

The Fiscal Crisis in Wisconsin

An Analysis of Its Origins, Implications and Solutions

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Introduction

Make no mistake about it – Wisconsin state government is confronting a fiscal crisis of substantial proportions. A \$2.8 **billion** budget deficit¹ is projected for the next biennium. The time for the state’s financial, political, business, labor and education leaders to come together to provide viable solutions to this critical problem is **NOW**.

That is why we, the contributors to this paper, have been working for months to develop ideas for solving this crisis. We represent the many individuals in Wisconsin who are united in their deep concern about the fiscal crisis and its threatening implications for Wisconsin. We comprise a broad, diverse ideological mix – Democrats, Republicans, and Independents; conservatives, middle-of-the-roaders, and liberals with both public AND private sector experience. Several of us have special expertise in fiscal policy and public administration. Most of us have actually served in policy-making positions in state government, as members of the Legislature, and as secretaries of departments such as administration and revenue. Combined, our public service to Wisconsin totals more than 300 years. This is **our** proposal, not the University’s, nor state government’s nor the private sector’s.

After a thorough discussion and careful analysis of all the alternatives, a remarkable consensus developed among us about what needs to be done to solve the crisis. **While not all of us advocate each and every one of the ideas in the paper, we**

¹ Throughout this paper, we use the term **deficit** to express the state’s current fiscal shortfall. Technically, the \$2.8 billion refers to the amount of money (prior to adjustments for growth or inflation) necessary to meet the 2003 expenditure commitments we’ve made by law.

agree that the overriding importance of solving this crisis overwhelms our differences.

Solving this crisis will not be easy. Very painful choices lie ahead for state policy makers. We do not envy them. And because the magnitude of the problem is so enormous, some of the ideas proposed in this paper to resolve the crisis are unavoidably controversial. The intent is to bring these **ideas** into the open so that policy makers looking for real options to solve the crisis can safely examine them. To a person, we agree that **ideas** solve **problems** and **that good ideas** turn **problems** into **opportunities**. **This paper contains many good ideas.**

The unifying theme of the paper is that Wisconsin must solve its fiscal crisis **now**, do it **once**, and do it **right**. Our approach is to:

- Describe the state's fiscal crisis in understandable terms
- Discuss forthrightly the only available solutions to the crisis
 - Economic growth
 - Spending cuts/service reductions
 - Increased revenue creation
- Propose real and **implementable** solutions to the crisis for the immediate, intermediate and long-term health of Wisconsin

The Chinese symbol for crisis includes the characters for both danger AND opportunity. Sometimes, crises can result in positive change. We have developed the ideas presented in this paper with such a purpose in mind.

Many will disagree with some or all of the ideas we present. **There are indeed a variety of other solutions that reasonable people might propose.** Our ideas represent a conscientious effort to provide a comprehensive and realistic solution to this formidable challenge; a solution that we believe serves the best interests of Wisconsin.

In essence, our goal is to foster a widespread debate and discussion. Let that dialogue begin in earnest!

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Executive Summary

The fiscal crisis facing Wisconsin is complex. Any discussion of its origins, implications and solutions is, therefore, complex as well. This Executive Summary is intended to serve as an accessible context and framework through which the more detailed analysis of the fiscal crisis that follows can be readily grasped.

The fiscal crisis:

- Wisconsin faces a projected **budget deficit of \$2.8 billion** in the 2003-05 biennium
- According to generally accepted accounting principles (GAAP), the size of the Wisconsin deficit is recognized (percentage-wise) as the largest in the nation
- The size of the deficit is dynamic, not static – the pace of economic growth, consumer behavior, stock market performance and many other factors influence the deficit's size
- A delay in resolving the problem **at this time** will make the ultimate solution even more difficult, and more painful

The possible solutions:

- **Economic growth** (the best, long-term solution, but it cannot occur fast enough to solve the problem alone)
- **Spending cuts/service reductions** (an integral part of the solution, but reductions that go too deep, too fast, can increase property taxes, impair economic growth and negatively impact essential services)

- **Increased revenue** (primarily from **comprehensive tax reform**)
- **A combination of spending cuts and tax reform** (we recommend this approach as one viable solution)

Objectives the proposal is intended to achieve:

- Promote economic growth by raising personal incomes in Wisconsin
- Achieve more **balance** among personal income, government spending and taxes
- Restore sound fiscal management in state government
- **Fund** a state budget stabilization account (i.e., a “rainy day” fund) to weather economic fluctuations
- Reform state/local financial relationships
- Avoid simply shifting the tax burden from one level of government to another – control property taxes
- Simplify tax calculations and distribute the tax burden fairly

Increased revenue through revenue reform:

- Spending reductions that go too deep too fast can increase property taxes, damage economic growth and have a negative impact on essential services
- We advocate revenue reforms designed to:
 - Raise **new revenues**
 - Redesign the revenue system to reflect significant underlying changes in the state’s economy, such as the shift from manufacturing “goods” to providing “services”

- Expand sales taxes and raise user fees to **lower income taxes and control property taxes**
- Reduced income taxes may:
 - Encourage business expansion and create more high-wage jobs
 - Stem the “brain drain” by creating a more attractive environment for professional and technical workers
 - Attract new industries by having a greater supply of highly-trained professional and technical workers

The Commitment to Spending Reform:

- Long-term spending reform must be part of the solution. Here are some ideas –
 - State government – reduce state workforce size while preserving high quality services
 - Local government – consolidate local service delivery systems and local government jurisdictions
 - Education – consolidate school districts and promote shared services on an inter-district level
- Encourage the elimination of costly inefficiencies in order to invest in essential services, like education, training, transportation and health, that promote economic growth

Our hope is that these measures may not only serve to balance the budget, but that they might infuse a discipline for more careful spending, immediately fund a budget

stabilization account, control property taxes, reduce income taxes and, of course, promote long-term economic growth.

As Wisconsin begins to realize the benefits of economic growth, we are confident that these new resources will be used to generate public revenues for essential services without further raising taxes, eventually raising personal income levels for **all** state wage earners and reducing the relative tax burden for individuals and businesses, thus fueling even more accelerated economic growth

In short, this paper presents a proposal for balancing the state budget and restoring fiscal soundness to Wisconsin, recommending a combination of spending cuts and new revenue creation. We cannot, however miss the most important point – that economic growth is the **best** fiscal strategy for the long run, but it will contribute only modestly to solving the budget problem in the short run and can only be effective long-term if state spending is brought under control.

Section I Guiding Principles for Tax and Spending Reform

All complex tasks need guiding principles to assist group decision-making, to help resolve conflicts between competing alternatives and to provide a “vision” for what is being accomplished by the task.

Make no mistake about it, resolving the fiscal crisis in Wisconsin is indeed a complex task. To aid in this effort, the following principles and/or objectives guided the contributors to this paper as they formulated ideas and strategies for resolving the state’s fiscal crisis:

- Promote Economic Growth by raising personal incomes in Wisconsin
 - Encourage expansion of existing businesses
 - Encourage development of new businesses
 - Encourage importation of new businesses
 - Encourage quality education and training for Wisconsin residents
 - Encourage our graduates to live and work in Wisconsin
- Achieve more **balance** among:
 - Personal income
 - Government spending
 - Taxes
- Restore sound fiscal management in state government
 - Balance the state budget without “one-time fixes” or accounting maneuvers

- **Fund** a state budget stabilization account (i.e., a “rainy day” fund) to weather economic fluctuations
 - Reform state/local financial relationships
 - Avoid simply shifting the tax burden from one level of government to another – control property taxes
 - Generate confidence among citizens, workers, and businesses that government in Wisconsin **works**
- Simplify tax calculations and distribute the tax burden fairly
 - Make a commitment to long-term spending reform in state and local governments by instituting reforms designed to increase productivity and efficiency through innovation

With these principles/objectives in mind, the group of contributors vigorously deliberated the state’s current fiscal crisis and developed the possible solutions presented here.

Section II Brief Discussion of the Wisconsin Fiscal Crisis

During the 1990s, Wisconsin enjoyed relative fiscal success. For many of those years, personal income in Wisconsin outpaced the nation; unemployment dipped to record lows; tax collections repeatedly surpassed estimates. According to Todd Berry of the Wisconsin Taxpayers Alliance, “Wisconsin’s economy generated between \$1 billion and \$2 billion in surplus state revenues during the past decade.”²

So, what went wrong? As UW-Madison Professor Andrew Reschovsky points out, “the sad fact is that the cause of Wisconsin’s state government budgetary woes are more deep-seated (than the recession and September 11) and will still be with us for a long time after the economy recovers.” Thus, despite the budget surpluses of the 1990s, state spending in Wisconsin grew even faster! Moreover, every budget enacted during the past decade has carried what Reschovsky terms a “structural deficit.” As he explains:

“In simplest terms, budgets are in deficit when the amount of money the state spends exceeds the revenues it takes in. The state spends money in order to provide services to state residents Wisconsin faces a structural deficit whenever the amount of money needed to maintain current services exceeds the revenue generated by the state’s current tax system.”³

Both Berry and Reschovsky agree that among the many causes for the structural deficit – excessive spending, no reserves, unwise accounting – two areas have contributed substantially to the deficit: **education** and **corrections**.

² Todd A. Berry, “Reflections on Economic Uses for the State Budget,” Wisconsin Taxpayers Alliance (2001)

³ Andrew Reschovsky, “Wisconsin’s Structural Deficit: Our Fiscal Future at the Crossroads,” Robert M. La Follette School of Public Affairs, UW-Madison, May 2002.

- In 1994, the Legislature dramatically changed the way Wisconsin funded public education by committing future state budgets to provide, on average, **two-thirds** of the revenues school districts needed to operate. Since 1997, this two-thirds commitment has increased state government spending by more than \$5 **billion**.⁴
- General Purpose Revenue (GPR) expenditures for corrections in 2000-01 totaled **\$804.4 million**, up **286%**, or an average of 14.4% annually from 1990-91 when the total GPR expenditure was \$208.6 million.⁵

So, if you combine a gloomy economic outlook with lower than expected revenue collections and an estimated budget **deficit** of **\$2.8 billion**,⁶ then it's easy to understand why Moody's downgraded Wisconsin's bond rating last year and then put it on a negative outlook in March. A spokesperson for Moody's explained that the firm doesn't care whether the state raises taxes or cuts spending, the important thing is that it truly balances the budget.⁷

That's exactly what we came together to address – balancing the state budget.

⁴ It should be pointed out that the goal of this shift was to stabilize local property taxes and to help public K-12 education to reduce their reliance on the property tax. In this regard it has worked, somewhat.

⁵ "Trends in Corrections," *The Wisconsin Taxpayer*, Vol. 70, No. 7 (July 2002)

⁶ The Legislative Fiscal Bureau (LFB) has estimated that Wisconsin faces a budget shortfall of \$2.8 billion in the next biennium— \$1.3 billion in the first year (2004) and \$1.5 billion in the second year (2005). All of the proposals in this paper designed to cure the deficit are based on the LFB's figure.

⁷ Testimony of Kathleen Holt, Moody's vice president, before the Wisconsin Legislative Council Committee on Improving Wisconsin's Fiscal Management. September 19, 2002

Section III Overview of the Only Possible Solutions

(NOTE: Section VI of this paper – p.33-39 – offers a list of immediate spending reductions – including education, corrections, shared revenue, medical assistance and corrections – to help balance the budget.)

The current fiscal crisis can be solved in any one of three ways, or a combination of these three:

- Economic growth
- Spending cuts/service cuts
- Increased revenue

The reality is that there are **no** other available options. Let's briefly examine each of these alternatives.

1. Economic Growth

With sufficient economic growth the fiscal crisis could be solved somewhat painlessly, without raising taxes or cutting services. In other words, if the Wisconsin economy could experience sizeable and immediate growth, it might generate sufficient new revenues to cover the projected \$2.8 billion needed to balance the budget. If this scenario would occur, then core services need **not** be cut. In fact, it's possible that state support for education, healthcare, transportation, worker training and the like might actually be expanded.

BUT economic growth is a relatively slow process. It doesn't just happen over night. There is absolutely no chance that economic growth alone will occur fast enough to solve the fiscal crisis in the next (2003-05) biennial budget cycle. Economic growth, therefore, may contribute marginal value to solving the fiscal crisis in the short run.

Nevertheless, economic growth remains the best long-term solution for establishing a sound and stable fiscal policy in Wisconsin. Therefore, every short-term budget solution **must** be evaluated in terms of its longer-term impact on economic growth or else Wisconsin will descend further into fiscal crisis.

Let us be perfectly clear on this point – **short-term, politically expedient action on the fiscal crisis that damages economic growth will strike a devastating blow to the state, our workers, businesses and governments.**

2. Spending Cuts/Service Reductions

For most people, the spending-cut solution to balancing the state budget is a foregone conclusion. Part of the reason why spending reductions seem like an easy solution is because Wisconsin is an above-average state when government spending is compared to personal income per capita. Currently, state per capita personal income is 4.0% **below** the U. S. average, while the state-local tax burden is more than 17% **above** national norms.⁸

As a result, Wisconsin is also a high-tax state – the **third** highest in the nation when taxes are compared with personal income:

⁸ “Snapshots of State Fiscal health,” *The Wisconsin Taxpayer*, Vol. 68, No. 12 (December 2000)

State and Local Tax Burden

2002

<u>State</u>	<u>Rank</u>	<u>% of Personal Income</u>
Maine	1	12.8
New York	2	12.3
Wisconsin	3	12.0
Hawaii	4	11.6
Minnesota	5	11.3
Michigan	14	10.7
Iowa	22	10.4
Illinois	31	10.0
Alaska	50	6.3

Source: Tax Foundation, Washington, D.C.

The obvious conclusion to fixing the fiscal crisis is to reduce and/or control spending. But as the **only** solution are spending reductions **the** best solution? As our discussion of the importance of economic growth indicates, any short-term solution to solving the fiscal crisis **MUST** support long-term economic growth. Would across the board spending reductions best meet that goal?

Or put another way – can the projected \$2.8 billion deficit in the next biennium be suddenly eliminated from the budget solely by spending reductions, without harming economic growth or creating other negative consequences like increases in property taxes?

Let's examine a couple of possible scenarios:

® Scenario A: Cutting education

Education would undoubtedly absorb the largest share of a \$2.8 billion cut in the state budget because it collectively represents the largest share (by program size) of state

taxes and spending. Specifically, nearly 55% of **all** state spending goes toward public education:

- K-12 (including school aids and credits) totals 44%
- The University of Wisconsin System totals 9%
- The Wisconsin Technical College System totals 1.2%

But let's not cut education without considering the direct, substantial benefit it has on economic development. As the table below indicates, when the education levels of Wisconsin residents graduating from high schools, technical colleges and four-year colleges and universities increases, per capita income goes up. And, of course, when these educational levels go down, per capita income in Wisconsin goes down.

The Earnings Gap

2000

<u>Education Level</u>	<u>Annual Average Income</u>	<u>Lifetime Earnings</u>	<u>Lifetime Earnings Difference from High School Graduate</u>
High School Graduate	\$27,978	\$1,200,000	\$0
Some College	33,945	1,500,000	300,000
Associate Degree	35,103	1,600,000	400,000
Bachelors Degree	51,649	2,100,000	900,000
Masters Degree	61,295	2,500,000	1,300,000
Doctorate Degree	80,223	3,400,000	2,300,000
Professional Degree	\$95,150	\$4,400,000	\$3,200,000
Source: U.S. Department of Commerce			

If this is the case, then why is a supposedly highly educated state like Wisconsin that spends proportionally more on public education so low in per capita income?

Ironically, because we are not producing, or retaining, as high a percentage of graduates with a high school, tech college or four-year university degree.

Population with 4-Year Degree

Age 25 or Older

State	<u>State Rank</u>	<u>Percent</u>
Minnesota	7	31.2
Illinois	17	27.1
U.S. Average		26.0
Iowa	23	25.5
Wisconsin	31	23.8
Source: ACE & U.S. Census Bureau		

Thus, one strategy is to stem the brain drain – keep the graduates we have – but also to increase the brain gain. To look at this another way, if college and university graduates earn more and Wisconsin could add more, then the state could raise its annual per capita income by \$1400 to reach the U. S. average.

Annual Per Capita Income

(2000)

State	<u>Income</u>	<u>State Rank</u>
Illinois	\$32,259	10
Minnesota	32,101	11
U.S. Average	29,676	
Wisconsin	28,233	22
Iowa	\$26,723	33
Source: U.S. Bureau of Economic Analysis		

The net result of increasing the number of graduates in Wisconsin and raising the state’s personal income per capita to the national average could produce as much as an **additional \$7 billion** in tax base/purchasing power **annually**.⁹

⁹ David J. Ward, “The Wisconsin Economy: Benchmarks & Trends,” ©2002, NorthStar Economics, Inc.

Thus, we need to increase the numbers of ALL graduates, especially post-secondary ones, in order to help raise personal incomes in Wisconsin. If we reduce our investment in education it could negatively impact economic development in Wisconsin. Why? Because our numbers of high school, technical college and university graduates might go down. And if education levels go down, wages will go down, and if wages go down, then public revenues based on these wages will go down. And on and on.

Another major argument for continuing to support education is the stark reality that a well-trained and highly educated workforce is the backbone of business growth and expansion. Without a trained and educated workforce, Wisconsin will not retain its existing businesses and industries, add new national, organizational headquarters, nor attract the new and different industry/cluster mix critical to producing higher paying jobs. And, of course, without these higher paying jobs, we will not be able to keep our best and brightest graduates. It's a vicious cycle, but one that leads inevitably to the conclusion that drastic cuts in education is not a good long-term answer to the fiscal crisis.

® Scenario B: Cutting shared revenue

Shared revenue is another category where large reductions might be necessary in order to balance the state budget in the next biennium. Shared revenue is money collected by the state and distributed to local units of government. Primarily, it does two things

- Helps poorer communities pay for needed local services
- Helps keep property taxes down

The recent budget discussions demonstrated pretty clearly that deep and sudden decreases in shared revenue would not fly. Legislators realized that cuts in shared

revenue that went too deep, too fast might force severe increases in local property taxes and/or sudden discontinuation of vital, local services like police and fire protection.

Does our analysis of the limitations of each of these budget cutting scenarios mean that we should refrain from making any reductions in education, shared revenue, or other state services to solve the fiscal crisis? Absolutely not! The current fiscal crisis is so severe that spending reductions are inevitable.

However, spending reductions alone, as an exclusive remedy for the fiscal crisis, may compound the state's problems by hurting long-term economic growth. And they could raise property taxes. The overriding consideration must be to decide how we can make cuts that do the least damage to long-term economic growth and the public stability that economic growth promotes.

3. New Revenue Generation

As we observed previously, economic growth **is** the best long-term strategy for solving the fiscal crisis. Economic growth, however, will not produce enough new revenue in the next two years to balance the budget. **Nevertheless, whatever is done during the next two years to solve the fiscal crisis must also promote economic growth in the long term. Specifically, Wisconsin must work aggressively to broaden its economic base,¹⁰ be a magnet for more corporate headquarters and generate more high paying jobs.**

Again, these are long-term strategies. If “new” revenues are needed to balance the budget in the next two years, they will need to be generated in new ways.

¹⁰ According to the Wisconsin Taxpayers Alliance (*Focus*, June 2000), individual wealth is accumulating in those states that, unlike Wisconsin, have a preponderance of individuals who have a stake in financial services and technology firms.

Comprehensive revenue reform is the answer. It will enable the state to raise new revenues in a way that solves several problems at once:

- Cures the fiscal crisis
- Avoids crippling spending cuts and potentially higher property taxes
- Promotes economic growth through continued investment in growth-drivers like education and training
- Enables immediate payments to budget stabilization fund
- Provides some necessary growth-promoting tax relief by lowering income taxes

Eventually, as the Wisconsin economy rebounds and the fiscal crisis is brought under control, the state may again enjoy a budget surplus. If this occurs, Wisconsin must NOT return to its former excessive spending ways. **Rather, any budget surplus should go toward expanding the budget stabilization (i.e., “rainy day”) fund, additional tax reductions and additional investments in those areas – such as education, training, transportation, entrepreneurship and health – that have a direct, positive impact upon long-term economic growth.**

* * *

As we’ve indicated, the only available solutions to the state’s current fiscal crisis are economic growth, spending cuts and new revenue generation, or some combination thereof. We have pointed out the important relationship among these categories, and we’ve recognized that economic growth will **not** produce new revenues fast enough to balance the budget in the next two years. Moreover, we believe that deep, swift spending

cuts could hurt long-term growth, may raise property taxes, and might wind up getting the state further into the hole. Thus, whatever is done to balance the budget short term **must** promote economic health, long term.

Section IV The Case for Revenue Reform

In Section III, our proposal suggests that new revenues should be raised in the next budget to solve the fiscal crisis and that judicious spending cuts are part of the solution. But, we also observed that spending cuts of \$2.8 billion (the amount required to balance the budget without revenue growth) in the next biennium might go too deep, too fast, hurting long-term economic growth and damaging Wisconsin's chance to achieve genuine fiscal stability in the long run.

We concluded, therefore, that comprehensive revenue reform was the answer. As we see it, comprehensive revenue reform could achieve a number of objectives simultaneously:

- Raise new revenues to help solve the budget crisis and restore fiscal soundness
- Redesign the revenue system to reflect significant underlying changes in the state's economy, such as the shift from taxing goods to taxing services (see below)
- Expand sales taxes and raise user fees to lower income taxes and control property taxes, thereby addressing the state's "high tax" reputation
- Fund a budget stabilization ("rainy day") fund designed to even out chaotic fluctuations in state revenues, avoid future fiscal crises and restore confidence with bond rating agencies.

An expanded consumption (sales) tax would shift more of the state tax burden to out-of-state visitors and tourists and non-resident homeowners who use Wisconsin services, but do not pay for them proportionally. In effect, Wisconsin would be taxing sales more than wages, a change that would help a low wage, low wealth state like Wisconsin.

It's also possible that lower income tax rates may influence corporate decision-makers to locate and expand businesses in Wisconsin, bringing much needed high wage jobs to Wisconsin workers. Lower income taxes can further support a "brain gain" strategy by providing a more appealing environment for highly trained and educated professional and technical workers to live and work .

Income taxes have long been considered an appropriate vehicle for distributing taxes progressively or fairly. This view posits that high income individuals should pay a substantial share of society's costs because they can afford to do so. This concept of "ability to pay" is the philosophical underpinning of the progressive income tax.

However, there is another defensible view of the income tax that warrants consideration. It holds that if the income tax is inordinately burdensome on those with high incomes, then it is, in effect, really anti-growth and harmful to ordinary wage earners because it :

- Discourages economic growth and increases in personal incomes by driving companies with high wage jobs to locate in low income tax areas
- Contributes to a "brain drain" since professionals often choose to live and work in states where they can "take home" more of their wages.

- Hinders a “brain gain” strategy since high wage companies with high paying jobs are unlikely to locate or expand in areas with insufficient numbers of professional and technical workers

The concept of economic growth for the benefit of all the state’s citizens requires us to reexamine many of the long-held beliefs – such as the role of the income tax – that may have had an unintentional effect on Wisconsin’s economic growth, high wage jobs and personal income. It should be noted that some progress has been made on reducing Wisconsin’s heavy reliance on the income tax in recent Legislative sessions.

Section V A Commitment to Long-term Spending Reform

(NOTE: Wisconsin is blessed with smart, hard working and dedicated public sector employees at all levels of government and education. None of the recommendations in this section should be construed to imply that these state employees are unproductive or inefficient. Rather, the recommendations are directed at the somewhat outdated structures, policies and processes within which these good employees are required to work.)

This section outlines a number of possible long-term spending reforms. It also provides implementation strategies for the proposed reforms, strategies designed to preserve Wisconsin's high levels of services despite having to absorb spending cuts.

Evoking our caveat that immediate spending cuts of \$2.8 billion could go too deep, too fast and harm Wisconsin's chance to achieve long-term fiscal stability, we'll examine briefly long-term spending reform options for:

- State government
- Local assistance
- Education

State Government

Expenditures for government operations in Wisconsin rank 36th in the nation. This is a favorable ranking, but the state could further reduce spending without reducing the quality of core services in several ways. For example, the current number of state government employees is just under 67,000. It is estimated that approximately 25% of these state employees may be eligible for retirement over the next three years, or nearly 17,000 potential retirees.

This retirement scenario represents a substantial opportunity. Through a strategic workforce planning process over the next year, some positions (**not** people) could be identified for potential elimination. Such a reduction could produce considerable savings. Although these savings would not be realized immediately, they will contribute substantially to long-term spending reforms.

In order for the state to continue to provide the requisite customer services being provided by these eliminated positions, it would need to capitalize on innovative applications of technology, the Internet and process reform. In addition, some reorganization and “flattening” of the current organizational structure in state government may be necessary.

Local Assistance

Local government spending in Wisconsin ranks 5th in the nation. According to the Wisconsin Taxpayers Alliance, local assistance funding – aids to various local units of government and school districts – is the largest recipient of General Purpose Revenue (GPR – state tax money) expenditures.¹¹ For the 2001-03 budget, the WTA estimates that about 60 cents of every state dollar collected goes, not to run state government or to fund state programs, but to subsidize delivery of local services.¹² The problem here is not that local government officials are frivolous spenders, it’s just that there are too many of them – over 3,000 county, municipal, town, special and school district local units, according to the *State of Wisconsin Blue Book*.

¹¹ “Background to a State Budget Crisis,” *The Wisconsin Taxpayer*, Vol. 70, No. 1 (January 2002).

¹² Ibid.

Thus, controlling state taxes is not possible without bringing local spending down over time and preserving services through:

- Local service delivery consolidation
- Local jurisdictional consolidation

Moreover, additional reductions and/or consolidations could help to control local property taxes and further reduce the need for state “shared revenue” to local governments over time. The state may want to consider a new strategy for getting all levels of government to work together cooperatively to achieve these objectives including efforts to:

- Make revenue sharing more equitable
- Provide long-term financial incentives for communities that have already consolidated and/or achieved savings by merging services
- Tear down barriers that actually discourage communities from trying to innovate

Education

As we observed in Section II, one of the major contributors to the fiscal crisis is the state’s commitment to fund 66 2/3 % of the cost of K-12 education. This figure represents an **increase** of over **\$5 billion** since 1997. Put another way, during the 1990s, school aids in Wisconsin grew by approximately **150%** while income in Wisconsin grew by only **70%**. The challenge here is to find ways to maintain high-quality education for Wisconsin K-12 students with less cost.

We propose to reduce the state share of K-12 costs from 66 2/3% to 63%, a reduction of **\$578 million** in the next biennium. This is a relatively small reduction when

compared to the over \$5 billion increase since 1997. Nevertheless, the recommended decrease will require school districts to find ways to invest funds in high value areas in order to compensate for this reduction. We recommend that overhead costs and building costs be targeted for serious review in order to avoid reducing items that have an obvious, positive impact on education by cutting spending on less productive activities.

In recent years, a strong consensus has emerged regarding the contributions of **smaller class sizes** and **qualified, adequately compensated teachers** to maintaining quality K-12 education. As funding for education is reduced, we must ensure that both these features are protected.

On the other hand, it might be time to review the feasibility of reducing the number of local school districts in Wisconsin. Minnesota, which has a K-12 population similar in size to our 900,000 students, has **100 fewer** school districts. Might this be an area for potential consolidation?

In addition to possibly consolidating school districts, substantial savings might be achieved by more inter-district agreements for providing a variety of services. School districts in Wisconsin vary dramatically in size – the smallest district has a little over 100 students; the largest 100,000. Thus, economies of scale are enabling larger districts to keep administrative costs down. Smaller districts could achieve the same advantageous economies of scale by inter-district agreements to provide services on a consolidated basis.

Additional spending reduction options to be considered include:

- Creating central purchasing mechanisms

- Assessing alternative arrangements for the payment of fringe benefits (one dollar in every four goes toward these escalating costs) – options include larger employee contributions, competitive bidding and larger pools of employees
- Reducing the amount of future debt service costs funded by the state for local school building projects
- Focusing the educational dollar on classroom instruction – non-instructional costs are increasing more rapidly than instruction costs.

While the next governor may consider a blue-ribbon task force on how to improve quality education while controlling costs, he should recall the Kettl Commission's belief that smaller class sizes pay the highest dividends in kindergarten and first grade and for disadvantaged students. Across the board class size reductions may be more expensive than effective.

In summary, a commitment to long-term spending reform is essential for the ongoing fiscal health of Wisconsin. That's because such a commitment would:

- Bring spending and taxes more into balance with personal income
- Encourage eliminating costly inefficiencies in order to invest in essential services like education, training, transportation and health that promote economic growth

Promoting economic growth, in turn, can lead to higher personal income, relatively lower taxes and lower spending. As we have repeatedly stated in this paper, long-term economic growth is the best fiscal strategy, and long-term economic growth is related to long-term spending reform.

Section VI A Proposal for Solving the Fiscal Crisis with Tax Reform and Spending Reductions

The longer we delay in solving the current fiscal problem, the deeper the crisis will become. We need to begin to reverse the crisis NOW. As we've said before such a process will not be easy and it will not be painless. But, if the State adheres to our guiding principles and makes the difficult choices, then Wisconsin's future will be brighter. Outlined below is a specific proposal for balancing the state budget with a combination of immediate spending cuts and revenue increases.¹³

To be sure, this proposal will not please everyone. But we are more than cautiously optimistic that it puts Wisconsin solidly on the road to fiscal stability.

Spending Changes

- **K-12 Education**

Reduce the School Aids appropriation from the current 66 2/3^{rds} to 63%, in each year.

Fiscal effect in 2003-04: -\$289 million

Fiscal effect in 2004-05: -\$289 million

- **Shared Revenue**

Reduce the current level of funding by \$50 million in the 2004-05 fiscal year.¹⁴

Fiscal effect in 2003-04: \$0

Fiscal effect in 2004-05: -\$50 million

¹³ **NOTE: The Wisconsin Legislative Fiscal Bureau, the Wisconsin Department of Revenue and the Wisconsin Taxpayers Alliance are the sources of financial information contained in this proposal.**

¹⁴ These reductions in shared revenues should come from county governments since they will receive additional revenues from the expanded sales tax to compensate for this reduction.

- **University of Wisconsin System**

Reduce General Fund appropriations by \$25 million in each year. Provide the UW System with tuition flexibility to help to compensate for the reduction. UW tuition ranks very low among Big 10 universities.

Fiscal effect in 2003-04: -\$25 million

Fiscal effect in 2004-05: -\$25 million

- **Medical Assistance and Corrections**

Reduce funding for these areas by a total of \$25 million per year in each year.

Fiscal effect in 2003-04: -\$25 million

Fiscal effect in 2004-05: -\$25 million

- **Budget Stabilization Fund**

Change the way our Budget Stabilization Fund is funded, according to the details of the attached plan. Begin making **immediate** contributions to this fund.

Fiscal effect in 2003-04: +\$58.5 million

Fiscal effect in 2004-05: +\$58.5 million

Total of Spending Proposals

Fiscal effect in 2003-04: -\$280.5 million

Fiscal effect in 2004-05: -\$330.5 million

Total Biennial Effect: -\$611 million

Revenue Changes

- **Individual Income Tax**

Calculate the tax based on federal taxable income. Retain the property tax rent credit (PRTC). Maintain the current brackets but reduce the tax rates effective with the 2003 tax year

Current	2003-04	2004-05
4.60%	4.55%	4.09%
6.15%	6.09%	5.47%
6.50%	6.44%	5.79%
6.75%	6.68%	6.01%

Fiscal effect in 2003-04: -\$674.2 million
Fiscal effect in 2004-05: -\$1,687.2 million
(Annualized: -\$1,205.1 million)
(From one-time withholding table change effective July 1, 2004: -\$482.1 million)

- **Corporate Income Tax**

Leave as is; no fiscal effect

- **Sales Tax**

Expand the base of the sales tax by applying the tax to the goods and services listed on page 37. Increase the sales tax rate from the current 5% to 6%. **Note that food and prescription drugs will continue to be exempt.**

Fiscal effect of base expansion in 2003-04: \$623.2 million (effective 1/1/04)
Fiscal effect of base expansion in 2004-05: \$1,246.3 million

Fiscal effect of rate change in 2003-04: \$574.5 million (effective 1/1/03)
Fiscal effect of rate change in 2004-05: \$766.0 million

- **Cigarette Tax**

Increase the cigarette tax by 50 cents per pack (from its current level of 79 cents per pack to \$1.29 per pack). Set aside a portion of these monies to support statewide efforts to reduce tobacco consumption.

Fiscal effect in 2003-04: \$163.4 million
Fiscal effect on general fund in 2004-05: \$166.8 million

- **Gas Tax**

Increase the gas tax by 2 cents per gallon. Disperse the increased revenues in the following way: 80% to the general fund and 20% to the transportation fund in 2003-04 and 60% to the general fund and 40% to the transportation fund in 2004-05.

Fiscal effect on general fund in 2003-04: \$41.6 million
Fiscal effect on general fund in 2004-05: \$37.8 million

- **Automobile Registration Fees**

Increase the vehicle registration fees for automobiles by an amount which would produce an increase in these revenues of approximately \$100 million per year.

Instead of the current flat rate for all automobiles, implement a formula based on the weight and the age of the vehicle. Disperse the increased revenue in the same way as the gas tax mentioned above.¹⁵

Fiscal effect in 2003-04: \$66 million (effective 9/1/03)

Fiscal effect in 2004-05: \$60 million

Total of Revenue Proposals

Fiscal effect in 2003-04: +\$794.5 million

Fiscal effect in 2004-05: +\$589.7 million

Total Biennial effect of revenue proposals: +\$1,384.2 million

See chart on page 38 for complete recap of spending reductions and revenue changes.

(NOTE: The above totals and the calculations on the table on page 38 do NOT reflect the impact of a projected growth rate in revenues of 3% per year. When this increase is included with the spending reductions and new revenues, the deficit is closed.)

¹⁵ According to the Wisconsin Taxpayers Alliance, the state's transportation fund itself needs monies to pay for already-committed transportation projects such as the Marquette Interchange near downtown Milwaukee.

Proposed items to which the sales tax would now apply

- **Exemptions for Government Agencies and Nonprofit Organizations**
Fees for Admission and Camping at State Parks
- **Exemptions Related to Farming** (Electricity used in farming)
- **Definitional and Miscellaneous Exemptions**
Labor Input into Construction
Retailers' Discount
- **Personal, Recreational and Related Services**
Beauty and Barber Services
Bank Account Service Charges
Dues and Fees Paid to Business Associations and Fraternal Organizations
Live Bands and Orchestras
Health and Reducing Clubs
Admissions to Educational Events and Places
Veterinary Services for Pets
Dance Studios
Auto and Travel Clubs
- **Professional Services**
Legal Services
Architectural, Engineering and Surveying Services
Accounting Services
- **Exemption for Property Sold Primarily to Households**
Newspapers, Periodicals, and Shoppers Guides
- **Business Services**
Advertising
Computer Services
Management Consulting and Public Relations
Personnel Services
Addressing and Mailing
Credit Rating and Collection Services
Protective Services
Research, Development and Testing Services
- **Services Related to Real Property**
Commissions to Real Estate Brokers
Repair of Real Property
Interior Design
Janitorial Services
Disinfecting and Exterminating Services

Proposal Summary
Spending Reductions and Revenue Increases

2003-05 Biennium

Item	2003-04 (in millions)	2004-05 (in millions)	2003-05 Biennium (in millions)
Spending Changes			
K-12 Education Reduce to 63%	-\$289	-\$289	-\$578
Shared Revenue		-\$50	-\$50
Medical Assistance, Corrections	-\$25	-\$25	-\$50
UW System	-\$25	-\$25	-\$50
Budget Stabilization Fund	+\$58.5	+\$58.5	+\$117
<i>Total Spending Changes</i>	-\$280.5	-\$330.5	-\$611
Revenue Changes			
Individual Income Tax	-\$674.2	-\$1,687.2	-\$2,361.4
Sales Tax			
Rate Increase	+\$574.5	+\$766.0	+\$1,340.5
Base Expansion	+\$623.2	+\$1,246.3	+\$1,869.5
Cigarette Tax	+\$163.4	+\$166.8	+\$330.2
Gas Tax	+\$41.6	+\$37.8	+\$79.4
Auto registration fees	+\$66	+\$60	+\$126
<i>Total Revenue Changes</i>	+\$794.5	+\$589.7	+\$1,384.2
<i>Total Fiscal Effect</i>	+\$1,075	+\$920.2	+\$1995.2 *

* When 3 % growth in revenues for each year of the biennium is factored into the total fiscal effect the projected budget deficit is closed.

Percentage Distributions of General Fund Taxes

2001-02 actual vs. proposed

Taxes	2001-02 actual	2001-02 proposed
Individual Income	49.7%	35.4%
General sales & use	36.9%	49.4%
Corporate income	5.0%	5.0%
Public utility	2.5%	2.5%
Cigarette	2.9%	4.2%
Liquor	0.4%	0.3%
Beer	0.1%	0.1%
Tobacco	0.1%	0.1%
Estate	0.8%	0.8%
Insurance companies	1.0%	1.0%
Miscellaneous	0.6%	1.0%
<i>Total Taxes</i>	100%	100% (adjusted by rounding)

Section VII Conclusion: A Balanced Budget and the Restoration of Fiscal Soundness

This paper presents a proposal for balancing the state budget and restoring fiscal soundness to Wisconsin, recommending a combination of spending cuts and revenue reform. The paper also discusses the rationale for these proposals and makes the case that the fiscal crisis has both short-term and long-term solutions. These solutions must complement one another.

As we've reiterated throughout, economic growth is the best long-term fiscal strategy. Any/all short-term solutions to the fiscal crisis must support this long-term strategy. Violating this principle will only deepen the crisis. Immediate spending cuts that go too deep, too fast may hurt economic growth and raise property taxes. The budget-balancing proposal in this paper is designed to raise new money through comprehensive revenue reform that **promotes** economic growth rather than hurts it.

But as the Wisconsin economy recovers, we should be careful NOT to resort to business as usual. We've heard these warnings before. Sixteen years ago, **The Wisconsin Expenditure Commission** was created to examine state government spending. In their report, the Commission cautioned:

“The revenue roller coaster in the past has resulted in a shortsighted approach to budgeting. To achieve a longer-term spending goal for the State of Wisconsin, a method for managing through periods of revenue shortfall – a revenue stabilization fund – must be found.¹⁶

Let's really do it this time! Our paper also encourages state policy makers to institute measures to achieve long-term spending reforms in state and local government, includes specific strategies for accomplishing these goals. We believe that our proposal

¹⁶ *Final Report of the Wisconsin Expenditure Commission* (December 1986).

is one path to the goal of establishing more balance among taxes, spending and personal income. The fiscal crisis is forcing us to tighten our belts and to increase productivity. It is forcing us to compare the relative value produced by spending money on various alternatives, such as those we've proposed for education.

The ideas discussed in this paper could be the basis for rapid resolution of a painful financial crisis that threatens our state's future. Wisconsin is a great state with a long tradition of clean and competent government, invaluable assets to economic growth and to fiscal stability in Wisconsin. The ideas presented here are intended to help us maintain those traditions and maintain that good reputation.

ADDENDUM

Possible Provisions for an Effective Budget Stabilization (“Rainy Day”) Fund

The Wisconsin State statutes provide that .5%¹⁷ of general purpose revenues be transferred from the general fund to the Budget Stabilization Fund annually. This would be done every year until the Fund held 5% of general purpose revenues (figured as described below). The governor and legislature would not be prohibited from depositing additional monies into the Fund beyond the .50% per year, and this is intended to act in concert with the current requirement that 50% of all surpluses go into the fund (with existing limitations to this remaining in place), as well as the cap of 5% of GPR.

The Fund could not be tapped until at least 2% of general purpose revenues are held in the fund. Once at least 2% of general purpose revenues are in the Fund, it could be tapped under the following circumstances:

- Actual revenue collections were below projected revenues
- The governor submits a proposal to the legislature for using the Fund to offset the lower than expected revenues
- Both houses of the legislature, either in regular session or special session, would then need to approve by simple majorities, the transfer of monies from the Budget Stabilization Fund to the general fund

¹⁷ * The .5%, 2%, and the 5% measures would all be made by taking the previous biennium’s general purpose revenues numbers and dividing by 2. Therefore, we get the numbers given above, the \$58.5 million, etc. 5% is the minimum that the National Conference of State Legislatures recommends and something that bond rating agencies recommend.

- The amount that can be tapped cannot exceed the difference between projected revenues and actual revenues
- The amount that can be tapped can take the Fund below the 2% of general purpose revenues level.

If ever tapped into, transfers to the Fund from the general fund would then continue the next year (until the fund is again at the 5% of general purpose revenues level).

This structure, if implemented in the 2003 biennium, would produce the following savings levels over the next biennium (based on the 2001-03 Budget Act 16 general purpose revenues total of approximately \$23.4 billion).

2003 – \$58.5 million

2004 – \$58.5 million

Biennial total \$117 million