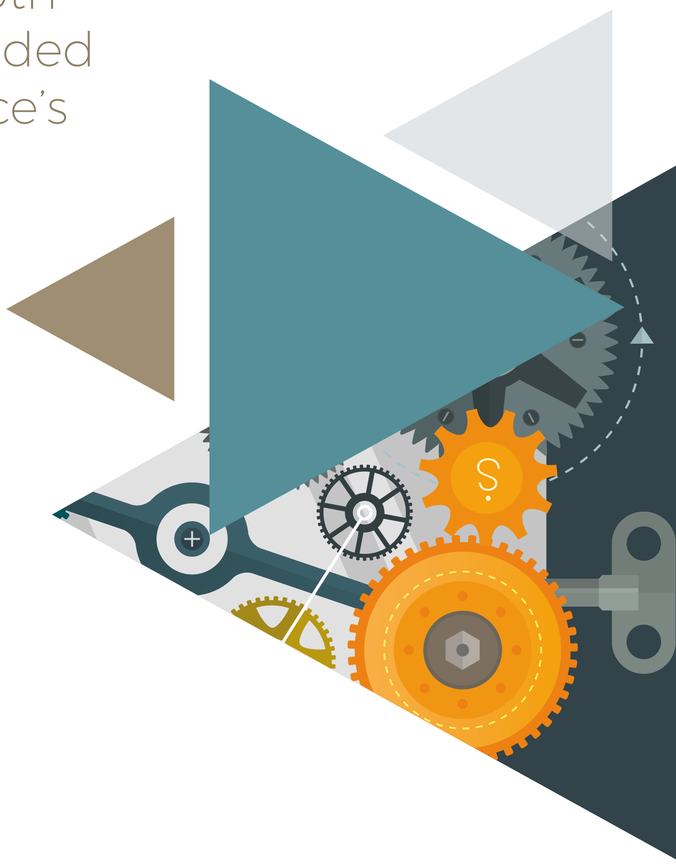
From the perspective of the office staff, the public meetings serve as milestones and inflection points for the completion of work that requires Board approval.

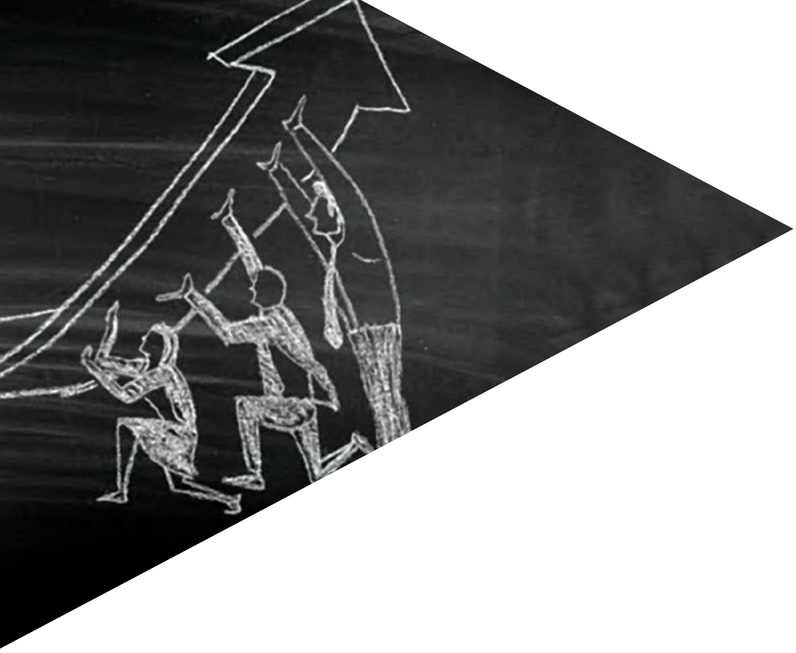
Policy shifts that would impact existing guidelines, final contracts for third-party banking and investment services, and review of portfolio performance are all routinely brought to the Board and its subcommittees for discussion and approval.

Over the past four years, my office has undertaken significant reforms in three areas where the Board has historically exercised varying degrees of engagement:

- in the case of the redesign of the investment portfolio, this was an area where the Board had always maintained a high level of policy-making discretion and active review;
- in our project to restructure the banking architecture, we were dealing with operational issues over which the Board had maintained significantly less oversight and done little policy-making; and
- our proposal to have the Board's responsibilities expanded to include the review of the State's debt policy and practice represented an altogether new mandate, completely outside the Board's existing purview.

Notwithstanding these very different contexts, the Board served as both ultimate arbiter of, and value-added partner with respect to, our Office's initiatives.





## REDESIGNING THE INVESTMENT PORTFOLIO

The Board's focus over time has been on monitoring the performance of, and overseeing application of its investment guidelines to, Delaware's cash portfolio.

Since the Board was put in place, state funds have been apportioned between 6-12 outside managers who are contracted by the Treasurer's Office every 3-5 years pursuant to a competitive bidding process with final approval by the Board.

Funds under management vary over the fiscal year, averaging between $1.6 - $2 billion.

The members of the Board are highly familiar with the State's investment portfolio and well acquainted with the related operations of the State Treasurer's Office.

The longest serving public appointees to the Board have worked with six different State Treasurers and experienced several market cycles during their tenure. They have intervened directly in the management of the portfolio on an emergency basis in times of crises, but in general, their focus has been on setting policy.

As a new Treasurer, I immediately became both a member of the Board and the head of the agency responsible for its administration.

My background as an asset manager provided me with a level of credibility with the Board, but also aroused suspicion that I might interpret my role as one of active management (as opposed to investment policy development and oversight).

From my perspective, I was wary as to the Board's tempestuous relationship with my predecessor and concerned that their experience might lead to a territorial defense of the status quo.

We were able to overcome the initial reservations on both sides by working together in two capacities. On the one hand, we were fortunate to have an immediate project to retain managers for the State's endowment accounts, a hands-on process with a clear deliverable under a short time frame.

On the other hand, we committed material time in our first several meetings to the development of a long-range plan to examine each component of the State's cash management operations, an open-ended inquiry of broad scope with no preconceived set of outcomes.

In the first year, we collaborated not only on the engagement of the endowment managers through the request for proposal (RFP) process, but followed that with the same team of Board members and OST staff to hire a new consultant for the Board. (Notably, the outgoing advisor had been engaged by my predecessor without the Board's involvement and answered directly to the State Treasurer.)

These working experiences allowed us to streamline the RFP processes that were subsequently employed to replace the custodian for the portfolio as well as the nine cash managers.

By the end of four years, we had systematically rebid all outside vendors attendant to the investment portfolio. These joint exercises built respect for one another's work ethic, management style and organizational skills.

A parallel process led to even more momentous change: the first overhaul of the cash management guidelines since their implementation in 1982.

That process began with a series of modest amendments to specific provisions of the guidelines to better enable investment managers to deal with the Federal Reserve's decision to begin raising interest rates (after several years where the Fed's main policy rate had been held flat and near zero).

While there was disagreement as to the scope of these changes, the discussion of their need constituted the first steps towards the development of an intellectual framework for revisiting the guidelines in their totality.

Since inception, the Board has operated under a three-part mandate to ensure that state funds are safe, liquid and earn an acceptable rate of return.

While safety of funds always has been paramount, the means for determining the State's operational cash requirements never has been clear.

Over time, this has resulted in an uncertain balancing of the need to keep investments in short-dated notes that earn very little yield but suffer no loss of principal when sold, versus longer-dated bonds that earn greater returns but carry a risk of loss if they are sold prior to maturity.[3]

In order to resolve the question of cash needs, we undertook an extensive examination of the State's receipts and disbursements from periods of budget surplus and deficit.

By examining daily cash flows over a decade (including the period of the Great Recession) we were able to establish an estimate of the State's maximum cash requirements and commit funds in excess of that base to a tiered reserve structure of increasingly longer maturities.

The redesigned investment portfolio meets the liquidity needs of the State while earning a yield that nearly would have doubled returns in the past 10 years and is projected to be 20-25% higher over periods of more normalized interest rates.[4]

No changes were made that lower the quality of assets or security of the funds; in fact, the State's "Rainy Day" monies, or emergency funds, now are held in more liquid accounts.

Overall costs of managing the new portfolio, as measured by custodial, consultant and managements fees, are slightly lower with higher service levels embedded in the new contracts.

Operationally, we also improved on the transparency and equity of returns paid on school district and special agency funds, and our overall forecasting of earnings reportable to the General Fund is significantly more sophisticated.

The extent to which we redeveloped investment policies and procedures related to the State's cash management functions demonstrates that material improvement is possible even where a board has been actively involved and has extensive experience.

The keys to our success in this context were the engagement in collaborative exercises that leveraged that existing experience and learning and an open-ended and open-minded commitment to examining all facets of our operations.

The redesigned investment portfolio meets the liquidity needs of the State while earning a yield that nearly would have doubled returns in the past 10 years and is projected to be

+20-25%

higher over periods of more normalized interest rates.[4]

3 The lack of a clear understanding and agreement between the Board and the former Treasurer as to the balance between liquidity and yield were partially to blame for material losses suffered by the portfolio in 2013 (the only year of which I am aware when the total portfolio return was negative).

4 NEPC, the consultant to the Board, modeled both the new and current portfolio designs over a range of varying market conditions and historical periods. On average, the new design produced returns that were 100 basis points, or 1%, higher than the current portfolio. In the past 10 years, a period of ultra-low interest rates, the portfolio has returned less than 1.25% on average per annum. The additional 1% in this period represents an increase of more than 80%. In an environment where the portfolio earns as much as 4-5% per year (which it did in the higher interest rate market of the early part of this century), the additional 1% would represent a 20-25% improvement.

## RESTRUCTURING THE BANKING ARCHITECTURE

In seeking the Board's assistance in rebuilding the State's banking architecture, we did not start with a comparable level of engagement in setting guidelines or familiarity with state operations.

Banking activities are less subject to policy prescription and performance review than the investment portfolio, and therefore had not historically figured as prominently in the Board's oversight.

One advantage we did have was the professional experience of the two public appointees who serve on the Banking Subcommittee.

A second advantage was that our banking review did not proceed in tandem with the investment portfolio redesign, but followed some 18 months in arrears, allowing us to leverage key insights from that process.

During our extensive review of the investment guidelines, we discovered significant shortcomings in our banking operations.

While the Board's guidelines required the collateralization of all cash on hand, actual practice deviated substantially from that mandate, insuring as little as 5% of intra-day balances.

Similarly, though the Delaware Code provided for the Board's oversight over all state monies (with the exception of pension and retirement funds), a trove of school district and agency banking accounts totaling close to $60 million were found to be outside the accountability of the State's systems.

Rather than attempt to manage these problems without input from the Board, we presented them to the Banking Subcommittee for discussion, examination and feedback. We also brought to the Board's attention material problems we had with outside banking partners.

The bankruptcy and acquisition of the key vendor for the State's system for accepting credit card payments became an immediate instance for working together to understand the severity of the situation and design an RFP to replace that organization.

Likewise, we collaborated on the investigation into the State's provider for the direct deposit of pension and payroll payments when that national bank was found to have defrauded Delaware accountholders.

In that instance, we abandoned a planned RFP for such services and instead replaced the vendor on an emergency, expedited basis approved by the Board.

Far from undermining our Office's credibility, these experiences bolstered support for our efforts to modernize and improve on banking operations.

Bringing Board members in to help solve the key details of our banking challenges rapidly accelerated their learning curve.

These exercises also made clear to all of us that the network of our banking vendors and related practices had been put into place thoughtfully, but serially over time.

Never had there been a comprehensive examination of how they all fit together or a holistic inquiry into their overall efficiency and effectiveness.

One reason that such a process had never occurred was simple lack of human resources. The Office of the State Treasurer was neither organized nor staffed to enable an in-depth review, much less participate in the day-to-day servicing, of the banking operations of all state departments and divisions.

Rather, the Office had historically engaged vendors on behalf of the State at the enterprise level and allowed each agency to individually implement and manage its own application of the contracted services.

To undertake a proper review of our current network required us to form an inter-agency banking task force and engage an experienced outside consultant.

The findings from that exercise proved up what we had come to anticipate: the whole was less than the sum of its parts.

A new structure, if implemented globally, could lower overall out-of-pocket expenses, enhance cyber-security protections and increase the productivity of scores of financial personnel across state government.

To make that vision a reality would necessitate the collaboration between not just our Office and the Board, but also the backing of the State's Government Efficiency and Accountability Review Board (GEAR), and in particular its Financial Services Delivery Committee.

With the support of both groups, our banking architecture review became one of the Governor's signature accountability undertakings.

The work that has ensued culminated most recently with the conclusion of the RFP process and the vote of the Board described in the introduction above. The project to restructure the State's banking architecture now moves from concept and contracting to implementation.

This stage will involve increased reliance on both the Board and GEAR to help shepherd a process that will take several years to complete and will outlive my administration and perhaps even that of the current Governor.

The time invested in making both the Board and GEAR fully cognizant of this undertaking and active partners in its fulfillment may prove to be the institutional glue that holds this project together over the long term.

A process that we began with a rapid education of Board members and some trial by fire, infused with transparency and humility through our disclosure of operating challenges, and ultimately resourced with support beyond our own office, likely will prove our single greatest accomplishment for the State when completed.

## REVIEWING DEBT POLICY AND PRACTICE

In a final testament to the usefulness and import of boards in state government, our Office has proposed an expansion of the powers of the Cash Management Policy Board to include the review and oversight of the State's debt policies and practices.

While this mandate is outside the current scope of the Board's authority — and would require both gubernatorial and legislative action to implement — our experience in redesigning the investment portfolio and restructuring the banking architecture suggests that there is an opportunity to build on and emulate that success in the area of debt issuance and management.

Currently, there is no formal public body that oversees Delaware's debt practices and policies; nor does the State conduct regular assessments of its debt affordability or monitor metrics that other states use to measure debt feasibility.

Instead, the State relies on its four bond issuing officers — the Governor, Secretary of State, Secretary of Finance and State Treasurer — to approve each issuance of general obligation debt with the assistance of outside bond counsel and advisors. This process falls well short of an ongoing and comprehensive examination of policies and practices.

The Board, on the other hand, is ideally positioned to take on this role owing to its composition and current mandate.

Three of the State's four bond officers serve on the Board, and the administration of the debt issuance and management processes is shared among the agencies administered by two of them.

The Board therefore provides a ready forum for a more regular review of these officers' debt issuing roles and responsibilities.

Strategically, the Board is engaged on the "buy side" of fixed income markets, overseeing the State's cash portfolio of debt securities and monitoring the performance of bond markets.

The State's issuance of municipal bonds takes place on the reciprocal "sell side" of this marketplace, presenting an opportunity for the State to leverage synergies from the Board's policy-setting and advisory roles.

The precise scope of the Board's work should be the subject of extensive discussion but could include responsibility for conducting or commissioning periodic debt affordability studies, recommending changes to the State's debt limit statutes, assessing and proposing alternative means of financing capital projects, approving the engagement of the State's bond issuing consultant and outside legal counsel, reviewing and advising on the State's debt-related practices, and otherwise serving as an independent resource to the bond issuing officers.

Overall, an expanded Cash and Debt Management Policy Board could take on proactively the challenges that foreseeably will receive the attention of the agencies that bestow ratings on state debt issues.

Using the Board, Delaware has both the opportunity and means to build on its fundamentally sound approach to the management of its debt portfolio, further bolstering the case for its AAA bond rating and insuring the State of low borrowing costs well into the future.

## CONCLUSION

As I contemplate my imminent departure from public office, the work that has gone on between my administration and the Cash Management Policy Board is a source of both pride and hope.

For those members of the Board who will continue on, particularly those members of the public who serve without remuneration and with little recognition, I want to say "thank you."

John Flynn, Dave Marvin, Mike Karia, Warren Engle and Lynda Messick, your contributions to our State have been both significant in quantity and substantial in quality.

Knowing that Lynda is taking her "retirement" contemporaneously with my own, the task falls to the Governor to appoint someone who will continue to imbue this Board with the professionalism and integrity that have come to characterize its comportment and character for almost four decades, an obligation that I have little doubt he will fulfill.

From the perspective of the staff with whom I have worked these past four years, the carriage of the Office of the State Treasurer now falls to you and my successor.

Together, you will have the opportunity to bring new ideas to the table and advance initiatives that were not part of the strategic plans of my administration.

I wish you great success in these endeavors while encouraging you to continue to share your vision with the Cash Management Policy Board and the other boards that the office administers.

The members of these boards have invested greatly in building the intellectual frameworks that define their missions, even as they have labored to assist with the operational challenges that face our Office. Continue to take advantage of their wisdom.

To my successor, Treasurer-Elect Davis, I hope that when the time comes to attend your last meeting of the Board — in whatever incarnation it may then have taken on — that your experience, like mine, is one that conjures feelings of amicability with your fellow members as well as a shared sense of accomplishment. Truly, these collaborations are the essence of good government.

Finally, for the members of the public to whom I have addressed these missives over time, and who have endured their ever-growing length and adventure into more obscure but erstwhile topics, I say "Get on [a] Board; Get Committee'd."

The State's website lists hundreds of boards, committees, councils and task forces, the application form to apply to any of which is only a few pages long. For convenience, I include the link here: https://governor.delaware.gov/boards-commissions/.

If you take nothing else from this piece, take this: ordinary citizens serving on boards can have an incredible and outsized impact on the success of our state government. If you are not a financial professional, you do not have to serve on the Cash Management Policy Board.

Wherever your interests lie and whatever your experience may be, chances are that there is a board somewhere in state government that has an appropriate opening. Find it and fill it.

Your State Needs You.

Ken

Ken Simpler, Delaware State Treasurer