

Reflections on Economic Uses for the State Budget

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Given the political attention and news coverage the state budget attracts, it is tempting to suggest a major role for it in promoting Wisconsin's economic well-being. Certainly that is the impression left by the hundreds of press releases emanating from state executive and legislative offices each year. But, once certain unavoidable financial and political realities are acknowledged, one has to ask whether there is a significant role for the state budget in charting Wisconsin's economic course in the 21st century. Realistically, what might the economic uses of the state budget be? Or is the best advice for state budgeters simply "to do no harm"? This paper explores both the limits and potential uses of the state budget as an economic tool.

Context: Limits to Direct Impact

Although more active than in some states, the public sector here is not large enough to drive the state economy, even if that were a desired goal. General revenues collected by state and local governments were \$28.4 billion (b) in fiscal 1999; direct general expenditures were \$28.0b (Source: U.S. Census Bureau). This is less than 17% of gross state product (GSP), which totaled \$166.5b during that year. When federal monies over which state and local governments often have limited say are excluded, public revenues raised within the Badger State amounted to \$23.8b, or just over 14% of GSP.

Wisconsin's unusual approach to state-local finance further diminishes the economic role state government might play. Traditionally, the state has been the lead tax collector—but not the prime purveyor of public services. In fiscal 1999, about 63% of all state-local revenues were raised by the state. Yet only about 37% of all state-local expenditures were administered at the same level. The large gap between the two percentages is due to the state's traditional commitment to devoting about 60% of general fund spending to aids to various local governments and school districts.

This means that only 6.3% of GSP was due to state-delivered services. Local expenditures were a larger 10.6% of GSP; but these were highly diffuse—spread over 72 counties, 426 school districts, 1889 municipalities and a number of special districts. Wisconsin's tradition of local control makes it difficult, if not impossible, then, to develop any coordinated economic strategy around public expenditures.

To the degree that there might be state programs that could have an economic impact at the state level, they are limited. Three areas funded by the state from all sources of revenue (taxes, fees and the federal government) accounted for the majority (58.6%) of state spending in fiscal 1999. Public welfare programs represented the largest share (27.9%), followed by higher education (21.0%) and transportation (9.7%); all other categories, e.g., natural resources, corrections, administration and debt service, trailed.

Thus, it might be argued that less than half, and perhaps as little as a third, of the budget could be used to impact the state's long-term economic fortunes, either through investment in human capital (higher education) or infrastructure (transportation). The former is highly decentralized and, due to academic freedom and faculty governance, not given to coordination or direction. The latter is handled through a segregated fund and involves considerable sums of federal money.

In short, the immediate economic impact of the state budget should not be overstated. And, as past recessions and the recent World Trade Center tragedy demonstrate, national and global forces increasingly affect Wisconsin's economy.

Does this mean the state budget has no impact on the state's economic health? Clearly, in terms of direct impact, opportunities are limited. However, there are several potential, indirect uses—or abuses—of the state budget that merit attention. The remainder of this essay examines these in three categories—signaling, planning and benchmarking—and closes with recommendations.

Signaling: What 'Outsiders' See

Often as important as the spending a governor and legislature authorize are the symbolic actions they take or don't take, the national reputation they cultivate or harm. Consider several examples that signal to outside observers the instability of Wisconsin state politics, budget processes and state finances.

- *Budget Timing and Atmosphere.* Compared to other states and to our own past, recent state budgets have been among the last in the country to be enacted. In 1997, the Badger State was one of the last four states to pass a budget; in 1999, it brought up the rear with Massachusetts. In 2001, Wisconsin was one of only seven states not to have completed a budget by the start of its new fiscal year. Timing in itself may say little. Delays could be due to cautious deliberation, lack of efficiency in public bodies, or loading budgets with controversial non-fiscal items. But in Wisconsin's case, late budgets are becoming the norm.

So too is the interpersonal and partisan acrimony that has accompanied budget delays. This year was particularly noteworthy for the extreme positions staked out by legislative opponents solely for bargaining purposes. Unfortunately, news of such positions can quickly leave the state capitol, enter boardrooms, cross state borders and take on a life of its own. In the end, symbolism becomes as important as results. If entrepreneurs and employers seek a stable and predictable public environment in which to develop and grow, Wisconsin's budget process in recent years might not offer that comfort.

- *Fiscal Management.* More will be said about state financial planning later, but comments published nationally in the past year suggest that word of Wisconsin's fiscal management is spreading, that the state is developing a reputation that is not altogether positive.

Last fall, a national publication from Merrill Lynch analysts pointed out that only two states were running deficits, according to generally accepted accounting principles (or GAAP), Wisconsin and Illinois. Wisconsin's GAAP deficit is reportedly the largest in the country.

In February 2001, *Governing* magazine, in its annual issue rating state governments, gave Wisconsin a C+ for its fiscal management. Only six states received lower grades. Its analysis found:

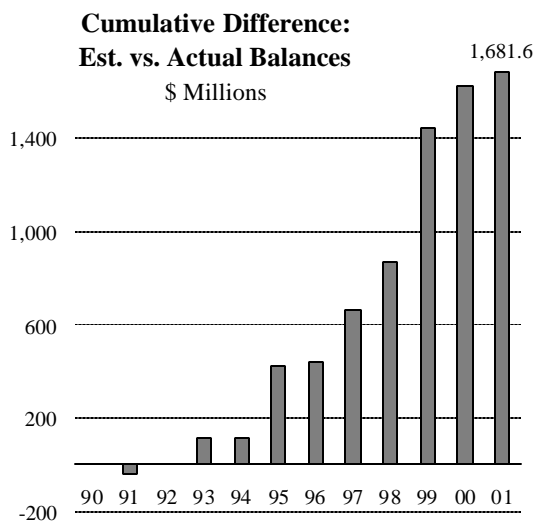
Wisconsin is required by law to balance its budget, but under Generally Accepted Accounting Principles, it has been running a deficit for years . . . the balance between revenues and expenditures is still worrisome . . . the state spent \$475 million more than it took in. Another bad sign: The budget was late again . . .

At summer's end, the state's general obligation bonds were downgraded by two of the national rating agencies. This was Wisconsin's first downgrade since 1982. At the time the bad news was delivered, only two rated states had lower Moody's ratings than Wisconsin, New York and Louisiana. Moody's analysts singled out, among other items, the "persistent structural imbalance" and "the state's traditional policies of maintaining minimal reserves and paying relatively little planning attention to recurring spending commitments."

Planning: Thinking in Years, Not Months

At its most elemental, a budget is a plan for collecting and committing public revenues. Yet, what others are writing about Wisconsin suggests a perception that the state cannot plan fiscally. And, there is abundant evidence "here at home" that state government, collectively, has given little forethought to the planning uses of its budget. To wit:

- *Surplus Revenues.* The 90's were perceived as boom years in Wisconsin. At times, personal income growth here outstripped the nation. Unemployment dipped to record lows. Tax collections



repeatedly beat estimates: Between 1990 and 2000, actual collections exceeded published budget estimates by almost \$1.1b. When net ending balances are taken into account, the cumulative difference between published estimates and actual figures was more than \$1.6b. These figures, gathered from state *Annual Fiscal Reports*, are displayed to the left. No matter how the calculation is done, it is safe to say that Wisconsin's economy generated between \$1b and \$2b in surplus state revenues during the past decade.

- *Yet Deficits.* Despite, or more likely because of these heady numbers, state budgets grew even faster than personal income, but the spending was not pay-as-you-go. Every budget enacted during the past ten years carried a “structural deficit” in the second year of the biennium, and these deficits grew worse as the decade progressed: \$58m in 1993, \$136m in 1995, \$209m in 1997, \$274m in 1999, \$558m by January 2001, and \$761m by May of this year. (Source: state Department of Administration). Before the September 11 massacre, the 2001-03 budget carried an estimated \$310m “hole” in the second year of this biennium.

- *No Reserves.* The state left itself no room for error. Although revenue growth was robust, the net ending budget balances enacted by the legislature and governor were virtually nonexistent—just fractions of a percentage point of net appropriations. They ranged from just 0.03% in 1995 to 0.26% in 1999. (Source: Legislative Fiscal Bureau biennial budget bill summaries). This would be equivalent to an individual with an annual income of \$30,000 setting aside between \$10 and \$75 for the year for emergencies.

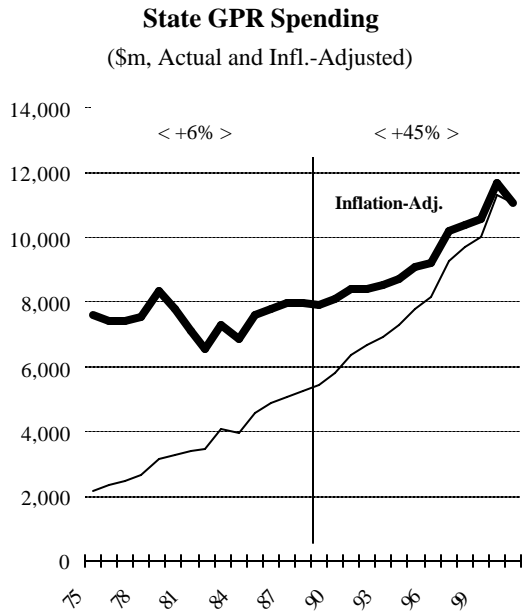
- *Unwise Accounting.* These practices were arguably made more likely by the state’s reluctance to follow GAAP accounting in developing and enacting its budgets. Since 1990, the state has summarized, ex-post, its annual financial condition in GAAP terms. These comprehensive annual fiscal reports from state auditors show Wisconsin has run GAAP deficits every year since 1990. The financial imbalances have ranged from a low of \$743m in fiscal 1990 to a high of \$1.473b in fiscal 1997. The GAAP deficit in 2000 was \$830m.

- *Lessons Not Learned, Opportunities Missed.* To make matters worse, Wisconsin has heeded neither the lessons of its own past, nor the preferred practices of neighboring states. In 1986, the governor’s Expenditure Commission warned of the dangers of boom-busting budgeting:

. . . when government revenues increase . . . expenditures grow to meet the available resources. When revenues decline, constituent demands to maintain programs begun during more affluent times require tax increases. The budget is balanced, but at what size?

The Commission concluded that “. . . the revenue ‘roller coaster’ in the past has resulted in a shortsighted approach to budgeting.” It recommended the state create a budget stabilization, or “rainy day,” fund that would segregate surplus revenues during times of prosperity to avoid service disruptions and tax increases during recessions. Wisconsin established such a fund in 1986; yet, despite huge revenue windfalls, the state failed to make a deposit to the fund. Meanwhile, states such as Minnesota and Michigan took advantage of the “good times” to build reserves of over \$1b each.

One way to understand the missed opportunity the 90s represented is to examine state general fund spending in actual (light line) and inflation-adjusted, or “real,” terms (bold), as the following graph



does. In the 15 years between 1975 and 1990, real state expenditures grew 6%; in the decade from 1990 to 2000, spending climbed 45%. In “real terms,” the dollars were there to build state reserves.

- *A Case Study.* Nowhere are the effects of state government’s short-term thinking more evident than in school finance. In 1994, the state legislature dramatically changed the way Wisconsin funded public education by committing future state budgets to providing, on average, two-thirds of the revenues school districts needed to operate. In its original form, the idea was floated in February; by the end of March, it was law. The “two-thirds” scheme was

passed and signed without a public hearing, without a plan for financing it, and with no attempts at anticipating its ultimate impact on taxpayers, other state programs, or schools.

Hindsight shows the effects on taxpayers were major. Although school property tax growth was stemmed in many districts, the incentive effects of higher state school subsidies resulted in more than \$400m in added annual debt service costs for state and local taxpayers. Property taxes levied by other jurisdictions accelerated to capture some of the foregone school levies. And income tax collections soared, growing almost twice as fast as personal income, to cover the costs of rising state school support.

Program dislocations elsewhere in the state budget were huge, and structural deficits were recurrent. In the past five years, more than 60% of all new state spending was devoted to school aids and related tax credits—almost double their share of state general fund expenditures prior to 1994. Consequently, “real” funding for state agencies, the UW System, and counties and municipalities was cut or frozen to help generate more than \$1.2b in new money for school aids and tax credits.

Finally, no thought was given at the state level to the eventual effects of the school funding shift on schools themselves. No one bothered to review the extensive education finance research that showed, unequivocally, that increased concentration of school funding at the state level eventually results in top-down school governance, micro-management by the legislature *cum* school board, and, most strikingly, eventual erosion of school performance.

Benchmarking: To Know Where We Are

If the state cannot plan for the future, it should at least monitor its past. Examining key economic and social trends can aid in understanding where the state has been and what the consequences of

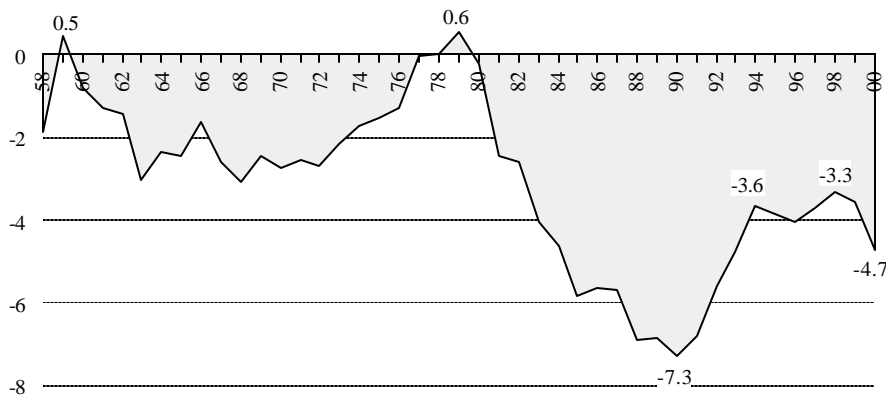
previous actions were. Unfortunately, on this score, too, there seems to be only limited understanding of recent developments. Several examples make the point.

- *Personal Income Per Capita.* Perhaps no single statistic better summarizes the state’s relative economic health than personal income per capita. As the graph below shows, Wisconsin has only been at or above parity with the nation twice. Briefly in the late 50s and again in the late 70s, per capita income was 0.5% and 0.6%, respectively, above the U.S. average. The recession of the 80s drove it down to 7.3% below the national norm. The recovery of the early 90s saw it close the gap to within 3.3% of the U.S. average in 1998.

The statewide perception, one reinforced by state officials and the press, was that the past decade was one of sustained and unprecedented prosperity. However, the data paint a more complicated picture. It was only during the first half of the 90s that the state made true economic headway. Between 1994 and 1999, per capita income progress vis-à-vis the nation stagnated. And last year, the Badger state actually lost ground, falling 4.7% behind the U.S. These trends were known to analysts in and out of state government, but there is little evidence that the executive and legislative branches tracked these developments in a disciplined way.

Wisconsin Per Capita Personal Income Trails U.S.

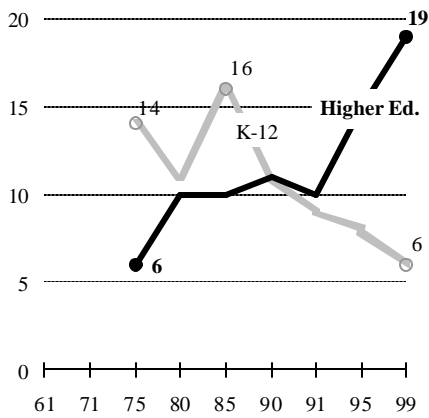
Percent Above/Below U.S.



- *Education.* Much the same can be said for education. Of all expenditures, education has historically been at the top of Wisconsin’s priority list. In 1975 (see graph, following), state spending as a share of personal income placed the state 14th on K-12 education and sixth on higher education. Those positions had been slowly switching over the ensuing years. However, the state’s decision to increase support for elementary and secondary education in the mid-90s dramatically accelerated that trend. By 1999, the U.S. Census Bureau showed Wisconsin expenditures ranking 19th on higher education and sixth

Shifting Education Priorities

Ranking State Spdg. as % Pers. Inc.



on K-12 education. In fairness, it should be noted that in *both* education categories Badger state spending relative to personal income is 20% to 30% above national average.

Nevertheless, one has to wonder whether state leaders were fully aware of the shift they set in motion, given their frequent references as of late to the centrality of higher-level training, cutting-edge research and university spin-off of new ventures to positioning Wisconsin for the 21st century “knowledge economy.”

- *Taxes.* A final example of the state’s lack of attention to trends relates to taxes. The state buy-down of school property taxes was enacted with much fanfare and

touted as a panacea for Wisconsin’s tax problems. Federal Census data now show that the state-local tax burden changed little over the past decade. The state was third in the nation in 1990, and third in 1999. A state income tax cut enacted for 2000-01 is not reflected in these ranking figures.

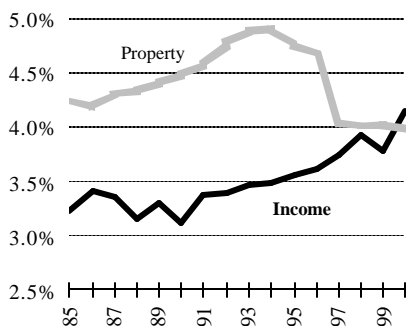
Why no change in the relative tax position of Wisconsin? There are a number of reasons. One, the aggressive tax reductions that occurred in other states, is out of our control. Another is the slowing of state personal income growth during the second half of the decade. This is a factor because tax rankings are most commonly calculated based on personal income, a measure of ability-to-pay.

Another factor was the lack of attention paid by state policy-makers to the individual income tax. Fueled by a soaring stock market, real personal income gains and state neglect (for more than a decade) of

an income tax law in need of reform and updating, the individual income tax edged steadily higher as a share of personal income. This effectively cancelled out any progress that was made in reducing the burden of the property tax, as the graph to the left shows.

Prop. vs. Inc. Taxes

Taxes as Pct. of Income



Given political rhetoric in the mid- and late-90s that the state-local tax burden here had been reduced, it is again worth wondering whether state leaders were keeping close tabs on the significant shifts that occurred.

Recommendations

Recognizing that the state budget's direct economic impact is not without limits and that budget decisions are ultimately political, this discussion has focused on indirect uses of the state budget as a tool for influencing economic policy in three areas: signaling, planning and benchmarking. This final section offers recommendations for public discussion in each of these areas.

- *Signalling*

This is the most difficult area in which to offer suggestions for using the state budget as an economic tool, because what is really at stake is the symbolism of political acts. Governors and lawmakers cannot be told to be civil in their discourse and circumspect in their actions. However, because the state benefits from a reputation of political and financial stability, some process reforms that might help build consensus and ensure timeliness and openness in budget development are offered. Specifics, such as dates and percentages, are merely illustrative.

Rec. S1: Create a statutorily authorized Council of Economic Advisors with members named by the governor, legislative majority leaders and the UW System president. The Council would be required to develop a consensus economic forecast leading up to each biennial budget

Rec. S2: Develop a process for consensus revenue estimating by a joint executive-legislative team that draws on the consensus economic forecast (Rec. S1). Estimates would be prepared in November of the even-year with necessary revisions by the end of January of the odd-year. The timing would dovetail with the existing biennial budget calendar.

Rec. S3: To limit the complexity and scope of the budget and promote public understanding, create a joint survey committee of legislators and public members responsible for identifying and removing non-fiscal policy items from the biennial budget. A budget bill would need committee certification for introduction and final passage.

Rec. S4: Enact changes to ensure that state budgets become law by the beginning of the biennium. Approaches to consider include: (1) limiting length of legislative sessions to fixed dates with no action of any kind authorized outside those dates; (2) specifying that state government could not expend funds without an enacted budgeted; (3) authorizing no payment of legislative salaries or per diems for days after June 30 of the odd-year on which the state did not have an enacted biennial budget.

Rec. S5: At each stage of the budget process, i.e., governor's introduction, Finance committee passage and individual house action, require a "cooling-off" period and at least one public hearing to give press and public a chance to evaluate and comment on new budget provisions.

- *Planning*

As with the prior section, it is important to remember that laws and edicts cannot force long-term financial planning by the state. There has to be an institutional commitment to it. Recent years have

shown that the commitment is wavering, at best. Nevertheless, there are steps that could be taken to promote sound fiscal decision-making. The benefits to the state's reputation, bond ratings and vulnerability to economic cycles should be obvious.

Rec. P1: Require that state budgets be prepared according to generally accepted accounting principles (GAAP), rather than on a cash basis.

Rec. P2: Reestablish the state's commitment to the state-local spending targets and budget stabilization fund outlined in the 1986 Governor's Expenditure Commission report. Link this commitment to fiscal target setting (Rec. P3). The 1986 report recommended that Wisconsin "glide" to a level of state-local spending over a specified number of years that would be at the national average. Thereafter, expenditures would be linked to personal income growth.

Rec. P3: Require a binding, biennial "fiscal target" act proposed by the governor no later than February 1 and passed by the legislature no later than February 15. The act would: (1) fix revenues for each year of the biennium; (2) appropriate a required statutory budget balance tied to a specified percentage of revenues; and (3) make an additional appropriation, if necessary, to guarantee a fully-funded budget stabilization fund set at a statutory amount, e.g., 5% of average annual revenues for the biennium. Subsequent biennial budget action would have to live within these targets and reserves.

Rec. P4: Require that in each year of the biennium, on-going revenues be sufficient to cover on-going expenses with any unanticipated surplus be deposited to the budget stabilization fund. Should the stabilization fund be fully funded, statutory provision should be made for refunding the excess to the taxpayer or endowing a grant fund to promote research and development, both private and university-based.

Rec. P5: To foster a legislative commitment to long-term decision-making, extend the terms of state senators to six years, with one-third of the house being elected every two years. Also, consider: (1) electing state senators on a nonpartisan ballot and (2) granting former governors lifetime, voting privileges in the state senate, if they chose to exercise them.

- *Benchmarking*

Rec. B1: Institutionalize a biennial, statewide economic summit in the fall leading up to a new biennium. Tie release of the biennial economic forecast (Rec. S1) to the summit.

Rec. B2: Require the summit to identify a *limited* (perhaps as few as five or six) number of economic benchmarks, e.g. per capita personal income, state-local tax burden, capital availability, population share of college graduates, that it wants the state to monitor over a multi-year period. The summit would recommend target performances on each of these benchmarks on a rolling six-year basis and make specific policy suggestions for meeting those benchmarks. The annual benchmarking effort

now conducted by the Wisconsin Taxpayers Alliance for Competitive Wisconsin, a business-farm-labor-education consortium, provides a model.

Rec. B3: The governor would be required in his annual State-of-the-State Address to review progress toward and project likely changes in these benchmarks. In his budget address, he would have to share again that information and identify specific initiatives aimed at meeting the summit's benchmark targets.

Final Remarks

To those seeking an activist role for state government in economic policy-making, these recommendations will not go far enough. For those troubled by Wisconsin's persistent high-tax status and its adverse impact on economic growth, similar sentiments are likely, for very different reasons.

However, it is hard to deny that state budgets of recent years have conveyed the message that Wisconsin is a politically unstable, unpredictable place in which to innovate, hire, work and grow. There is an increasing common view both in and out of Wisconsin that this is an atypical state, not because of its proud history, but because it is unable to conduct its public affairs and manage its finances in a deliberate and proactive manner. The suggestions made here are simple reforms that aim to reverse those growing perceptions.