State Finances: Rewind? Or Recovery Ahead?

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With the U.S. economy showing signs of establishing a base from which to recover, the obvious question for Wisconsin is: What lies ahead for the state economy? Perhaps an even more unsettling question for public officials and taxpayers is: What lies ahead for state finances? Are state deficits behind us?

If recent years have taught us anything, it is the considerable difficulty economists face in forecasting future economic activity. America’s late-2007 move into recession, the severity of that plunge, and the subsequent calamity in the financial markets were all developments not well anticipated.

That uncertainty has brought with it Wisconsin’s share of state and local budget woes. General fund tax collections during 2007-09 were initially anticipated to rise almost 6.0% when the state budget was enacted in October 2007. Hindsight now tells us they dropped by about that amount.

Now that the U.S. economy appears poised for recovery, can Wisconsin economists assume that an equally healthy state rebound is forthcoming? And, more significant, can state and local officials now expect that their budget problems are behind them?

WHITHER WISCONSIN’S ECONOMY?

The answer to the first question is only as good as economic projections. However, recent recessions suggest the state economic cycle “leads” the U.S. In both 1990s and again during 2004-07, Wisconsin’s economy surged and then slowed before the country’s. In the graph below, the state’s real GDP outpaced the nation’s in both 2001 and 2002 as we emerged from recession. Note, also, that in 2008, Wisconsin apparently grew (+0.2%) while the U.S. contracted (-0.2%).

Annual Growth in Real GDP: US vs. Wisconsin, 1998-2008 (BEA)
From an economic perspective, then, does that mean Wisconsin’s problems will soon be behind us? Probably not. What history also tells us, unfortunately, is that during periods of sustained prosperity, (e.g., late 1990s and mid-2000s), the Badger State often fails to grow as fast as the U.S.

A more fundamental reason that growth here will probably be more moderate than elsewhere is demography. Wisconsin is an “older” state than others: Our senior population is in the process of doubling by 2030, while the total school-age population has been falling since the late 1990s. Indeed, over 60% of state school districts are losing enrollment. What this eventually means is contraction of the state labor force followed by fewer household formations. It also means that there will be more consumer-retirees whose incomes and needs are less—and their reluctance to pay taxes, greater.

Another reason for a more modest recovery here than elsewhere is our “employment mix.” Long one of the nation’s leading manufacturing states, Wisconsin’s job mix is skewed more to high school graduates than to those with college degrees. Thus, our average wages in most sectors are lower here than elsewhere, and those wages are continuing to lose ground to national averages. Federal and state tax data confirm that the adjusted gross incomes of our taxpayers are skewed more to the lower- and middle-income ranges than is the case nationwide. By the same token, the percentage of U.S. filers with incomes over $1 million is about double the Wisconsin share.
Wisconsin’s relative economic strength becomes clear when state per capita GDP (GDPpc) is compared to state GDP growth over the past ten years (previous graph). Borrowed from a business consultancy to evaluate consumer products, this approach divides states into four groups. In the upper right quadrant are states with above-average GDPpc and above-average GDP growth. In consultants’ parlance, these states are “stars.” In the lower left quadrant are the “dogs”—states whose GDPpc and GDP growth are both below average. Wisconsin is located in the lower, left portion of the graph.

PAST ACTIONS . . .

Regardless of the timing and nature of Wisconsin’s pending rebound, other factors impact the state’s future fiscal health. Large budget reserves would position Wisconsin for a relatively pain-free return to normalcy even if the recovery is slow and modest. Unfortunately, “solutions” to past budget problems will complicate decision-making when work begins in earnest after the 2010 mid-term elections on the state’s 2011-13 biennial budget.

The roots of this problem can be found in the economic boom of the 1990s. A soaring stock market, income and job growth that outpaced the nation, and a state income tax whose brackets, deductions, and credits were not adjusted for inflation all combined to swell the state treasury. State politicians could be “all things to all people.” Examples include a dramatic jump in state support for public schools that exceeded $1 billion, sweeping welfare reform that attracted national attention but whose associated childcare and healthcare costs were large, new prescription drug benefits for seniors, and a $700 million sales-tax rebate.

As long as the economy continued to grow and state tax collections continued to beat estimates, these many new commitments could be sustained. With the 2001 recession and the 9/11 terrorist attacks, however, tax collections dropped. The rest is history. A billion-dollar
state deficit emerged; and, although this has not been widely suggested, a convincing argument can be made that Wisconsin has never fully come to grips with the excesses of the 1990s and the subsequent budget imbalance. For the past five biennia, governors and legislators of both parties have lurched from budget crisis to budget crisis.

On paper, state budgets have been balanced using a number of one-time techniques and, what some would label, accounting tricks. In 2001-03, tobacco bonds were sold to generate over $1 billion in one-time money to produce a “balanced” budget. In subsequent biennia, one-time dollars were transferred from other funds to the general fund to keep the latter in the black. More than $1.3 billion was moved from the transportation fund; another $200 million – now disputed in court – was moved from the physician-funded Injured Patients Compensation fund; smaller sums of money were moved from a public utility benefits fund, the recycling fund, and so on. Perhaps the most egregious “budget-balancing” move was repeated use of an accounting trick that allowed the state to pay out property tax-relief credits in one year but not fund them until the following budget year.

To make matters worse, the state has, for more than three decades, almost entirely ignored a 1986 “budget stabilization” law that allowed it to set aside surplus revenues in good times in order to avoid budget cuts and tax hikes during downturns. Entering the current recession, the average state had amassed surpluses equal to almost 7% of annual spending; percentages in Iowa and Minnesota were in the ten-percent range. Wisconsin reserves, by comparison, were less than 1% of expenditures and sometimes approached 0%.

Although governors and legislators could hide unbalanced budgets through various tricks and techniques, Wisconsin’s official financial statements, prepared by the state controller according to generally accepted accounting principles (GAAP), could not. On a GAAP basis, the Badger State has officially reported general fund deficits for years. The following graph reveals that those shortfalls have approached or exceeded $2 billion since 2003. Projections done by the executive branch at the time the proposed 2009-11 state budget was unveiled suggest more GAAP deficits over the next few years.

**Wisconsin’s Official GAAP Deficits, Actual and Projected ($ Billions)**
RECENT DEVELOPMENTS

There is little debate that Wisconsin’s state budget problems deteriorated over the past two years when the economy—and tax collections—slumped. Nevertheless, as the prior discussion shows, state budget problems emerged more than a decade ago and have gone largely unaddressed since. Short-term and quick “fixes” have kept the general fund balanced on paper, but the average CPA or savvy citizen knows better. In 2007, the Badger State’s GAAP deficit (see above) was the second largest in the nation in raw dollar terms, the largest per capita.

Earlier in 2009, the governor and legislature had another opportunity to work on state finances. The resulting product enacted this summer was a biennial budget that will serve Wisconsin through mid-2011. What did the governor and legislators accomplish, and what does the state’s fiscal future now look like?

In a budget bill whose weight exceeds three pounds, one can devote volumes to discussing the contents of the 2009-11 spending plan. But, with a few facts and figures, the answer to that question becomes apparent. The following table recaps the budget, comparing 2007-09 expenditures with those budgeted for 2009-11. In terms of the general fund (“GPR”), austerity is evident. The amount budgeted for the next two years ($27.68 billion) is less than estimated spending for the prior two-year period ($27.73 billion).

However, the story behind the new budget really lies in the final three columns of the table. When user fees, program charges, and federal dollars are added to general fund revenues, largely income, sales, and excise taxes, the result is the “all-funds” budget. Proposed expenditures are slated to rise over 9% from $56.64 billion to $61.99 billion. The key to reconciling GPR and all-funds budgets can be found in the next column. Federal dollars flowing through state coffers in 2009-11 will be $4 billion more than in 2007-09.

### State Spending (Estimated 2007-09 vs. Budgeted 2009-11; $ Billions)

<table>
<thead>
<tr>
<th>Fisc. Yr. Ends</th>
<th>GPR</th>
<th>All Funds</th>
<th>Tax/Fee Incr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008a</td>
<td>13.526</td>
<td>27.365</td>
<td>7.1</td>
</tr>
<tr>
<td>2009b</td>
<td>14.199</td>
<td>29.279</td>
<td>7.4</td>
</tr>
<tr>
<td><strong>2008-09</strong></td>
<td><strong>27.725</strong></td>
<td><strong>56.644</strong></td>
<td><strong>14.5</strong></td>
</tr>
<tr>
<td>2010g</td>
<td>13.476</td>
<td>30.930</td>
<td>9.4</td>
</tr>
<tr>
<td>2011g</td>
<td>14.204</td>
<td>31.065</td>
<td>9.0</td>
</tr>
<tr>
<td><strong>2010-11</strong></td>
<td><strong>27.680</strong></td>
<td><strong>61.995</strong></td>
<td><strong>18.5</strong></td>
</tr>
<tr>
<td><strong>07-09 to 09-11</strong></td>
<td><strong>-0.2%</strong></td>
<td><strong>9.4%</strong></td>
<td><strong>27.4%</strong></td>
</tr>
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The 27% jump in federal monies is due to several factors, but an important one is Washington’s economic stimulus package enacted early in 2009. Some stimulus dollars are going for one-time expenditures, such as roads or school weatherizing, but the new state budget also uses stimulus funds to “backfill” for cuts in general fund programs, most notably the two programs that normally combine to account for almost 60% of GPR spending, school aids/credits and Medicaid (medical assistance for low-income and disabled recipients).

What the 2009-11 budget does then is very much like what was done in past budgets. One-time monies are paying for permanent, ongoing programs. In recent budgets, it was transportation or recycling fund monies that “papered over” general fund deficits; this time it is federal stimulus dollars. Use of these various one-time revenues along with accounting tricks and promises of future tax cuts or new spending yield a structural imbalance that will have to be dealt with come 2011.

This so-called “structural deficit” is projected to approach $900 million in 2010-11 and, if no action is taken, it will more than double the following year. The graph that follows shows that the approaching structural problems in the next budget are hardly new. In fact, Wisconsin has entered every biennium since 1997 with an imbalance. That said, the 2011-13 “deficit” will be the second largest in 14 years.

The one new budget development this year, unlike years past, is the magnitude of state tax increases contained in the 2009-11 budget bill (now, Act 28) and its prequel (Act 2). Including retroactive tax increases, the total new revenues the state is hoping to collect over fiscal years 2009-10-11 are about $3 billion. Included in the increases are technical, but significant increases in corporate taxes, a new hospital tax, big jumps in tobacco tax rates, and over one-half billion in new income taxes through a higher “top” rate and a reduced capital gains exclusion.
The size of such tax hikes might give some state officials hope that expanded tax laws coupled with a strong recovery would combine to erase the approaching structural deficit. The problem with that hope is mathematical. If the state collects $12.9 billion in general fund taxes as it projects for 2010-11, and if those collections grow at 5% in 2011-12—a rate that is historically possible but less likely coming out of a serious recession—the state general fund could expect almost $650 million in new revenues. Even that amount of new money, however, does not begin to erase a carryover structural gap that, in the final analysis, will probably approach $1 billion.

And so . . . we end where we began—with a question about the state’s future fiscal health: “Rewind or Recovery Ahead?” Barring an unexpected and almost unprecedented surge in the economy and tax collections, it appears that, regardless of the identity of the individuals occupying the executive and legislative branches come 2011, as they begin work, they will only need to push the “rewind” button. The 2011-13 state budget situation is likely to be quite similar to ones experienced over the past decade.

Santayana comes to mind: “Those who do not learn from history . . . “